THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PATHFINDER

MAY 2017 DIET
PROFESSIONAL LEVEL EXAMINATIONS

Question Papers

Suggested Solutions

Marking Guides

Plus

Examiner's Reports

FOREWARD

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

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

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

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

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

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

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

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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2017

CORPORATE REPORTING

Time Allowed: 3 hours

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

SECTION A: COMPULSORY (30 MARKS)

QUESTION 1

Rapuya Plc. is a Nigerian public limited company operating in the mining industry. The draft Statements of Financial Position of Rapuya Plc., and its two subsidiaries, Puta Limited and Soma Limited as at April 30, 2017 are as follows:

	Rapuya ₦'m	Puta ₦'m	Soma Defa'm
Non-Current Assets			
Property, Plant and Equipment	740	220	760
Investments in subsidiaries			
Puta	226	-	-
Soma	184	-	-
Financial Assets	30	14	100
	1,180	234	860
Current Assets	236	200	660
Total Assets	1,416	434	1,520
Equity			
Share Capital	316	76	400
Retained Earnings	604	112	600
Other Components of Equity (OCE)	14	8	-
	934	196	1,000
Non-Current Liabilities	112	84	320
Current Liabilities	370	154	200
Total Liabilities	482	238	520
Total Equity and Liabilities	1,416	434	1,520

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

(i) On May 1, 2016 Rapuya acquired 52% of the ordinary shares of Soma Limited a foreign subsidiary. The retained earnings of Soma Limited on this date were 220million defas. The fair value of the identifiable net assets of Soma

Limited on May 1, 2016 was 990million defas. The excess of the fair value over the net assets of Soma Limited is due to an increase in the value of non-depreciable land.

Rapuya Plc. wishes to use the 'full goodwill' method to consolidate the financial statements of Soma. The fair value of the non-controlling interest in Soma Limited at May 1, 2016 was 500million defas.

Soma Limited is located in Tome, a small country in West Africa and operates a mine. The income of Soma Limited is denominated and settled in defas. The output of the mine is routinely traded in defas and its price is determined initially by local supply and demand. Soma Limited pays 30% of its costs and expenses in naira with the remainder being incurred locally and settled in defas. Soma's management has a considerable degree of authority and autonomy in carrying out the operations of Soma Limited and is not dependent upon group companies for financial support. The Finance Controller is not certain from the above whether the defas or naira should be taken as the functional currency of Soma Limited.

There have been no issue of ordinary shares and no impairment of goodwill since acquisition.

(ii) Also on May 1, 2016, Rapuya Plc. had acquired 70% of the equity interests of Puta Limited. The purchase consideration amounted to ₦226million which Rapuya Plc. paid through bank transfer in compliance with the cashless policy of the Federal Government of Nigeria. The fair value of the identifiable net assets recognised by Puta Limited was ₦240million excluding the patent below. The identifiable net assets of Puta Limited at May 1, 2016 included a brand which had a fair value of ₦8million. This had not been recognised in the financial statements of Puta Limited. The brand is estimated to have a useful life of four years. The retained earnings of Puta Limited were ₦98million and other components of equity were ₦6million at the date of acquisition. The remaining excess of the fair value of the net assets is due to an increase in the value of non-depreciable land.

Rapuya Plc. wishes to use the 'full goodwill' method in consolidating the financial statements of this subsidiary. The fair value of the non-controlling interest in Puta Limited was ₦92million on May 1, 2016. There have been no issue of ordinary shares since acquisition and goodwill on acquisition is not impaired.

(iii) The following exchange rates are relevant for the preparation of the group financial statements:

	Defas to ₦
May 1, 2016	3:1
April 30, 2017	2.5:1
Average for year to April 30, 2017	2.9:1

Required:

(a) Advise the Finance Controller on what currency should be taken as the functional currency of Soma Limited applying the principles set out in IAS 21 - The Effects of Changes in Foreign Exchange Rates. (5 Marks)

(b) Prepare a consolidated statement of financial position of the Rapuya Group as at April 30, 2017, in accordance with International Financial Reporting Standards (IFRS). **(Show all workings)** (25 Marks)

(Total 30 Marks)

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

QUESTION 2

The following figures have been extracted from the financial statements of Lanke Plc and its subsidiaries for the years ended December 31, 2014 and 2015.

	GROUP		COMPANY	
	2015	**2014**	**2015**	**2014**
	₦ 'm	₦ 'm	₦ 'm	₦ 'm
Revenue	21,843	17,519	15,848	12,198
Cost of Sales	15,676	12,571	11,165	8,588
Gross Profit	6,167	4,948	4,683	3,610
Other Income	234	308	612	34
Selling & Distribution Exps.	(1,413)	(1,368)	(951)	(844)
Admin. Expenses	(1,817)	(1,702)	(1,150)	(1,260)
	3,171	2,186	3,194	1,540
Interest Expenses	(499)	(546)	(298)	(429)
Profit before taxation & Non-controlling Interest	2,672	1,640	2,896	1,111
Tax expenses	(481)	(283)	(313)	(185)
Profit after tax but before non-controlling interest	2,191	1,357	2,583	926
Non-controlling interest	(7)	(191)	(-)	(-)
Profit for the year	2,184	1,166	2,583	926
Property, Plant and Equipment	9,587	9,102	6,381	6,876
Investments	3,767	3,131	4,609	3,731
	13,354	12,233	10,990	10,607
Current Assets	7,076	6, 221	3, 820	3,772
Current Liabilities	7,750	7,863	3,463	5,777
Net-Current Assets/(Liabilities)	(674)	(1,642)	357	(2,005)
	12,680	10,591	11,347	8,602

	GROUP		COMPANY	
	2015	2014	2015	2014
	₦ 'm	₦ 'm	₦ 'm	₦ 'm
Share Capital	454	454	454	454
Capital Reserve	3,182	3,182	3,147	3,147
General Reserve	6,283	4,793	6,176	4,218
Equity	9,919	8,429	9,777	7,819
Non controlling interest	776	906	Nil	Nil
	10,695	9,335	9,777	7,819
Loan Notes	1,985	1,256	1,570	783
	12,680	10,591	11,347	8,602

The directors of Lanke Plc. would like to know how the individual performance of the company and that of the group compares with each other and over the two years. In particular they are interested in performance measure around profitability, long term solvency and asset utilisation (using only the ratios indicated below). They would also want a brief explanation of why the analysis of the performance of a single company may differ from that of a group company.

Required:

Prepare a performance report that addresses the needs of the directors of Lanke Plc for the two year period 2014 and 2015.

Note: Limit your ratio computation to the following:

- **Return On Capital Employed (ROCE)**
- **Profit margin**
- **Asset turnover**
- **Gearing**
- **Interest cover**

(Show all workings)

(Total 20 Marks)

QUESTION 3

a. The economic environment in the country has been very harsh and it is now a common knowledge that the economy is in recession. This in turn may impact on the income generating capacity of assets of companies especially in those industries experiencing a downturn in fortunes. This calls for the financial reporting regulators to pay attention to evidence of impairment of assets in the financial statements submitted by these companies.

   Required:

   Discuss briefly the reasons why the Financial Reporting Council of Nigeria (FRCN) should focus on the impairment of non-financial assets and deferred tax assets of listed companies in Nigeria in this period of slow economic growth, setting out the key areas which entities should focus on when accounting for these items. (7 Marks)

b. IAS 36 stipulates how a company should test for impairment of assets. A multinational oil marketing company operating in Nigeria is not sure how to test for impairment of its assets especially those that do not generate cash flows that are independent of other assets.

Required:

(i) Identify **TWO** external and **TWO** internal indicators that an asset of the multinational oil company may have been impaired.

(2 Marks)

(ii) Briefly discuss how the multinational oil company should test for impairment of assets that do not generate independent cash flows. (6 Marks)

c. A cash generating unit holds the following assets:

	₦'Million
Goodwill	160
Patent	320
Property, plant and equipment	480

An annual impairment review is required as the cash generating unit contains goodwill. The most recent review assesses its recoverable amount to be ₦720million. An impairment loss of ₦240million has been incurred and has been recognised in profit or loss.

Required:

Show how the value of the assets held by the cash generating unit will change after the impairment test based on the information provided above.

(5 Marks)

(Total 20 Marks)

QUESTION 4

Dango Plc is a conglomerate company operating in Nigeria with diverse interest across Africa. It prepares its financial statements in accordance with International Financial Reporting Standards with year ending September 30. The following transactions relate to Dango Plc.

(a) In February 2016, Dango Plc won a significant new contract to supply large quantities of rice to the government of Guyama, a small West African Country for the next two years. Under the terms of the arrangement, payment is made on delivery in cash once goods have been cleared by customs. The rice will be delivered in batches four (4) times every year, on April 1, July 1, October 1 and January 1. The batches for April 1, 2016 and July 1, 2016 amounting to ₦250million and ₦380million respectively were delivered and paid. Dango incurred significant costs on customs duties for the first batch of delivery. The October 1 batch valued at ₦520million was shipped prior to the year-end but delivered and paid for on October 1, 2016.

(8 Marks)

(b) On October 1, 2010 a 12-year licence was awarded to Dango Plc by the Federal Government to be the sole manufacturer of a chemical used in the Nigerian pharmaceutical industry. The licence was recognised on that date at its fair value of ₦196million. The award of the licence motivated Dango Plc in 2011 to purchase a division of another Nigerian competitor company making similar products. Goodwill of ₦240million was recognised on purchase of the division. Dango Plc merged the activities of the newly acquired division with its own to create a specialist chemical sub-division which it now classified as a separate cash-generating unit. By 2016, the revenue of this cash generating unit now amounts to 5% of the Group's revenue. (4 Marks)

(c) Dango Plc. buys raw materials from overseas suppliers. It has recently taken delivery of 1,000 units of components X, used in the production of chemicals.

The quoted price of component X was ₦1,200 per unit, but Dango Plc. has negotiated a trade discount of 5% due to the size of the order.

The supplier offers an early settlement discount of 2% for payment within 30 days and Dango Plc. intends to achieve this.

Import duties of ₦60 per unit must be paid before the goods are released through customs.

Once the goods are released, Dango Plc. must pay a delivery cost of ₦5,000 to have the components taken to its warehouse.

Required:

Write a report to the directors advising them on the correct accounting treatment of the above transactions in the financial statements for the year ended September 30, 2016 in accordance with the provisions of the relevant standards.

Note: You may consider the relevance of the following standards to the transactions: IAS 20, IAS 2, IAS 38, IFRS 3 and IFRS 15. (8 Marks)

(Total 20 Marks)

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

QUESTION 5

An annual report is a comprehensive report on a company's activities intended to give information about the company's activities and financial performance. In addition to the audited financial statements, annual reports contain a great deal of extra information which could be financial and non-financial. The extra information provided may be required by law, hence, it is mandatory. However, many companies provide additional information not required by law, on voluntary basis.

Required:

a. Identify **THREE** of such reports that are voluntarily disclosed in annual reports of Nigerian companies. (3 Marks)

b. Why would a company disclose information not required by law in its annual report? Propose **FOUR** reasons for and give any **TWO** limitations of such disclosures. (7 Marks)

c. Institutional investors, if not all investors, need information about corporate governance in order to make rational and reasonable investment decisions. As such, the Securities and Exchange Commission (SEC) of Nigeria requires that the annual reports of all quoted companies should include a corporate governance report.

Required:

Identify the contents of such corporate governance report. (5 Marks)

(Total 15 Marks)

QUESTION 6

a. The International Accounting Standards Board (IASB) aims at enhancing the guidance available for assessing fair value in order to increase consistency and comparability in fair value measurements and related disclosures. To this end, fair value measurements are categorised into a three-level hierarchy, based on the type of inputs to the valuation techniques used in IFRS 13. IFRS uses the terms principal or most advantageous market.

Required:

i. What are the fair value hierarchies under IFRS 13? (3 Marks)

ii. Distinguish between the principal and most advantageous market and state how price is determined in the principal market taking into consideration transport and transaction costs. (5 Marks)

b. It is important for entities to understand and properly classify their financial instruments. This is because some financial instruments may have features of both debt and equity, which can lead to inconsistency in reporting. To this end, financial reporting standards provide guidance on the difference between financial instruments classified as equity and liabilities.

With relevant examples, distinguish between liability and equity under IAS 32, Financial Instruments Presentation. (7 Marks)

(Total 15 Marks)

QUESTION 7

a. Megida hopes to obtain contracts from both the private and public sectors following the new government economic initiatives. The company's revenue had always been accounted for in line with IAS 18 since the company had adopted IFRS. Some directors of Megida understand that with the introduction of IFRS 15 Revenue from Contracts, the way revenue from contract is being recognised may change. In particular one of them that attended an IFRS training organised by the Institute of Chartered Accountants of Nigeria (ICAN) heard about IFRS 15 and its five step model for revenue recognition but did not understand.

Required:

Itemise and briefly discuss the **FIVE** step model approach to revenue recognition under IFRS 15. (9 Marks)

b. The directors of Duranga Plc. has learnt that corporate reporting could be improved by adopting the International Integrated Reporting Council's Framework for Integrated Reporting. The directors believe that International Financial Reporting Standards, which the company has recently adopted following the decision of the Federal Executive Council, are already extensive and provide stakeholders with a comprehensive understanding of its financial position and performance for the year. They believe that with over 100 countries adopting IFRS, their financial statements speak international financial reporting language and practice. In particular, statements of cash flows which the company prepares in accordance with IAS 7 enables stakeholders to assess the liquidity, solvency and financial adaptability of a business. They are concerned that any additional disclosures could be excessive and obscure the most useful information within a set of financial statements. This is against the backdrop of a recent effort by IASB on excessive disclosures in financial statements. They are therefore unsure as to the rationale for the implementation of a separate, or combined, integrated report.

Required:

Discuss the extent to which statements of cash flow provide stakeholders with useful information about an entity and whether this information would be improved by the entity introducing an Integrated Report. (6 Marks)

(Total 15 Marks)

SOLUTION 1

(a) **ADVICE ON THE FUNCTIONAL CURRENCY OF SOMA LTD**

The financial controller should note the following for consideration:

According to IAS 21 – *The Effects of Changes in Foreign Exchange Rates*, the functional currency is the currency of the primary economic environment in which the entity operates. This has the implication that the functional currency should be determined at the entity level. The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash.

Soma's functional currency should be determined by considering the following factors in accordance with IAS 21:

(i) The currency:
- that mainly influences the determination of the sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and

- of the country whose competitive forces and regulations mainly the sales prices of its goods and services.

(ii) The currency that mainly influences labour, material and other costs of providing goods or services (this will often be the currency in which such costs are denominated and settled).

Other factors that may also provide evidence of an entity's functional currency include:

- The currency in which funds from financing activities (i.e. issuing debt and equity instruments) are generated.

- The currency in which receipts from operating activities are usually retained.

Additional factors to be considered are:

- The degree of autonomy of a foreign operation. An example is when the foreign operation only sells goods imported from the reporting entity and remits the proceeds to it.
- Whether transactions with the reporting entity are a high or a low proportion of the foreign operation's activities.

- Whether cash flows from the activities of the foreign operation directly affect the cash flows of the reporting entity and are readily available for remittance to it.

- Whether cash flows from the activities of the foreign operation are sufficient to service existing and normally expected debt obligations without funds being made available by the reporting entity.

In Soma's case, sale prices are influenced by local demand and supply, and are traded in defa.

Analysis of the revenue stream points to the defa as being the functional currency. The cost analysis is variable as the expenses are influenced by the defa and the Naira.

Soma's management operates with a considerable degree of authority and autonomy in carrying out the operations of Soma and is not dependent upon group companies for financial support. Consideration is given to whether the foreign operation generates sufficient functional cash flows to meet its cash needs, which in this case Soma does, as it does not depend on the group for finance.

Therefore, the functional currency of Soma will be the defa as the revenue is clearly influenced by the defa, and although the expenses are mixed, secondary factors point to the fact that the functional currency is different to that of Rapuya Plc.

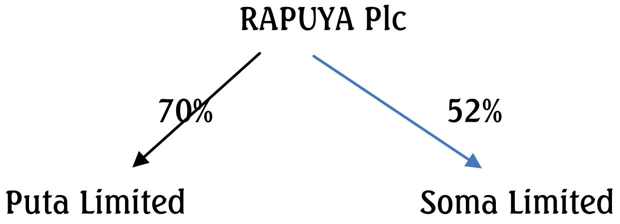
(b) **Rapuya Plc**

Statement of financial position as at April 30, 2017

	₦'m
PPE	1,472.00
Goodwill (wk 3&4)	94.80
Intangible asset -patent wk 5	6.00
Financial asset	84.00
	1,656.80
Current assets	700.00
	2,356.80
Equity and liabilities	
Share capital	316.00
Retained earnings (wk 7)	727.91
Other components of equity (wk 8)	15.40
	1,059.31
Non-controlling interest (wk 9)	369.49
	1,428.80
Non-current liabilities	324.00
Current liabilities	604.00
	2,356.80

Workings

1. **Group structure**



2. **Translation of the financial statements Soma**

Item	Defas	Rate	₦'m
Property, plant and equipment	760.00	2.50	304.00
Financial assets	100.00	2.50	40.00
Current assets	660.00	2.50	264.00
	1,520.00		**608.00**
Share capital	400.00	3.00	133.33
Retained earnings:			
- pre-acquisition	220.00	3.00	73.33
- Post acquisition (including exchange gain)	380.00		193.34
Non-current liabilities	320.00	2.50	128.00
Current liabilities	200.00	2.50	80.00
	1,520.00		**608.01**

3. **Goodwill-Puta**

		₦'m
Fair value Consideration transferred		226.00
Fair value of NCI		92.00
		318.00
Net assets acquired		
Total Fair of Net asset at acq	240.00	
Add: Patent	8.00	
Fair value of consideration transferred		248.00
Goodwill		**70.00**

4. **Goodwill-Soma**

	Defas	Rate	₦'m
Consideration transferred (₦184 x 3)	552.00	3.00	184.00
NCI at fair value	500.00	3.00	166.67
	1,052.00		**350.67**
Less: Fair value of net asset at acq.	**990.00**	3.00	**(330.00)**
Goodwill May 1, 2016	62.00	3.00	20.67
Exchange gain			4.13
Goodwill April 30, 2017	62.00	2.50	24.80

5. Fair value Adjustments – Puta

Fair value of identifiable assets		240.00
Carrying amount net assets		
Share capital	76.00	
Retained earnings	98.00	
Other components of equity (8 - 2)	6.00	**180.00**

	Fair value land			60.00	
	Dr Land and Cr OCE with ₦60m				

6.	**Fair value Adjustments – Soma**		**Defas**	**Rate**	**₦'m**
	Fair value of identifiable assets		990.00		
	Share capital	400			
	Retained earnings	220	620.00		
	Fair value - Adj. Land May 1, 2016		370.00	3.00	123.33
	Fair value Adj. - Land April 30,2016		370.00	2.50	148
	Exchange gain as the land is non-depreciable				24.67

7.	**Retained earnings**	**Rapuya**	**Puta**	**Soma**
		₦'m	**₦'m**	**₦'m**
	As per question	604.00	112.00	266.67
	Amortisation patent		(2.00)	
	Fair value Land Exchange Gain Soma			24.67
	Pre-acq - per question		(98.00)	
	Pre-acq - as translated (wk 2)			(73.33)
	Post acquisition retained profit		12.00	218.01
	Puta share - 70% x 12	8.40		
	Soma share - 52% x 218.01	113.36		
	Share of Exchange gain on goodwill 52% x 4.13	2.15		
		727.91		

8.	**Other Components of Equity (OCE)**	**Rapuya**	**Puta**
		₦'m	**₦'m**
	As per question	14.00	8.00
	Pre-acquisition		(6.00)
	Group's share 70% x 2	1.40	
		15.40	

9.	**Non controlling Interest**	**Puta**	**Soma**	**NCI**
		₦'m	**₦'m**	
	At acquisition (wk 3 and wk 4)	92.00	166.67	
	NCI Share of post acquisition profit			
	Puta (wk 7) 30% x 12	3.60		
	Soma (wk 7) 48% x 218.01		104.64	
	Post acq OCE 30% x 2	0.60		
	Exchange gain on goodwill (48% x 4.13)		1.98	
	Acquisition of 10% of NCI			
		96.20	273.29	
				369.49

EXAMINER'S REPORT

The question tests principles that determine functional currency in accordance with IAS 21 and preparation of consolidated statement of financial position in accordance with IFRS.

Candidates' understanding of Part (a) of the question was fair. However, all the candidates attempted part (b) of the question and most of them performed above average.

The commonest pitfall of the candidates in part (a) was their inability to mention the factors that determine the functionality of currency. That of part (b) was the inability to calculate goodwill arising on consolidation and the related non-controlling interest (NCI).

Candidates are advised to pay more attention to this section of the syllabus for better performance in future examination.

MARKING GUIDE

SOLUTION 1		**MARKS**	**MARKS**
a.	Identification of any four factors from IAS 21 @ 1 mark each	4	
	Conclusion/Advice based on above	1	5
b.	Correct postings in the consolidated statement of financial Position @ ½ mark each	5	
c.	Correct entries in the working notes @ ¼ mark each	20	25
	Total marks		30

SOLUTION 2

To: The Board of Directors, Lanke Plc

From: Finance Director

Date: May 16, 2017

Re: Performance Evaluation Report of Lanke Plc for the Two Years Ended December 31, 2014 and 2015

The purpose of this report is to review the performance of the group and its subsidiaries for the two years ended December 31, 2014 and 2015. The information used for the report was extracted from the financial statements for the year ended December 31, 2015. The calculated ratios are as shown in the appendix attached to this report. Our comments and observations on the calculated ratios are as follows:

Returns On Capital Employed (ROCE)
The group's return on capital employed has improved from 20.64% in 2014 to 25.01% in 2015 while that of the company also improved significantly from 17.90% in 2014 to 28.15% in 2015. This increase could be attributable to improvements in both asset turnover and profit margin. The company's calculated ratio is better than that of the group.

Profit Margin
The company's profit margin improved significantly from 12.63% in 2014 to 20.15% in 2015 indicating that costs control measures of the company is more efficient in 2015 than in 2014. The group's profit margin increased slightly from 12.48% in 2014 to 14.52% in 2015. Company's profitability is better than that of the group for the two years.

Asset Turnover
For the group, the asset turnover improved marginally from 1.65 times to 1.72 times between year 2014 and year 2015. This shows that the group is more efficient in the use of its assets to generate revenue. However, for the company there is a marginal drop in asset turnover from 1.42 times to 1.40 times. The group could be said to utilize asset more efficiently than the company.

Gearing
The gearing of the group has increased from 11.86% to 15.65% during the period under review. The increase in gearing is attributable to the increase in the loan notes from ₦1,256m to ₦1,985m in 2015. The gearing of the company also increased from 9.10% to 13.84% which is also due to the significant increase in the loan notes from ₦783 million to ₦1,570 million in 2015. The gearing of the company is lower than that of the group; however, both are in a good leverage position.

The Interest Cover

The interest cover calculated confirms that the company and the group would be able to pay interest costs as the operating profit covers the interest cost 4 times and 6 times in 2014 and 2015 respectively for the group; 3.59 times and 10.72 times in 2014 and 2015 respectively for the company.

The interest cover for the group was slightly better than that of the company in 2014 but the ratio for the company was tremendously improved in 2015 making the company to be better in 2015 than the group. However, the interest covers for both the group and the company is good as they are able to cover interest payment several times with their earnings. The calculated ratios are not less than 3.0 times which is usually considered to be low.

Differences between Company and Group Operating performance

The differences between the company and the group performance as analyzed above could be attributed to the presence of the non-controlling interest as part of the shareholders of the group. For instance, when calculating the capital employed for the group and the gearing ratio, non-controlling interest will have to be included. This invariably affects the figures calculated.

Conclusion

The overall performance of the group and the company for the periods was good but the group's performance was weakened by the poor performance of other group members. The reduction in the overall operating performance of the group when compared to that of the company shows that some other members of the group must have operated at a loss.

Signed

Mallam Megida
Finance Director

APPENDIX

1. Returns on capital employed

$$= \frac{\text{Profit before interest and tax (PBIT)}}{\text{Capital employed}} \times 100$$

Capital employed = Share capital + Reserves + loan notes

Note: For a group, non-controlling interest is included in the capital Employed

2015

Group $= \frac{₦3,171}{₦12,680} \times 100 = \underline{\underline{25.01\%}}$

Company $= \frac{₦3,194}{₦11,347} \times 100 = \underline{\underline{28.15\%}}$

2014

Group $= \frac{₦2,186}{₦10,591} \times 100 = \underline{\underline{20.64\%}}$

Company $= \frac{₦1,540}{₦8,602} \times 100 = \underline{\underline{17.90\%}}$

2. i. Profit margin

Net Profit Margin

$$= \frac{\text{Profit before interest and tax (PBIT)}}{\text{Revenue}} \times 100$$

2015

Group $= \frac{₦3,171}{₦21,843} \times 100 = \underline{\underline{14.52\%}}$

Company $= \frac{₦3,194}{₦15,848} \times 100 = \underline{\underline{20.15\%}}$

2014

Group $= \frac{₦2,186}{₦17,519} \times 100 = \underline{\underline{12.48\%}}$

Company $= \frac{₦1,540}{₦12,198} \times 100 = \underline{\underline{12.63\%}}$

ii. Gross Profit Margin = $\frac{\text{Gross Profit}}{\text{Revenue}} \times 100$

2015

Group = $\frac{₦6,167}{₦21,843} \times 100 = \underline{\underline{28\%}}$

Company = $\frac{₦4,683}{₦15,848} \times 100 = \underline{\underline{29\%}}$

2014

Group = $\frac{₦4,948}{₦17,519} \times 100 = \underline{\underline{28\%}}$

Company = $\frac{₦3,610}{₦12,198} \times 100 = \underline{\underline{29\%}}$

3. **Asset turnover**

= $\frac{\text{Revenue}}{\text{Capital employed}}$

= $\frac{\text{Revenue}}{\text{Share capital + reserves + loan notes}}$

2015

Group = $\frac{₦21,843}{₦12,680} = \underline{\underline{1.72 \text{ times}}}$

Company = $\frac{₦15,848}{₦11,347} = \underline{\underline{1.40 \text{ times}}}$

2014

Group = $\frac{₦17,519}{₦10,591} = \underline{\underline{1.65 \text{ times}}}$

Company = $\frac{₦12,198}{₦8,602} = \underline{\underline{1.42 \text{ times}}}$

4. **Gearing ratio**

Gearing, also called leverage, measures the total loan note of a company as a percentage of either:

(a) the equity capital in the company

Gearing ratio = $\frac{\text{Loan Note}}{\text{Share capital + reserves (Equity)}} \times 100$

(b) the total capital of the company

$$\text{Gearing ratio} = \frac{\text{Loan Notes}}{\text{Loan notes + share capital + reserves}} \times 100$$

(a)

2015

Group = $\frac{₦1,985}{₦10,695}$ (Including Non-Controlling Interest) x 100 = 18.56%

Company = $\frac{₦1,570}{₦9,777}$ x 100 = 16.06%

2014

Group = $\frac{₦1,256}{₦9,335}$ (Including Non-Controlling Interest) x 100 = 13.45%

Company = $\frac{₦783}{₦7,819}$ x 100 = 10.01%

OR

(b)

2015

Group = $\frac{₦1,985}{₦1,985 + ₦10,695}$ x 100 = 15.65%

Company = $\frac{₦1,570}{₦1,570 + ₦9,777}$ x 100 = 13.84%

2014

Group = $\frac{₦1,256}{₦1,256 + ₦9,335}$ x 100 = 11.86%

Company = $\frac{₦783}{₦783 + ₦7,819}$ x 100 = 9.10%

5. Interest cover

$$= \frac{\text{Profit before interest and tax (PBIT)}}{\text{Interest expenses}}$$

2015

Group = $\frac{₦3,171}{₦499}$ = 6.35 times

Company = $\frac{₦3,194}{₦298}$ = 10.72 times

2014

Group = $\frac{\text{₦}2,186}{\text{₦}546}$ = <u>4.00 times</u>

Company = $\frac{\text{₦}1,540}{\text{₦}429}$ = <u>3.59 times</u>

EXAMINER'S REPORT

The question tests candidates' knowledge of financial analysis relating to group of companies with the aid of financial ratios.

About 92% of the candidates attempted the question. Most candidates have a good understanding of the requirements of the question and performance was above average.

Commonest pitfall was the inability of the candidates to identify and apply appropriate formulae.

Candidates are advised to pay more attention to ratio analysis for better performance in future examinations.

MARKING GUIDE

	Mark	Mark
Report Format	1	
Formulas ($^1/_2$ mark for each formula)	$3^1/_2$	
Calculations	5	
Discussion on each ratio (1.5 X 5)	$7^1/_2$	
Differences between Group and the Company	1	
Conclusions	2	
Total		**20**

SOLUTION 3

a. Impairment of non-financial assets and deferred tax assets

The following are the reasons why Financial Reporting Council of Nigeria (FRCN) should focus on the impairment of non-financial assets and deferred tax of listed companies:

- Particular attention should be paid to the valuation of goodwill and intangible assets with indefinite life spans.
- The entity should focus on certain specific areas including cash flow projections, disclosure of key assumptions and judgements, and appropriate disclosure of sensitivity analysis for material goodwill and intangible assets with indefinite useful lives.
- IAS 36 Impairment of Assets points out that greater weight should be given to external evidence when determining the best estimate of cash flow projections.

The following are the key areas which entities should focus on when accounting for these items:

- A continuous period of slow economic growth could indicate to regulators that non-financial assets will continue to generate lower than expected cash flows, especially in those industries experiencing a downturn in fortunes.
- In measuring value-in-use, cash flow projections should be based on reasonable and supportable assumptions which represent the best estimate of the range of future economic conditions.
- Each key assumption should be consistent with external sources of information, or there should be disclosure of how these assumptions differ from experience or external sources of information.
- Such an economic climate could result in the recognition of tax losses or the existence of deductible temporary differences where perhaps impairments are not yet deductible for tax purposes.
- The recognition of deferred tax assets requires detailed consideration of the carry forward of unused tax losses, whether future taxable profits exist, and the need for disclosing judgements made in these circumstances.
- IAS 12 Income Taxes limits the recognition of a deferred tax asset to the extent that it is probable that future taxable profits will be available against which the deductible temporary difference can be utilised.

- IAS 12 states that the existence of unused tax losses is strong evidence that future taxable profit might not be available. Therefore, recent losses make the recognition of deferred tax assets conditional upon the existence of convincing other evidence.
- The probability that future taxable profits will be available to utilise the unused tax losses will need to be reviewed and if convincing evidence is available, there should be disclosure of the amount of a deferred tax asset and the nature of the evidence supporting its recognition.

It is particularly relevant to disclose the period used for the assessment of the recovery of a deferred tax asset as well as the judgements made.

b. IAS 36 "Impairment of assets".

(i) Indications that an asset or group assets may have been impaired

External factors

- A significant decrease in the market value of an asset in excess of normal passage of time.
- A significant adverse changes in the market or business in which the asset is used.
- Adverse changes to the technology, economical or legal environment of the business.
- An increase in market interest rates likely to affect the discount rate used in calculating value in use.
- The carrying amount of the entity's net assets exceeds its market capitalisation.
- Where interest rates increase adversely affecting recoverable value
- Unexpected changes in government policies that could affect the business adversely.

Internal factors

- Physical damage or obsolescence has occurred.
- Adverse changes to the method of use of the asset
- Where indications suggest that the economic performance of the asset will be worse than expected.
- Where management intends to re-organise the entity.
- Where actual cash flows are less than estimated cash flows if an asset is appraised in terms of value.

(ii) Test for impairment of an asset that does not generate independent cash flows

Where the oil company's asset does not generate independent cash flows i.e. cash inflows that are largely independent of those from other assets, it will be assumed that:

- The recoverable amount of that individual asset cannot be determined;
- If it is not possible to estimate the recoverable amount of an individual asset, an entity shall determine the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit);
- In such cases, value in use and, therefore, recoverable amount, can be determined only for the asset's cash-generating unit, and impairment is then tested at the level of cash generating unit for such asset;
- An impairment loss shall be recognised for a cash-generating unit if, and only if, the recoverable amount of the unit is less than the carrying amount of the unit or group of units;
- The impairment loss shall be allocated to reduce the carrying amount of the assets of the unit or in the following order:
    - first, to reduce the carrying amount of any goodwill allocated to the cash-generating unit, and
    - then, to the other assets of the unit; pro rata on the basis of the carrying amount of each asset in the unit.

  These reductions in carrying amounts shall be treated as impairment losses on individual assets and recognised; and
- In allocating an impairment loss in accordance with IAS 36, an entity shall not reduce the carrying amount of an asset below the highest of:
    - its fair value less costs to sell (if determinable);
    - its value in use (if determinable); and
    - zero.

(c)

Impairment is calculated as the higher of	
Carrying amount	960
Recoverable amount	720
Impairment	240

Allocation of the impairment

Asset	Carrying amount	Impairment	Carrying amount after impairment
	₦'million	₦'million	₦'million
Goodwill	160	160	----
Patent	320	32	288
Property, plant and Equipment	480	48	432

EXAMINER'S REPORT

The question tests candidates' understanding of IAS 36 and IAS 12 with particular emphasis on impairment as it relates to non-financial assets.

About 75% of the candidates attempted the question but did not display good understanding of the requirements of the question, hence, performance was very poor.

Candidates are advised to read thoroughly all the International Financial Reporting Standards specified in the ICAN Study texts for better performance in future examinations.

MARKING GUIDE

			MARKS	MARKS
a.	Impairment of non-financial assets and deferred tax asset (any 7 points @1 mark each)		7	
b.	Identify 2 external and 2 internal indicators			
i.	Two external indicators (any 4 points @ ¼ mark each)	1		
	Two internal indicators (any 4 points @ ¼ mark each)	1		
			2	
ii.	Test for impairment of an asset that does not generate independent cash flows (6 points at 1 mark each)		6	
c.	Calculation of the value of the assets held after the impairment test		5	
				13
	Total			**20**

SOLUTION 4

REPORT

From: Mr. ABC

To: The Directors
Dango Plc

Date: May 16, 2017

Subject: Relevant accounting treatments of transactions

The purpose of this report is to explain the relevant accounting treatments on mentioned transactions in accordance to the applicable accounting standards and International Financial Reporting Standards (IFRS) such as IAS 20, IAS 38, IFRS 3 and IFRS 15. The explanations are as follows:

(a) **Revenue recognition:** In accordance with IFRS 15, Revenue from Contracts with Customers, the core principle is delivered in a five step model framework viz:

- ✓ IFRS 15 requires revenue to be recognised when (or as) the performance obligation is satisfied;
- ✓ The performance obligation is satisfied when an entity transfers a promised goods or service to a customer;
- ✓ The good or service is considered transferred when (or as) the customer obtains control of the good or service (i.e. the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset);
- ✓ To determine the point in time when a customer obtains control of a promised asset and an entity satisfies a performance obligation, the entity would consider indicators of the transfer of control; and
- ✓ Indicators of transfer will include the customer having the significant risks and rewards of ownership of the asset and the customer accepting the asset.

Applying the above to the Dango case, the performance obligation and transfer of control will be deemed to take place on delivery of the rice of the government of Guyama. This is when the customer takes on the risks and rewards and accepts the goods.

Therefore, in the year ended September 30, 2016, revenue should be recognised for the April 1, 2016 (₦250million) and July 1, 2016 deliveries (₦380million) making total revenue of ₦630million.

Based on the above, revenue will not be recognised for the October 1, 2016 delivery as it does not take place until after the year end.

The significant costs incurred by Dango on customs for the first batch of delivery should be expensed in line with the matching concept.

Costs incurred in relation to the October 1, 2016 delivery should be held as work in progress in the statement of financial position until revenue is recognized in the year ended September 30, 2017.

(b) In compliance with IAS 38, the license awarded by the Federal Government to Dango Plc on October 1, 2010, which was recognized on that date at its fair value i.e. ₦196million, should be amortized over its useful life of 12 years. It should be noted that fair value implies the price that would be received to sell an asset or paid to transfer or settle a liability in an orderly transaction between market participants at the measurement date.

Goodwill of ₦240million was created as a result of business combination (purchase of division). The goodwill created in this manner should be recognized in the financial statements. Under IFRS 3 **"Business combination"** goodwill is the excess of the purchase consideration over the fair value of the acquiree's identifiable net assets. Once recognized, goodwill is held indefinitely and will not be amortized but will be subjected to annual impairment review.

Also, according to IAS 38, all internally generated goodwill should **not** be recognized in the financial statements.

A cash generating unit according to IAS 38 is the smallest identifiable unit that generates independent cash-flows. There is no requirement by IAS 38 that it must constitute a minimum revenue threshold before such classification as a cash generating unit can be made.

(c) **Valuation of Inventory as at September 30, 2016**

According to IAS 2 "Inventory", inventory should be valued or measured at the lower of cost and net realisable value. Based on IAS 2 "Inventory", cost of inventory includes the purchase price and all directly attributable costs incurred in bringing the item of inventory to its current location and saleable condition.

IAS 2 states that "the cost of inventories shall comprise all cost of purchase, cost of conversion and other costs incurred in bringing the inventories to their present location and condition".

Calculation of cost of inventory

Calculation of cost of inventory	₦
Purchase price (1,000 units x ₦1,200)	1,200,000
Less trade discount (5% x ₦1,200,000)	(60,000)
Net purchase price	1,140,000
Import duties (₦60 x 1,000 units)	60,000
Delivery costs	5,000
	1,205,000

Note: It should be noted that purchase price **excludes** any settlement discounts and is the cost after deduction of trade discount. This implies that purchase cost of inventory involves deduction of trade discount, but settlement discount is irrelevant.

The cash discount of 2% represents discount received and should not affect inventory valuation but should be recognised as an income in the statement of profit or loss.

Conclusion

The provisions of IFRS on the correct treatment of revenue for contracts with customers, the recognition of internally generated goodwill and valuation of inventory has been dealt with in the above explanation for Dango Plc. to apply in the financial statements.

EXAMINER'S REPORT

The question tests the understanding of the correct application of the provisions of International Financial Reporting Standards (IFRS), that are relevant to scenarios illustrated in the question.

About 40% of the candidates attempted the question and they demonstrated poor understanding of the requirements of the question, therefore resulting in poor performance.

Commonest pitfall was the inability of the candidates to apply the specific provisions of IAS 20, IAS 2, IAS 38, IFRS 3 and IFRS 15 to practical situations.

Candidates are advised to understand the IFRS in-depth for better performance in future examinations.

MARKING GUIDE

		MARKS	MARKS
a.	Core Principle of Revenue recognition		
	Main points listed on IFRS 15		
	(any 3@ 1 mark each)	3	
	(any five @ 1 mark each)	5	8
b.	Explanation relating to Federal Government		
	license (any three parts @ 1 mark each)	3	
	Goodwill created under business combination	1	4
c.	Explanation on IAS 2 "Inventory"	1½	
	Computation of Purchase cost of inventory	5	
	Explanation regarding trade discount and		
	settlement discount	1½	8
	Total		20

SOLUTION 5

a. Identification of reports that are voluntarily disclosed in annual reports of Nigerian companies:

- Statement of corporate governance;
- Environmental and social report;
- Report on corporate and social responsibility/Sustainability Report;
- Five-year Financial Summary;
- Key Performance Indicator (KPI);
- Value added statement;
- Chairman's report; and
- Statement of Director's responsibilities.

b. A company would disclose information not required by law in its annual report for the following reasons:

- As a marketing and public relations tool;
- It enhances the level of transparency upon which the financial information is produced;
- It helps in projecting an entity as a better managed company;
- It enhances the demand for an entity's shares as investors tend to allocate more capital to a more transparent company;
- To build goodwill or enhance reputation; and
- As a competitive advantage strategy.

Limitations:

- The company can decide what to include in the report and what to leave out; the reality you see is the reality the company wants you to see;
- Since such voluntary disclosures are not regulated by laws or standards, such disclosures tend to lack uniformity and standardization;
- The information is often presented in a very positive form, as public relations for investors, and might not be entirely reliable;
- Information overload; and
- Window dressing (Creative Accounting).

c. The contents of corporate governance report are:

- Compliance with laws and regulations;
- The Board Composition;
- Role of the Board;
- Directors' Interest in Contracts;
- Board Meetings;
- Board changes;
- Committees of the Board;

- Roles and responsibilities of the Board committees and the discharge of such;
- Control Environment;
- Induction and Training;
- Performance Evaluation process;
- Code of Business Conduct and Code of Governance for Directors;
- Human resource policies, internal management structure, relations with employees, employee share ownership schemes and other work place development initiatives;
- Statement of Company's Risk Management Policies and Practices; and
- Dealings in Securities Code.

EXAMINER'S REPORT

The question tests the knowledge of the candidates on the content of company's Annual Report with reference to voluntary disclosure, mandatory disclosure and corporate governance report.

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

Commonest pitfall is that most of the candidates could not clearly distinguish between the mandatory and voluntary information in the annual report.

Candidates are advised to familiarise themselves with the annual report of various companies as well as relevant Accounting Standards on disclosure of information in the annual report.

MARKING GUIDE

			MARKS	MARKS
a. i.	Identification of Voluntarily disclosed report (any three @ 1 mark each)			3
b.	Reasons for disclosing information			
	i.	Not required by law (any four @ 1 mark each)	4	
	ii.	Limitation of such disclosure (any three @ 1 Mark each)	3	
				7
c.	General requirements of contents of corporate governance report (any five @ 1 mark each)			5
	Total			**15**

SOLUTION 6

(i) Fair Value Hierarchies

The hierarchy categorizes the inputs used in valuation techniques into three levels. The three levels are as contained below:

- **Level 1 input**

  Level 1 inputs are quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date.

  A quoted market price in an active market provides the most reliable evidence of fair value and is used without adjustment to measure fair value whenever available.

- **Level 2 inputs**

  Level 2 inputs are inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

  Level 2 inputs will include:

  i. quoted prices for similar assets or liabilities in active markets;
  ii. quoted prices for identical or similar assets or liabilities in markets that are not active; and
  iii. inputs other than quoted prices that are observable for the asset or liability.

- **Level 3 inputs**

  Level 3 inputs are unobservable inputs for the asset or liability.

  Unobservable inputs are used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date

(ii) **Principal market**

The market with the greatest volume and level of activity for the asset or liability

Most advantageous market

It is the market that maximizes the amount that would be received to sell the asset or minimizes the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs.

In determining fair value at the principal market the following must be borne in mind

- **Transaction cost** - This cost is not considered in principal market fair value determination.

- **Transport cost** - This cost must be considered in arriving at the principal market fair value.

b. A financial liability is any liability that is:

(a) a contractual obligation :

 i) to deliver cash or another financial asset to another entity; or

 ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and is non derivative.

Debt is a typical example of a liability. An instrument will be classified as debt if:

- Redemption is at the option of the instrument holder;
- There is limited life to the instrument;
- Redemption is triggered by a future uncertain event which is beyond the control of both the holder and the issuer; and
- Dividends are non-discretionary.

An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

An instrument will be classified as equity if:

- The instrument is non-redeemable; and
- Dividends are discretionary.

EXAMINER'S REPORT

The question tests candidates' knowledge of IFRS 13 and IAS 32. About 50% of the candidates that sat for the examination attempted the question and their performance was below average.

Commonest pitfall was candidates' inability to understand the fair value hierarchies level of inputs as identified by the standards.

Candidates are advised to concentrate more on the ICAN Study Text for this level of examination for better performance in future.

MARKING GUIDE

			MARKS	MARKS
a.	i.	3 hierarchies (1 mark each)		3
	ii.	(a) Distinction between principal market and most advantageous market (1½ mark each)	3	
		(b) Price determination in Principal Market		
		- Transport cost	1	
		- Transaction cost	1	5
				8
b.		1 mark each for seven points mentioned out of eleven points above		7
		Total		15

SOLUTION 7

The five steps model approach systems under IFRS 15 are:

a. **Step 1 – Identify the contract with the customer**

A contract can be written, verbal or implied. It is within the scope of IFRS 15 when:

(i) Both parties have approved it and are committed to it;

(ii) Each party's rights regarding the goods and services to be transferred can be identified;

(iii) The payment terms can be identified;

(iv) The contract has commercial substance; and

(v) It is probable that the consideration will be received.

Step 2 – Identify the separate performance obligations

A performance obligation is a promise in a contract with a customer to transfer to the customer either:

(i) a good or service (or a bundle of goods or services) that is distinct; or

(ii) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer;

(iii) A good or service, which has been delivered, may not be distinct if it cannot be used without another good or service which has not yet been delivered; and

(iv) Similarly, goods or services which are not distinct should be combined with other goods or services until the entity identifies a bundle of goods or services which is distinct.

Step 3: Determine the transaction price

(i) An entity must consider the terms of the contract and its customary practices in determining the transaction price

(ii) The transaction price assumes transfers to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed or modified.

(iii) The transaction price is not adjusted for effects of the customer's credit risk.

(iv) For this purpose, an entity shall consider the effects of all the following:

- ❖ variable consideration;
- ❖ the constraint on variable consideration;
- ❖ time value of money;

- non-cash consideration;
- consideration payable to the customer.

Step 4: Allocate the transaction price to the performance obligations

(i) The entity allocates a contract's transaction price to each separate performance obligation within that contract on a relative stand-alone selling price basis at contract inception.

(ii) A stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer.

(iii) IFRS 15 suggests that any of the following three methods will be suitable for estimating the stand-alone selling price:
- adjusted market assessment approach;
- expected cost plus margin approach; and
- residual approach.

Step 5: Recognize revenue when or as an entity satisfies performance obligations

(i) Revenue is recognised when or as the promised goods or services are transferred to a customer.

(ii) A transfer occurs when the customer obtains control of the good or service.

(iii) Indicators of control include:
- The entity has a present right to payment for the asset;
- The customer has legal title;
- The customer has physical possession (exceptions for bill and hold, consignment sales and repos);
- The customer has the significant risks and rewards of ownership of the asset; and
- The customer has accepted the asset.

(iv) Benefit of an assets are the potential cash flows obtainable directly or indirectly from the assets.

b.

i. The extent to which statements of cash flow provide stakeholders with useful information about an entity

- Statements of cash flows provide valuable information to stakeholders on the financial adaptability of an entity.

- Cash flows are objective and verifiable and so are more easily understood than profits.

- Profits can be manipulated through the use of judgement or choice of a particular accounting policy. Operating cash flows are therefore useful at highlighting the differences between cash and profits.

- The cash generated from operations is a useful indication of the quality of the profits generated by a business.

- Good quality profits will generate cash and increase the financial adaptability of an entity. Cash flow information will also have some predictive value. It may assist stakeholders in making judgements on the amount, timing and degree of certainty on future cash flows.

- Cash flow is useful as an input in the valuation model.

- The classification of cash flows can be manipulated between operating, investing and financing activities. It is important therefore not to examine the cash flow information in isolation.
- It is only through an analysis of the statement of financial position, statement of comprehensive income and notes, together with cash flow, that a more comprehensive picture of the entity's position and performance develops.

- It is true that International Financial Reporting Standards are extensive and their required disclosures very comprehensive.

This has led to criticism that the usefulness may be limited where the most relevant information is obscured by immaterial disclosures.

ii. Extent to which statement of cash flows provides stakeholders with useful information and whether this information would be improved by the entity introducing an Integrated Report.

- Integrated Report (IR) presents a company's performance in terms of both financial and other value relevant information.
- IR reflects the broad and longer-term consequences of the decisions organizations make, based on a wide range of factors, in order to create and sustain value.
- IR enables an organization to communicate in a clear, articulate way how it is drawing on all the resources and relationships it utilizes to create and preserve value in the short, medium and long-term.
- IR system helps investors to manage risks and allocate resources most efficiently.
- An integrated reporting system would increase disclosure as well as imposing additional time and cost constraints on the reporting entity.
- Integrated reporting will provide stakeholders with valuable information which would not be immediately accessible from an entity's financial statements especially the cash flow statement.
- Financial statements are based on historical information and may lack predictive value.
- Financial Statements are essential in corporate reporting, particularly for compliance purposes but do not provide meaningful information regarding business value.
- IR is a strategic direction which is lacking from a traditional set of financial statements and will be valuable to stakeholders to make a more informed assessment of the organisation and its prospects.

Judging from the benefits of IR as enumerated above, it is very clear that IR cannot obscure the relevance of statement of cash flows in a comprehensive reporting framework but it will rather enhance its importance.

EXAMINER'S REPORT

The question tests the provision of IFRS 15. Part (a) of the question tests provision of IFRS 15 with regards to revenue from contract which hitherto have been accounted for under IAS 18. Part (b) of the question tests candidates' knowledge of the usefulness of statements of cash flow in a Financial Statements and the probable improvement the introduction of Integrated Report could have on the usefulness of statement of cash flow.

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

The commonest pitfall was the inability of the candidates to relate integrated reporting to cash flow statements.

Candidates are advised to ensure a good coverage of the syllabus directing attention to provisions of various standards (IFRS) in the ICAN Study texts for better performance in future examinations.

MARKING GUIDE

			MARKS	MARKS
a.	i.	Identification of 5 steps		
		(any 5 points @ ½ mark each)		2½
	ii.	Discussion of steps		
		Step 1 – Any 3 points	1½	
		Step 2 – Any 3 points	1½	
		Step 3 – Any 3 points	1½	
		Step 4 – Any 3 points	1½	
		Step 5 – Any 1 point	½	
				6½
				9
b.	i.	Usefulness of cash flow information		
		(any 3 points)		3
	ii.	Integrated Reporting		
		(any 3 points)		3
		Total		15

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2017

ADVANCED TAXATION

Time Allowed: 3 hours

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

You are the Tax Controller of Rex Pharmaceuticals (Nigeria) Limited having its Head Office in Ketu, Epe Local Government of Lagos State.

In the past three years, the company had been subjected to taxes by different Revenue Authorities within Lagos State and indeed, the entire country.

Apart from the Companies Income Tax, the issue of Withholding Tax is an area where the company's management is very much concerned. The Managing Director is 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 outrageous cost of capital which had led to increase in cost of production and attendant decrease in profit. The company's goods are becoming uncompetitive, compared to imported goods. The long term effect is either reduction in work force or relocation to a more favourable economic climate. The Managing Director summoned you to his office and among the issues raised at the meeting were:

(i) as a corporate body, the company ought not to be subjected to multiplicity of taxes beyond the Companies Income Tax;
(ii) the jurisdiction of the tiers of Government in imposition and collection of taxes;
(iii) the Withholding Tax;
(iv) the Pay As You Earn as it affects the staff; and
(v) the Capital Gains Tax.

You have also been informed of the following:
(i) the company's technical agreement with the foreign Head Office and the need to remit funds;
(ii) the Non-Executive Directors;
(iii) the Non-Resident directors are to receive ₦2,500,000;

(iv) centralization of staff PAYE deductions;
(v) dividend payment to shareholders in different parts of the country. Those resident in Kogi are to receive ₦375,000;
(vi) land for factory in Abuja purchased from Alhaji Garuba Maito who resides in Kano;
(vii) Rex Pharmaceuticals 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
(viii) at present, out of the thirty employees in Abuja, five are resident in Suleja, Niger State.

You are required to:

a. Explain briefly the following:

i. Capital Gains Tax
ii. Withholding Tax
iii. Double Taxation Treaty
iv. Multiple Taxation (12 Marks)

b. Discuss measures put in place by the government to reduce cases of multiple taxation. (6 Marks)

c. State the arms of government empowered by the Constitution to legislate on tax matters. (6 Marks)

d. Determine the Companies Income Tax due from Rex Pharmaceuticals Limited for the year ended December 31, 2015. (6 Marks)

(Total 30 Marks)

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

QUESTION 2

Oron Itu Petroleum Company Limited has been in the Oil and Gas business for several years. The company has just secured its first two contracts to supply consignments of Natural Gas to two companies in Ghana and Gambia.

The consignment to Ghana was valued at ₦589,000,000 while that to Gambia was valued at ₦375,500,000.

The relevant arm of the Nigerian National Petroleum Corporation (NNPC), issued Certificate of Export as follows:

Contract No	Amount ₦	Load Factor
I	589,000,000	58^0
II	375,500,000	62^0

The Managing Director of the company who has just resumed duty, could not understand the meaning of Load Factor. He would also want to be advised on the assessable amount of the two contracts. He has approached you as the Tax Consultant to advise him on the points raised.

You are provided with the table below:

Load Factor	G-Factor per centum
50^0	16.9
60^0	15.5
70^0	14.3
100^0	13.6

a. **You are required** to explain briefly the following:

i. The reason behind having a load factor on the Consignee's Certificate (3 Marks)

ii. G-Factor (1 Mark)

iii. Value of Chargeable Natural Gas (2 Marks)

iv. Compute the Value of Gas sold (9 Marks)

b. State **FIVE** incentives available to a company engaged in the Utilization of Associated Gas (5 Marks)

(Total 20 Marks)

QUESTION 3

a. Global Company Nigeria Limited is a construction company based in Abuja. It commenced business on January 7, 2009.

The company is finding it difficult to purchase the much – needed equipment to carry out its operations. It approached its bankers for a loan but the request was turned down because of the company's poor financial results.

At the meeting of the directors held on November 6, 2012, it was decided that the company should approach a finance house for assistance.

Your finance house was approached and was given the following information:

- The company bought an excavator on hire purchase on March 1, 2013 and paid a sum of ₦32,000,000 as a deposit on the purchase price.
- At the time of purchase, the cost price of the excavator was ₦55,000,000 but the company was allowed to pay the balance in twenty five monthly instalments of ₦1,200,000, effective April 1, 2013.

You are required to:

i. Calculate the Capital Gains Tax for the relevant Assessment Year, assuming that the excavator was sold for:

  - ₦65,000,000 after the payment of instalment on January 1, 2014. (7 Marks)
  - ₦69,000,000 after the payment of instalment on November 1, 2014. (7 Marks)

ii. Explain the implications of hire purchase interest on Capital Gains Tax computations. (2 Marks)

b. Capital Gains Tax is imposed on gains arising from the ownership of a capital asset changing hands, either by exchange, transfer, sale or gift.

The tax is chargeable on the total amount of the chargeable gains arising after deducting allowable expenses on the disposal of chargeable assets in any year of assessment.

Required:
State the allowable deductions under the Capital Gains Tax Act CAP C1 LFN 2004 as amended. (4 Marks)

(Total 20 Marks)

QUESTION 4

a. Oil and Gas are major sources of revenue for the Federal Government of Nigeria (FGN). This has become a burden to the government due to its inability to control the volume of production and price. To ameliorate this burden, the FGN is seeking alternative sources of revenue and solid minerals have been so identified.

Required:

State **FIVE** incentives put in place by the Federal Government of Nigeria (FGN) to attract potential investors to the solid minerals sector. (5 Marks)

b. In the words of Benjamin Franklin, "the only things that are certain are death and taxes". However, in some countries, taxes are not necessarily certain.

Required:

i. Explain briefly the term "Tax Havens". (4 Marks)

ii. State **THREE** factors in considering whether a jurisdiction is a Tax Haven (3 Marks)

iii. State **FIVE** countries that are Tax Havens (5 Marks)

c. Where a tax payer receives a Notice of Assessment, he either agrees or disagrees with it. Where he agrees with the assessment, the position of the law is that the tax must be remitted within the statutory time limit. Where he disagrees, he is expected to raise a Notice of Objection.

Required:

State **THREE** particulars to be specified in a Notice of Appeal against an assessment. (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

The dwindling oil revenue in recent times has constrained the earning capacity of the Nigerian government.

This situation accelerated the slide in the nation's economy into recession in 2016. There has been a lot of arguments as to which regime's actions or inactions brought about this economic malaise.

Some experts argue that Nigeria has good tax laws but successive governments displayed the lack of political will to implement them. They posit that the lack of implementation has caused the nation's Internally Generated Revenue (IGR) to nosedive.

As part of various recommendations by these experts, coupled with the compelling need to shore up the Internally Generated Revenue, the Federal Inland Revenue Service (FIRS) has created the Transfer Pricing Division located in the FIRS Building at Ikoyi, Lagos.

To give teeth to its mandate, the Division has been writing multinationals and group of companies to file returns with it, in respect of their transfer pricing activities.

MGBORIE GROUP LIMITED recently received one of such letters from the FIRS, which startled the Chairman/Chief Executive who is already sensing rough times with the FIRS.

As the company's tax consultant, the letter was forwarded to you for further explanations.

You are required to state:

a. The significance of Transfer Pricing. (2 Marks)
b. **TWO** objectives of the Income Tax (Transfer Pricing) Regulation Act of 2012. (2 Marks)
c. Contents of the Transfer Pricing Disclosure and Submission Forms to the FIRS. (5 Marks)
d. **THREE** Transfer Pricing Methods. (6 Marks)

(Total 15 Marks)

QUESTION 6

a. Tax planning encompasses many different considerations, including the timing of income, purchases and other expenditure, the selection of investments and the tax payer's filing status. Put differently, tax planning is the analysis of a financial situation or plan from a tax perspective.

Given the current government's drive to boost revenue, there is the compelling need for companies to adopt vigorous tax planning strategies.

You are required to briefly explain with examples the following:

i. Thin Capitalization (4 Marks)
ii. Non – Tax Factors (3 Marks)

b. You have been provided with the following information in respect of **THREE** small businesses:

Name of Company	Saladine Manufacturing Company Limited	ABC Foods Limited	Zenith Nigeria Limited
Date of commencement of business	January 1, 2008	January 1, 2014	January 1, 2011

Name of Company	Saladine Manufacturing Company Limited	ABC Foods Limited	Zenith Nigeria Limited
Nature of business	Manufacturing	Agriculture	Trading
Date of accounts	Year ended December 31, 2015	Year ended December 31, 2015	Year ended December 31, 2015
	₦	₦	₦
Revenue	998,000	930,700	950,100
Total Profit	425,000	365,000	411,000

You are required to:

i. Compute the Companies Income Tax liability for each of the companies for the relevant assessment year, using the small business rate. (3 Marks)

ii. Give reasons for your computations. (5 Marks)

(Total 15 Marks)

QUESTION 7

a. As the newly appointed Tax Consultant to a company, **you are required** to make a presentation stating **EIGHT** items specifically disallowed by the Petroleum Profits Tax Act Cap. P13 LFN 2004 as amended, in ascertaining the Adjusted Profit of an accounting period. (8 Marks)

b.

i. Describe briefly your understanding of the term "Memorandum of Understanding" as it applies to Petroleum Profits Tax computation. (3 Marks)

ii. State **FOUR** highlights of the Year 2000 Memorandum of Understanding. (4 Marks)

(Total 15 Marks)

NIGERIAN TAX RATES

1. CAPITAL ALLOWANCES

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

2. INVESTMENT ALLOWANCE 10%

3. RATES OF PERSONAL INCOME TAX

Graduated tax rates with consolidated relief allowance of ₦200,000 or 1% of Gross Income whichever is higher + 20% of Gross Income.

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

After the relief allowance and exemption have been granted, the balance of income shall be taxed as specified in the tax table above.

4. COMPANIES INCOME TAX RATE 30%

5. TERTIARY EDUCATION TAX (2% of Assessable Profit)

6. CAPITAL GAINS TAX 10%

7. VALUE ADDED TAX 5%

SOLUTION 1

(a)

i. **Capital Gains Tax**

Capital Gains Tax is a charge on capital gains accruing to an individual or organisation on the disposal of a capital asset (chargeable asset). The current rate as provided for in the Capital Gains Tax Act Cap CI LFN 2004 (as amended) is 10%. The tax is charged on the gains on actual or current year basis.

The tax is administered by the Federal Inland Revenue Service in respect of individuals resident in the Federal Capital Territory and corporate bodies, while the State Board of Internal Revenue administers the tax in respect of individuals resident therein.

ii. **Withholding Tax**

This is an advance payment of tax to be used as a tax credit for settling off of income tax liability of the particular year to which the income suffering 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 30 days of the date the duty to deduct arises whichever is earlier for corporate bodies.

The Federal Government through the Federal Inland Revenue Services collects Withholding Tax from residents of the Federal Capital Territory and corporate bodies, while the State Governments through the State Internal Revenue Boards, assess and collect Withholding Tax from individuals only.

Penalty for Non-Deduction/Non-Remittance of Withholding Tax

For non-deduction or remittance within 30 days, such 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 Central Bank of Nigeria minimum re-discount rate and imprisonment for period of not more than three years.

iii. **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 was 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 tax treaties with many countries. Such treaties provide reliefs to Nigerian companies earning foreign income that have already been taxed.

iv. **Multiple Taxation**

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

(b) **Government's Efforts to Reduce Cases of Multiplicity of Taxes**

i. 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 of September 30, 1998.

ii. The schedule listed the taxes and levies to be collected by the Federal Government, State Governments and Local Governments.

iii. The Constitution also provides that no tax should be imposed on the same person by more than one State or in respect of the same income by more than one Local Government area.

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

The power to legislate on taxation rests on the National Assembly, consisting of the Senate and the House of Representatives, and a State Government through the State Assembly.

The National Assembly can delegate assessment and collection to a State Government while the State Assembly may delegate the power to administer and collect any tax, fee or rate to a Local Government.
There must, however, be an assurance that such tax, or fee at stipulated rate is levied on the same person in respect of the same income by not more than one Local Government.

(d) 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 subject to further tax

	₦
Dividend received	4,500,000
Add: Tax at Source (₦4,500,000 x $\frac{1}{9}$)	500,000
Gross dividend received	5,000,000
Total Profit from trading activities	22,500,000
	27,500,000

	Profit to be taxed on trading activities	22,500,000
(i)	Company Income Tax @ 30%	6,750,000

EXAMINER'S REPORT

This question tests the candidates' understanding of Double Taxation Treaties and Multiple Taxation Legislations.

All the candidates attempted the question.

Performance was below average.

One of the major pitfalls observed was the inability of the candidates to distinguish between Double Taxation Treaties and Multiple Taxation Matters.

Candidates are advised to be more discerning in their understanding of concepts and requirements of questions before proffering solutions in future examinations.

MARKING GUIDE

			Marks	Marks
a	i.	Explanation of Capital Gains Tax	3	
	ii	Explanation of Withholding Tax	3	
	Iii	Explanation of Double Taxation Treaty	3	
	iv	Explanation of Multiple Taxation	3	
				12
b		Identification of measures put in place to reduce cases of Multiple Taxation		
	i	Stating the Decree 21 (Now an Act) of 1988	2	
	Ii	Listing the taxes & levies to be excluded by each tier of government	2	
	iii	Stating the provisions of the constitution on imposition of multiple taxes on the same person by one entity	2	
				6
c		Identifying the arms of Government empowered with Legislation on tax matters by the constitution		
		Federal Government through the National Assembly	2	
		State Government through the House of Assembly	2	
		Power to delegate by the two Taxing Authorities	2	
				6

		Marks	Marks
d	Development of Company Income Tax		
i	Stating the dividend of ₦4,500,000 from Laiketop Limited as Franked Investment Income	2	
ii	Determination of Income tax based on 30% of Total profit of ₦22,500,000	2	
	Identifying correct figure of Income Tax ₦6,750,000	2	
			6
			30

SOLUTION 2

(a) i. In the sale of gas contract, the actual value of the gas lifted cannot be reasonably subjected to tax. The reason for this is because losses may arise from spillage and evaporation because of its volatility. A relief is therefore given in form of a discount which depends on the quality of the gas, which in turn is defined by the load factor. The load factor has a corresponding gas factor or G-Factor.

ii. **G-Factor**
Gas production cost adjustment factor

iii. **Value of Chargeable Natural Gas**
Ascertainment of G-Factor
The value of all Chargeable Natural Gas in an accounting period shall be the sum of gross proceeds under individual gas sales contracts in the accounting period, less the G-Factor allowance as applicable to any such individual gas sales contracts at the appropriate rate percent of such proceeds under any such individual gas sales contracts as specified in the Table.

iv. **Calculation of the value of Gas sold**

Contract I

$$\frac{50-58}{50-60} = \frac{16.9 - X}{16.0 - 15.5}$$

$$\frac{-8}{-10} = \frac{16.9 - X}{1.40}$$

16.9 – X = 0.8 X 1.4
16.9 – X = 1.12
X = 16.9 – 1.12
X = 15.78%

Discount to be granted 15.78% of ₦589,000,000 = ₦92,944,200

	₦
Contract Value	589,000,000
Less: Discount	(92,944,200)
Assessable Value of Gas sold	496,055,800

Contract II

$$\frac{60-62}{60-70} = \frac{15.5 - X}{15.5 - 14.3}$$

$$\frac{-2}{-10} = \frac{15.5 - X}{1.2}$$

$0.2 = \frac{15.5 - X}{1.2}$

$15.5 – X = 0.2 \times 1.2 = 0.24$

$X = 15.5 – 0.24$

$X = 15.26\%$

Discount is 15.26% of ₦375,500,000 = ₦57,301,300

	₦
Contract Value	375,500,000
Less: Discount	(57,301,300)
Assessable Value of Gas sold	318,198,700

(b) Tax Incentives for the Utilisation of Associated Gas (Downstream Operation)

i. They are subject to the provisions of the Companies Income Tax Act.
ii. In cases of integrated oil and gas project, all expenditure pertaining to the integrated oil and gas project would be chargeable under the Petroleum Profits Tax Act.
iii. Accelerated capital allowances after the tax free period of 90% annual allowance with 10% retention for investment in plant and machinery.
iv. An initial tax-free period of three years which may be renewed for an additional period of three years subject to satisfactory performance of the business.
v. Gas transferred from the NGL to the Gas-to-Liquids facilities are to be at 0% PPT and 0% royalty.
vi. An Investment Tax allowance of 15%, which shall not reduce the value of the Asset is granted.
vii. Interest on loans for gas project is to be deductible provided that prior approval is obtained from the Ministry of Finance before taking the loan.
viii. Investment required to separate oil and gas from the reservoir into useable products shall be considered as part of the oil field development.
ix. All capital investment relating to the gas to liquid facilities shall be treated as Chargeable Capital Allowance and recovered against the crude oil income.
x. Tax free dividend during the tax-free period where the Investment for the business is in foreign exchange. The introduction of imported plant and machinery during the period must not be less than 30% of the equity Share Capital of the Company. The tax free period of a company

shall start on the day the company commences production as certified by the Ministry of Petroleum Resources.

xi. Increase in Investment Capital Allowance from 5% to 15%.

EXAMINER'S REPORT

This question tests candidates' knowledge and understanding of aspects of the provisions of the Petroleum Profits Tax Act, relating to concepts in the Gas Sector such as Load Factor and G-Factor, as well as the relevance of a Discount in the computation of the Value of Gas sold by any organisation operating in the Oil and Gas sector.

About 40% of the candidates attempted the question and performance was fair.

The commonest pitfall observed was the inability of a good number of the candidates to determine the percentage of discount granted in the process of evaluating the Value of Gas sold.

Candidates are advised to prepare better for future diets by making better use of the Institute's Study Texts as well as other relevant text materials.

MARKING GUIDE

			MARKS	MARKS
A	i	Explanation of reason for load factor on consignee certificate	3	
	ii	Identification of F-Factor	1	
	iii	Determination of Chargeable National Gas	<u>2</u>	6
	iv	Contract I:		
		Stating the correct equation for the G-Factor	1.5	
		Stating the correct calculation of percentage	1	
		Stating the correct amount of discount	1	
		Demonstrating the Assessable value of Gas sold	<u>1</u>	
				4.5
		Contract II:		
		Stating the correct equation for the G-Factor	1.5	
		Stating the correct calculation of percentage	1	
		Stating the correct amount of discount	1	
		Assessable value of Gas sold	<u>1</u>	
		Any five incentives listed		4.5
				<u>5.0</u>
				<u>20</u>

b

i. The explanation on the reason for load factor has there elements:
- The actual value of gas lifted is not easily ascertained
- Loss due to spillage and evaporation
- A relief in form of discount which depends on the quality of the

gas, defined by load factor

ii. G-Factor per centum in between the table given is calculated on pro-rata basis

i.e.

$$\frac{Upper\ \ load\ \ factor\ -the\ given\ \ load\ \ factor}{Upper\ \ load\ \ factor\ -the\ lower\ \ load\ \ factor\ \ on\ the\ table} = \frac{Upper\ \ G-Factor\ \ \%\ X}{Upper\ \ G-Factor\ \ \%\ Lower\ \ G-Factor}$$

X – represents the G-Factor Percentum

SOLUTION 3

GLOBAL COMPANY LIMITED
COMPUTATION OF HIRE PURCHASE INTEREST

	₦
Hire Purchase Price:	
- Deposit 1/3/2013	32,000,000
- 25 monthly instalments payable at ₦1,200,000 each	30,000,000
	62,000,000
Cash Price	(55,000,000)
Purchase interest for 25 months	7,000,000
Interest per Instalment $= \frac{7,000,000}{25} =$	280,000

a(i)

GLOBAL COMPANY LIMITED
COMPUTATION OF CAPITAL GAINS TAX
FOR ASSESSMENT YEAR 2014

(SALE OF EXCAVATOR ON 1/1/2014)

	₦	₦	₦
Sale proceeds of Excavator			65,000,000
Cost of Excavator:			
Deposit paid on March 1, 2013		32,000,000	
Instalments paid:			
(10 months at ₦1,200,000 each)	12,000,000		
Interest Portion (W1)	(2,800,000)	9,200,000	(41,200,000)
Chargeable Gain			23,800,000
Capital Gains Tax thereon at 10%			₦2,380,000

GLOBAL COMPANY LIMITED
COMPUTATION OF CAPITAL GAINS TAX
FOR ASSESSMENT YEAR 2014
(SALE OF EXCAVATOR ON 1/11/2014)

	₦	₦	₦
Sale proceeds of Excavator			69,000,000
Cost of Excavator:			
Deposit paid on March 1, 2013		32,000,000	
Instalments paid (20 months at ₦1,200,000 each)	24,000,000		
Interest Portion (W2)	(5,600,000)	18,400,000	(50,400,000)
Chargeable Gain			18,600,000
Capital Gains Tax thereon at 10%		=	₦1,860,000

WORKINGS

W1) **Calculation of Hire Purchase Interest Up to 1/1/2014**

Number of months covered by the agreement	-	25 months
Number of months covered up to 1/1/2014	-	10 months
Share of Hire Purchase interest		
$^{10}/_{25}$ x ₦7,000,000	=	₦2,800,000

W2) **Calculation of Hire Purchase Interest Up to 1/11/2014**

Number of months covered by the agreement	-	25 months
Number of months covered up to 1/11/2014	-	20 months
Share of Hire Purchase interest		
$^{20}/_{25}$ x ₦7,000,000	=	₦5,600,000

3ii) **Comments:**

- Sums allowable as deductions in computing the profits or losses of a trade for income tax purposes are not allowable deductions in Capital Gains Tax computation.
- The management of the company will pay a higher Capital Gains Tax if the property was sold on January 1, 2014, as shown in the computations above.

Where Property, Plant and Equipment are purchased under hire-purchase t terms, the cost for tax purposes is the Cash Price of the asset. The hire-purchase charges which represent the interest charges are allowable deductions under Section 20 of CITA, in arriving at the assessable profits.

3b) **Allowable deductions under Capital Gains Tax are:**

(i) Cost of acquisition or purchase price including all costs incidental to the purchase;

(ii) Improvement cost wholly, necessarily, exclusively and reasonably incurred;

(iii) Cost wholly, reasonably, exclusively and necessarily incurred in establishing, preserving or defending the owner's title to or a right over the asset; and

(iv) Incidental costs of disposal:

- Fees, commissions or remuneration, paid for professional services of surveyors or valuers, auctioneers, accountants, agents and or legal advisers;
- Cost of transfer or conveyance (including stamp duty);
- Advertisement cost to find a seller / buyer; and
- Cost reasonably incurred in making any valuation or apportionment required for the purpose of computing the capital gains including expenses in ascertaining market value where required.

EXAMINER'S REPORT

The question tests candidates' knowledge of the computation of Capital Gains Tax resulting from Hire Purchase transactions.

About 90% of the candidates attempted the question and performance was good.

The commonest pitfall was lack of clear understanding of the implication of Hire Purchase interest in the computation of Capital Gains.

Candidates are advised to be familiar with unusual scenarios when preparing for future examinations.

MARKING GUIDE

		Marks	Marks
a.	i. <u>Option I:</u>		
	Identification of the Sales price	1	
	Identification of the Deposit	1	
	Identification of interest paid	1.5	
	Identification of interest element	1.5	
	Calculation of Capital Gains Tax	<u>2</u>	
			7
	<u>Option II</u>:		
	Identification of Sales price	1	
	Identification of the deposit	1	
	Calculation of the full instalment	1.5	
	Identification of interest element	1.5	
	Calculation of Capital Gains Tax	<u>2</u>	
			7
	ii. Explanation of the implication of hire purchase interest on Capital Gains Tax computation		2
b.	Any four allowable deductions		<u>4</u>
			<u>20</u>

SOLUTION 4

(a) **Incentives to Attract Prospective Investors (Solid Minerals Sector):**

i. 3 to 5 years tax holiday;
ii. Deferred royalty payments depending on the magnitude of the investment and strategic nature of the project;
iii. Possible capitalization of expenditure on exploration and surveys;
iv. Provision of 100% foreign ownership of mining companies or concerns; and
v. In addition to roll-over relief, under the Capital Gains Tax (CGT), companies replacing their plants and machinery are to enjoy a once-and-for-all 95% Capital Allowance in the first year with 5% retention value until the asset is disposed of.

(b) i. Tax Havens are states, countries or territories where certain taxes such as Inheritance, Income or Capital Gains are levied at a low rate or none at all. Individual or Corporate entities can find it attractive to establish small subsidiaries or move themselves to such areas with reduced or nil taxation levels relative to international taxation.

ii. **Factors to be considered (Jurisdiction as Tax Havens):**
Nil or only nominal taxes: They are seen as places to be used by non-residents to escape high taxes in their home jurisdiction.

Protection of Personal Financial Information: Laws are put in place such that individuals and businesses can benefit from strict rules and protection against scrutiny by foreign tax authorities. Information about such people cannot be shared with their home countries.

Lack of Transparency: This can be in form of legal, legislative or administrative machinery. It also involves secret rulings, negotiated tax rates or other practices that are not transparent in operation.

iii. Examples of Tax Havens include:
- Switzerland;
- Luxembourg;
- Netherlands;
- Jersey;
- Isle of Man;
- Bermuda;
- Cayman Islands;
- Delaware (U.S.A);
- Puerto Rico (U.S.A); and
- British Virgin Island

(c) **Particulars to be contained in a Notice of Appeal include:**

i. The official number of the assessment, the date and the year for which it was made;
ii. The amount of total profits on which the tax was charged;
iii. The amount of the tax charged;
iv. The date of service of Notice of Refusal by the Revenue Service to amend the assessment;
v. The precise grounds of appeal against the assessment which must be the same as the grounds stated in the Notice of Objection; and
vi. Address for service of any notice, correspondence or other documents to be given to the appellant by the Secretary to the Appeal Commissioners.

EXAMINER'S REPORT

The question tests candidates' understanding of incentives put in place for solid mineral sectors development, the concept of tax havens and appeal against assessment.

Only about 60% of the candidate attempted the question and performance was very poor.

Many of the candidates who attempted the questions displayed a lack of proper understanding of the concept of Tax Havens, as well as countries that are so classified.

Candidates are advised to be more thorough in their preparations for future examinations by reading ICAN Study Texts and other relevant study materials.

MARKING GUIDE

SOLUTION 4			**MARKS**	**TOTAL MARKS**
(a)	Identifying each correct incentive – 1 mark each			5
(b)	i.	Explanation of Tax Havens with reference to <u>State</u>, <u>Country</u> or <u>Territory</u> and the taxes involved	3	
		Options for individual/Corporate entities	<u>1</u>	4
	ii.	Identifying the three correct factors – 1 mark each		3
	iii.	Identifying the five correct countries that are Tax Havens - 1 mark each		5
(c)		Identifying the three correct particulars – 1 mark each		<u>3</u>
				<u>20</u>

SOLUTION 5

MGBORIE GROUP LIMITED

a) Significance of Transfer Pricing

The price charged for goods or services supplied or transferred by one sub-unit of an organisation to another sub-unit or one member of a group to another can be referred to as a transfer price.

Transfer prices at which goods and services are transferred between entities are significant for both taxpayers and tax authorities. This is so because they impact on the income and expenses as well as taxable profits of related companies in different tax jurisdictions in which the enterprise and multinationals operate.

Many companies are interested in maximizing their head office profits, hence, they may adopt transfer pricing mechanism which can boost the head office profits to the detriment of the associated or subsidiary companies which operate in other tax jurisdictions.

Since associated enterprises transact business between themselves, considerations other than market conditions sometimes dictate the prices at which goods and services are transferred within the group. This could result in the shifting of profit from the tax jurisdictions in which they arise to jurisdictions which are more convenient and beneficial to the group head office or subsidiaries.

b) Objectives of the Income Tax (Transfer Pricing) Regulation Act of 2012

The objectives are to;

i. Ensure that Nigeria is able to tax on an appropriate taxable basis corresponding to the economic activities deployed by taxable persons in Nigeria including their transactions and dealings with associated enterprises;

ii. Provide the Nigerian authorities with the tools to fight tax evasion through over or under pricing of controlled transactions between associated enterprises;

iii. Provide a level playing field between multinational enterprises and independent enterprises doing business within Nigeria; and

iv. Provide taxable persons with the certainty of transfer pricing treatment in Nigeria.

c) Contents of the Transfer Pricing Disclosure and Submission Forms to FIRS

These are particulars of:

i. Reporting Company or Entity;
ii. Immediate Parent Companies;
iii. Directors of Reporting Companies;
iv. Major Shareholders of Reporting Companies and Related Parties;
v. Ownership structure of Reporting Entity and Related Parties;
vi. Subsidiary and other Connected Persons;
vii. External Auditors of Reporting Entity;
viii. Tax Consultant of the Reporting Entity;
ix. Company Secretary of the Reporting Entity; and
x. The person making the declaration.

d) Transfer Pricing Methods. These are:

i. Comparable Uncontrolled Price Method (CUPM)

This method compares the price charged for transactions between associated enterprises (related parties), with prices charged for similar transactions between independent enterprises (unrelated parties), in comparable circumstances. If there is any difference between the two prices, this might be an indication that the transactions between the associated enterprises are not made at arm's length.

ii. **Resale Price Method (RPM)**

The resale price method begins with the resale price to an independent enterprise of a product purchased from an associated enterprise and a gross margin is then deducted from this resale price.

An enterprise's gross margin may be determined by reference to the gross margin that it usually earns in comparable transactions with independent parties (internal comparable), or by reference to the gross margin earned by independent enterprises in comparable transactions (external comparable) within the industry.

iii. **Cost-Plus Method (CPM)**

Under this method, the costs incurred by the supplier in making the product transferred or services provided to an associated enterprise are ascertained and marked-up.

An appropriate mark-up may be determined by reference to the mark-up that the same supplier earns in comparable transactions with independent enterprises (internal comparable) or by reference to the mark-up earned in comparable transactions by independent enterprises (external comparable).

iv. **Profit Split Method (PSM)**

Here, the first step is to determine the combined profit that arises from a business transaction in which the associated enterprises are engaged.

This profit is then split between the associated enterprises in a manner that reflects the division of profit that would have been expected between independent enterprises.

The combined profit or loss attributed to the transactions in which the associated enterprises participated is allocated to the associated enterprises in proportion to their respective contributions to the combined operating profit or loss.

v. **Transactional Net Margin Method (TNMM)**

Under this method, the net profit margin that an enterprise earns from transactions with an associated enterprise is compared with the net profit margin earned in comparable transactions with an independent enterprise.

An appropriate net margin may be determined by reference to the net margin that the enterprise earns in comparable transactions with independent enterprises (internal comparable), or by reference to the net margin earned in comparable transactions by independent enterprises (external comparable).

EXAMINER'S REPORT

The question was designed to test candidates' understanding of the concept of Transfer Pricing.

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

The commonest pitfall was candidates' display of very poor understanding of the concept and objective of Transfer Pricing as well as that of the contents of the Disclosure and Submission Forms.

Candidates are advised to use the Institute's Pathfinder as well as other relevant Study Texts in their preparations for future examinations.

MARKING GUIDE

SOLUTION 5		**TOTAL MARKS**
a.	Identifying each correct significance - 1 mark	2
b.	Identifying each of any 2 correct objectives – 1 mark each	2
c.	Identifying each of any 5 correct contents – 1 mark each	5
d.	Identifying each of any 3 correct TPM – 2 marks each	6
		15

SOLUTION 6

a) i) **Thin Capitalization**

This is when a company's capital is made up of a much greater proportion of debt than equity, that is, its gearing or leverage is too high. This is perceived to create problems for two classes of people:

Creditors (Payables)

Creditors bear the solvency risk of the company which has to repay the bulk of its capital with interest.

Tax authorities

Tax authorities that are concerned about abuse in the use of excessive interest deductions.

Credit risk

In almost all jurisdictions, there are certain types of regulated entities which require a certain amount, or a certain proportion, of paid – up capital before being licensed to trade. The most common examples of this are banks and insurance companies. If such companies were to fail or go into liquidation, the economic effect of such failures can lead to a domino effect, which can have catastrophic consequences for other businesses and ultimately, regional economies.

Tax Issues

Even where countries' corporate laws permit companies to be thinly capitalized, tax authorities in those countries will often limit the amount that a company can claim as tax deduction on interest.

Some tax authorities limit the applicability of this capitalization rules to corporate groups with foreign entities to avoid "tax leakage" to other jurisdictions.

ii) Non – tax Factors

Once an investor has determined the business structure of his/her investment, he or she will start the process of identifying a jurisdiction with the infrastructure that will optimally attain his/her objectives.

The more important non-tax factors include:

- Economic and political stability ;
- Adequate physical, business, accounting and legal infrastructure ;
- The absence (or limited presence) of bureaucratic obstacles ;
- Adequate communication channels ;
- Ability to negotiate profit freely;
- Effective banking system ; and
- The availability of an adequate dispute resolution mechanism.

b. (i) Saladine Manufacturing Company Limited

Assessment Year 2016	₦
Total Profit	425,000
Company Income Tax Liabilities at 30%	127,500

ABC Foods Limited

Assessment Year 2016	₦
Total Profit	365,000
Company Income Tax Liabilities at 20%	73,000

Zenith Nigeria Limited

Assessment Year 2016	₦
Total Profit	411,000
Company Income Tax Liabilities at 30%	123,300

(ii) Under the Small Business Rate of Tax

A Nigerian Company will be assessable to tax at a rate of 20% of the Total Profit for the first five years of assessment and may be extended by two years, where the company shows evidence of good records and management and still remains in the sector for which the rate is granted.

The conditions are:

- The company must be engaged in manufacturing, Agricultural Production, Mining Solid Minerals or wholly export trade.
- The Turnover (Revenue) is less than ₦1,000,000

Saladine Manufacturing Company Limited
The prescribed period of 5 years of assessment and a possible extension of 2 years have lapsed, hence, the company is to be assessed to tax at the normal rate of 30%.

ABC Foods Limited
The company fulfils all conditions to be granted, the small companies rate of 20% as it is still within 5 years of assessment.

Zenith Nigeria Limited

The company does not fall within the prescribed conditions, hence, it is assessed to tax at the normal rate of 30%

EXAMINER'S REPORT

The question tests candidates' understanding of Tax Planning as well as the incentives for small businesses.

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

The commonest pitfall was the clear manifestation of a lack of understanding of the Non-Tax factors that may attract investors to an economy as well as the nature of Incentives available for small scale enterprises.

Candidates are advised to be more painstaking in their preparations for future examinations.

MARKING GUIDE

		MARKS	TOTAL MARKS
a(i)	Identifying a company is thinly capitalised	1	
	Identifying how does it reflect on the Gearing Ratio	1	
	Identifying effect on creditors	1	
	Identifying effect on Tax Authorities	1	
			4
(ii)	Identifying each of the factors ½ mark for any correct 6 factors		3
b(i)	Correct computation		
	- 1st company	1	
	- 2nd Company	1	
	- 3rd Company	1	
			3
(ii)	Explanation of the Small Business Rate of Tax	2	
	Explanation of each of the three companies rate	3	
			5
			15

SOLUTION 7

a. According to Section 13, sub-section 1 of the Petroleum Profits Tax Act of 2004, items specifically disallowed in ascertaining the Adjusted Profit of an accounting period are:

i. Any disbursement or expenditure not, wholly/exclusively made for petroleum operations purposes;
ii. Capital withdrawn or any sum employed or intended to be employed as capital;
iii. Capital employed for improvements as distinct from repairs;
iv. Any sum recoverable under an insurance or contracts of indemnity;
v. Rent of or cost of repairs to any premises or part of premises not incurred for petroleum operations;
vi. Any amount incurred as income tax, Profit tax or other similar taxes, whether charged within or outside Nigeria;
vii. Depreciation of any kind;
viii. Payments to any unapproved provident, savings, widows' orphanages or other society, scheme or fund;
ix. Custom duties on goods (including articles or any other thing) imported by the company:
    - For resale or for personal consumption of employees of the company, or
    - Where goods of the same quality as those so imported are produced in Nigeria and are available – at the time the imported goods were ordered by the company for sale to the public at prices that are less than or the same as the cost, to the company, of the ones imported.
x. Any expenditure for the purchase of information relating to the existence and quantum of petroleum deposits.

b. i. The term "Memorandum of Understanding" (MOU) as it applies to the computation of Petroleum Profits Tax, means an agreement entered into by the Federal Government of Nigeria with Oil Producing Companies, granting certain incentives for the following objectives:

- Enhancing Crude Oil Exports;
- Encouraging investment in exploration and development activities;
- Encouraging investments in the area of enhanced oil recovery projects;
- Encouraging increased lifting and sale of NNPC's Equity Crude; and

- Effectively reducing the tax impact on companies engaged in petroleum operations.

ii. Highlights of Year 2000 Memorandum of Understanding (MOU) are:

- The Guarantee of oil companies of a profit margin, irrespective of actual market prices of crude oil;
- A minimum guaranteed margin of $2.50 per barrel (after tax and royalty) to the oil company on its equity crude;
- A minimum guaranteed margin of $1.25 per barrel on NNPC Crude which the company lifts and sells.
- National Technical Cost is now set at $4.00 per barrel; and
- Where actual Capital Investment Cost (T2) as defined is in excess of $2.00 per barrel on average, then the minimum guaranteed National Margin shall be increased to $2.70 per barrel for the company's equity crude Lifted and $1.35 per barrel for NNPC equity crude Lifted.

EXAMINER'S REPORT

The question tests candidates' knowledge of the concept of Memorandum of Understanding as it relates to the Petroleum Industry.

About 60% of the candidates attempted the question and performance was average. Candidates should prepare better for future examinations.

The major pitfall was the inability to understand the terms MOU.

MARKING GUIDE

SOLUTION 7		**MARKS**	**TORAL MARKS**
a.	Identifying each of any eight (8) correct disallowed Item – 1 mark each		8
b. i.	Correct description of MOU as it applies to Petroleum Profit Tax Computation	1	
	vii. Any correct two (2) incentives	<u>2</u>	3
ii.	Identifying each of any four (4) correct highlights of the Year 2000 MOU @ 1 mark each	4	<u>4</u>
			<u>15</u>

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2017

STRATEGIC FINANCIAL MANAGEMENT

Time Allowed: 3 hours

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

K Plc., a listed company based in Warri, Delta state, has been involved in producing boats (but excluding the engines). The company is now considering diversifying into the production of a major component of outboard engine. For this purpose, the company has recently purchased the patent rights for ₦15million to produce the component.

K Plc. has spent ₦20million developing prototypes of the component and undertaking market studies. The research studies came to the conclusion that the component will have a significant commercial potential for a period of five years, after which, newer components would come into the market and the sales revenue from the component would virtually fall to zero. The research studies have also found that in the first two years (the development phase), there will be considerable training and development costs and fewer components will be produced and sold. However, sales revenue is expected to grow rapidly in the following three years (the commercial phase).

It is estimated that in the first year, the selling price would be ₦2,000 per component, the variable costs would be ₦800 per component and the total direct fixed costs would be ₦6,000,000. Thereafter, while the selling price is expected to increase by 8% per year, the variable and fixed costs are expected to increase by 5% per year for the next four years. Training and development costs are expected to be 120% of variable costs in the first year, 40% in the second year, and 10% in each of the following three years.

The estimated average number of outboard engine components produced and sold per year is given below:

Year	1	2	3	4	5
Units produced and sold	15,000	40,000	100,000	120,000	190,000

Machinery, costing ₦480,000,000, will need to be installed prior to commencement of the component production. K Plc. has enough space in its factory to manufacture the components and therefore will incur no additional rental costs. Tax allowable depreciation is available on the machinery at 10% on straight-line basis. The machinery is expected to be sold for ₦160,000,000 at the end of year 5. The company makes sufficient profits from its other activities to take advantage of any tax loss relief available from this project.

Initially, K Plc. will require additional working capital for the project of 20% of the first year's sales revenue. Thereafter, every ₦1 increase in sales revenue will require a 10% increase in working capital.

Although this would be a major undertaking for the company, it is confident that it can raise the finance required for the machinery and the first year's working capital. The financing will be through a mixture of a rights issue and a bank loan, in the same proportion as the market values of current equity and debt capital. Any annual increase in working capital after the first year, will be financed by internally generated funds.

Marine Engineers (ME) Plc. is a listed company involved in the manufacture of outboard engine components for many years.

Additional data

Extracts from Statement of Financial Position:

	K Plc.	**ME Plc.**
	₦'m	**₦'m**
Non-current assets	1,344	1,668
Working capital	296	628
6% Bank loan	624	-
5% Loan notes (2020 – 2022)	-	368
Share capital - ₦0.50 per share	208	-
- ₦1.00 per share	-	500
Reserves	808	1,428
Current market value per share (₦)	3.50	3.00
Quoted beta	1.3	1.8

The loan notes of ME Plc. are quoted at ₦102 per ₦100

Other data

Tax rate applicable to K Plc. and ME Plc.: 20%
It can be assumed that tax is payable in the same year as the profits on which it is charged.

Estimated risk-free rate of return : 3%
Historic equity market risk premium : 6%

Required:

a. Given the information on ME Plc. and the project financing mix, including any other relevant information, calculate the project specific cost of capital. (5 Marks)

b. Assess whether K Plc. should undertake the project of developing and commercialising the major component of outboard engine, assuming a discount rate of 12% as being applicable for the assessment, irrespective of your calculations in (a) above. (22 Marks)

c. State any **THREE** relevant assumptions made for your calculations in (a) and (b) above. (3 Marks)

(Total 30 Marks)

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

QUESTION 2

LL Plc. is a large engineering company. Its ordinary shares are quoted on the Stock Exchange.

LL Plc.'s Board is concerned that the company's gearing level is too high and that this is having a detrimental impact on its market capitalisation. As a result, the Board is considering a restructuring of LL Plc. long term funds, details of which are shown here as at 28 February, 2017:

	Total par value ₦m	Market value
Ordinary share capital (50k)	67.5	₦2.65/share ex-div
7% Preference share capital (₦1)	60.0	₦1.44/share ex div
4% Redeemable debentures (₦100)	45.0	₦90% ex-int

The debentures are redeemable in 2022. LL Plc.'s earnings for the year to 28 February, 2017 were ₦32.4 million and are expected to remain at this level for the foreseeable future. Retained earnings, as at 28 February, 2017 was ₦73.2 million.

The Board is considering a 1 for 9 rights issue of ordinary shares and this additional funding would be used to redeem 60% of LL Plc.'s redeemable debentures at par. However, some of LL Plc.'s directors are concerned that this issue of extra ordinary shares will cause the company's ordinary share price and its earnings per share (EPS) to fall by an excessive amount, to the detriment of LL Plc.'s shareholders. Accordingly, they are arguing that the rights issue should be designed so that the EPS is not diluted by more than 5%.

The Directors wish to assume that the income tax rate will be 21% for the foreseeable future and the tax will be payable in the same year as the cash flows to which it relates.

Required:

a. i. Calculate LL Plc.'s gearing ratio using both book and market values (5 Marks)

ii. Discuss, with reference to relevant theories, why LL Plc.'s Board might have concerns over the level of gearing and its impact on LL Plc.'s market capitalisation. (6 Marks)

b. Assuming that a 1 for 9 rights issue goes ahead, calculate the theoretical ex-rights price of LL Plc.'s ordinary share and the value of a right. (3 Marks)

c. Discuss the Directors' view that the rights issue will cause the share price and the EPS to fall by an excessive amount, to the detriment of LL Plc.'s ordinary shareholders. Your discussion should be supported by relevant calculations. (6 Marks)

(Total 20 Marks)

QUESTION 3

LA Ltd., a food packaging company, has operated as a private company for the past 10 years. The company has been growing rapidly over the last few years. The Directors are now considering listing the company on the stock market. Preparatory to this, the Directors are interested in determining a fair price per share for the company. Assume today is November 1, 2016.

The following information has been extracted from the most recent audited financial statements of LA Ltd:

Statement of Profit or Loss, October 31, 2016:

	₦million
Sales revenue	15,790
Costs of sales	(13,514)
EBITDA	2,276
Depreciation	(440)
EBIT	1,836
Interest expense	(330)
Earnings before tax	1,506
Tax at 30%	(452)
Profit after tax	1,054

Statement of Financial Position as at October 31:

	2016	2015
	₦m	₦m
Non-current assets	6,224	5,942
Current Assets		
Cash and bank	476	542
Account receivables	1,072	980
Inventory	2,542	2,078
Total Current Assets	4,090	3,600
Total Assets	10,314	9,542
Equity and Liabilities		
Non-current liabilities (Bonds)	2,400	2,500
Current Liabilities		
Short-term loans	1,936	1,432
Account payables	3,084	2,792
Total current liabilities	5,020	4,224
Equity	2,894	2,818
Total Equity and Liabilities	10,314	9,542

The following additional facts are available:

- The Directors believe that the free cash flow to equity model should provide appropriate valuation for the company's shares.

- An investment banker has provided the following estimates of cost of capital:
  - Cost of equity 15%
  - Post-tax cost of debt 4%
  - WACC 12.5%
- The Directors believe that the free cash flow to equity will grow by 18% for the next 5 years and by 5% thereafter.
- The company currently has 600 million shares in issue.

Required:

a. Calculate the free cash flow available to equity for the year ended October 31, 2016. (7 Marks)

b. Use Free Cash Flow to Equity model to calculate the current value per share. (5 Marks)

c. What are the key advantages and disadvantages of stock exchange listing? (8 Marks)

(Total 20 Marks)

QUESTION 4

You are a financial consultant to a major company based in Kano. The company plans to build a major warehouse in Abuja. You plan to convince the company's manager to raise the needed funds through a convertible bond issue. Based on the company's current bond rating of BBB, you have projected the following offer terms:

Maturity:	6 years
Annual coupon:	1%
Conversion ratio:	50 shares
Par value per bond:	₦1,000
Issue price:	98% of par value
Current stock price:	₦16
Risk-free rate:	0.5%
Coupon on straight bonds:	2% (trading at par)

The proposal suggests raising up to ₦20,000,000. However, with key financial ratios close to the boundaries of the rating category, offering the full amount could threaten the BBB rating. Given an average business risk profile, the following rating guidelines apply:

Rating Category	Minimum interest cover	Default spread
BBB	2.39	0.5%
BBB –	2.04	1.0%

Selected financial data about the company:

Estimated EBIT	₦2,200,000
Current Interest Expenses	₦800,000

Required:

a. i. Determine the value of the convertible bond offer (5 Marks)

ii. Discuss why the convertible bond cannot generally be considered as 'cheap debt' despite its low coupon, given its financing advantage quantified in economic terms. (3 Marks)

b. i. Compute the company's current interest coverage ratio. (1 Mark)

ii. How much money should be raised with the convertible bond issue (in thousands of naira in order to avoid the threat of a rating downgrade, based on the quoted rating guidelines? (4 Marks)

c. Advise the company on the advantages of convertible bond for companies on one hand and for investors on the other hand. (7 Marks)

(Total 20 Marks)

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

QUESTION 5

In each of the following situations, identify the stakeholders that could be involved in potential conflicts:

a. A large conglomerate 'spinning off' its divisions by selling them or setting them up as separate companies. (5 Marks)

b. A private company converting into a public company. (5 Marks)

c. Japanese car manufacturer building new plants in other countries. (5 Marks)

(Total 15 Marks)

QUESTION 6

Large Plc. (LP) wishes to borrow ₦200 million for five years to finance the purchase of new non-current assets. The preference of the company's Directors is that these funds are borrowed at a fixed rate of interest. The company's long-term debt is currently rated BBB, meaning LP would have to pay 6.5% p.a. for fixed rate borrowing. Alternatively, LP could borrow at a floating rate, i.e. the prime lending rate (PLR) + 2.25% at the present time.

The Directors of LP have recently been informed by its bank that TK Plc. is also currently looking to borrow ₦200 million for five years at floating rate of interest and its AA rating gives it access to floating rate borrowing at PLR + 1.50% per annum. TK Plc. would pay 5.50% per annum for fixed rate borrowing at the present time.

Required:

a. State **FIVE** reasons that a company might have for entering into an interest rate swap. (5 Marks)

b. Show how an interest rate swap could be used to the **equal** benefit of both companies, assuming that the terms of the swap agreement are such that LP's swap payment to TK Plc. is to be 5.5% fixed per annum. (7 Marks)

c. Identify, with a supporting brief explanation, which of the two companies would be disadvantaged, if PLR were to fall consistently within the five-year term of the interest rate swap. (1 Mark)

d. Identify **TWO** risks that both companies will face, should they decide to enter into the interest rate swap agreement. (2 Marks)

(Total 15 Marks)

QUESTION 7

You were recently appointed by a major manufacturing company as the senior accountant at one of the divisions of the company, which is located in Makurdi. You have received the following memorandum from the divisional manager:

"I tried to see you today, but you were busy with the auditors.

I have to go to a meeting at the head office on Friday about the new project. We sent to the head office its projected cash flow figures before you arrived.

Apparently one of the head office finance people has discounted our figures, using a rate which was calculated from the Capital Asset Pricing Model. I do not know why they are discounting the figures, because inflation is predicted to be negligible over the next few years. I think that this is all a ploy to stop us from going ahead with the project and let another division have the cash.

I looked up Capital Asset Pricing Model in a finance book which was lying in your office, but I could not make a head or tail of it, and anyway it all seemed to be about buying shares and nothing about our project.

We always use payback for the smaller projects which we do not have to refer to head office. I am going to argue for it now because the project has a payback of less than five years, which is our normal yardstick.

I am very keen to go ahead with the project because I feel that it will secure the medium-term future of our division.

I will be tied up all day tomorrow, so again I will not be able to see you. Could you please make a few notes for me which I can read on the way on Friday morning?

I want to know how the Capital Asset Pricing Model is supposed to work, plus any other things which you feel I ought to know for the meeting. I do not want to look like a fool or lose the project because they blind me with science.

As you have probably discovered, I do not know much about finance, so please do not use any technical jargon or complicated maths".

Required:

Prepare notes for the divisional manager which provide helpful background for the meeting. **(Total 15 Marks)**

Formulae

Modigliani and Miller Proposition 2 (with tax)

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

Asset Beta

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

Equity Beta

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

Growing Annuity

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

Modified Internal Rate of Return

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

The Black-Scholes Option Pricing Model

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

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

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

The Put Call Parity

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

Binomial Option Pricing

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

$$d = 1/u$$

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

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

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

The Miller-Orr Model

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

Annuity Table

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

Where r = discount rate

n = number of periods

Discount rate (r)

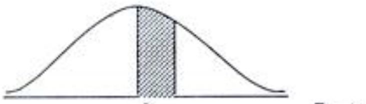
Period

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

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

NORMAL DISTRIBUTION

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



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

SOLUTION 1

(a) For K Plc. the new project is a diversification from boat making into outboard engine components making. We must make use of the asset beta of ME Plc. which is currently producing outboard engine components.

Asset beta – using the leverage of ME Plc.

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

V_E = 500m × ₦3 = ₦1,500m

V_D = ₦368m × 1.02 = ₦375.36m

$\beta_A = \frac{1.8 \times 1,500}{1,500 + 375.36(1-0.2)} + 0$ = 1.5

Equity beta – using the leverage of K Plc.

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

$V_E = \frac{208}{0.5} \times ₦3.50$ = ₦1,456m

$V_D = 624$ (from statement of financial position)

β_E = 1.5 + (1.5 – 0)$\left(\frac{624}{1,456}\right)$(1 – 0.2) = 2.014

Cost of equity = K_E = 3 + 2.014(6) = 15.08%

Weighted Average Cost of Capital (WACC)

WACC = K_o = $\frac{1,456 \times 15.08}{1,456 + 624} + \frac{624 \times 6 \times 0.8}{1,456 + 624}$ = 12%

(b) **Calculation of NPV**

Year	0	1	2	3	4	5
	₦'000	₦'000	₦'000	₦'000	₦'000	₦'000
Sales revenue		30,000	86,400	233,300	302,280	516,990
Variable costs		(12,000)	(33,600)	(88,200)	(111,120)	(184,680)
Fixed costs		(6,000)	(6,300)	(6,615)	(6,946)	(7,293)
Training & development		(14,400)	(13,440)	(8,820)	(11,112)	(18,468)
Cash operating profit		(2,400)	33,060	129,665	173,102	306,549
Tax at 20%		480	(6,612)	(25,933)	(34,620)	(61,310)
Tax savings on depr. (W2)		9,600	9,600	9,600	9,600	25,600
Working capital (W1)	(6,000)	(5,640)	(14,690)	(6,898)	(21,471)	54,699
Machinery	(480,000)	–	–	–	–	160,000
NCF	(486,000)	2,040	21,358	106,434	126,611	485,538
PVF at 12%	1	0.893	0.797	0.712	0.636	0.567
Present value	(486,000)	1,822	17,022	75,781	80,525	275,300

NPV = (₦35,550,000)

RECOMMENDATION

The project is not viable because the NPV is negative. Therefore, it should be rejected.

Working Notes

W1: Incremental WC

Year	1	2	3	4	5
Incremental revenue (₦'000)	-	56,400	146,900	68,980	214,710
Incremental WC (10%) (₦'000)	-	5,640	14,690	6,898	21,471
Year due	-	1	2	3	4

W2: Tax savings on tax allowable depreciation

	Depreciation	Tax savings @ 20%
	₦'000	₦'000
Year 1 10% of ₦480,000	48,000	9,600
2	48,000	9,600
3	48,000	9,600
4	48,000	9,600
	192,000	
Balance = ₦(480,000 – 192,000) =	288,000	
Year 5: Sales proceeds	(160,000)	
Balancing allowance	128,000	25,600

(c) **Assumptions**

(i) In computing both the asset beta and the equity beta, it is assumed that debt is risk-free with beta of 0 (zero).

(ii) Unless where stated otherwise, it is assumed that cash flows occur at the end of the year.

(iii) The patent purchase cost and the market survey costs are past costs and therefore irrelevant.

(vi) The book value of the bank loan is approximately its market value.

EXAMINER'S REPORT

This question tests candidates' knowledge of the computation of cost of capital and appraisal of capital project.

Being a compulsory question, almost all the candidates attempted it. Generally, the performance in the question was disappointing. This is difficult to understand because the scenario is straightforward and well defined in the question.

In part (a), many candidates could not properly differentiate between the given equity beta and the computed asset beta.

In part (b) most of the candidates could not calculate the incremental working capital and the tax savings associated with tax allowable depreciation.

We recommend that candidates presenting themselves for the Institute's future examinations should cover the syllabus comprehensively.

MARKING GUIDE

SOLUTION 1		**MARKS**	**MARKS**
(a)	Asset beta	1.5	
	Equity beta	1.5	
	Cost of equity	0.5	
	After tax cost of debt	0.5	
	WACC	1.0	5.0
(b)	Sales revenue	2.5	
	Variable costs	2.5	
	Fixed costs	1.5	
	Training & Development	2.5	
	Tax @ 20%	2.5	
	Tax savings on depreciation	2.5	
	Working capital	3.0	
	Machinery	0.5	
	Discount factor – 12%	0.5	
	PV/NPV	3.0	
	Assessment	1.0	22.0
(c)	Recommendation (1 mark per valid point – max 3)		3.0
	Total		30.0

SOLUTION 2

a)

i.

Gearing level	Book value		Market value
	₦m		₦m
Ordinary share capital (50k)	67.50	(135m x ₦2.65)	357.75
Retained earnings	73.20		
7% Preference share capital (₦1)	60.00	(60m x ₦1.44)	86.40
4% Redeemable debentures (2022)	45.00	(45m x 0.9)	40.50
Total funds	245.70		484.65
Total geared funds (₦m)	105.00		126.90
Gearing % 1 (Gearing/Total Funds)	42.7%		26.2%
Or			
Gearing % 2 (Gearing/Equity)	74.6%		35.5%

ii. **Traditional view**

Loan finance is cheap because

- It's associated risk is low
- The interest thereon is tax deductible.

This means that as gearing increases, WACC decreases.

Shareholders and lenders are relatively unconcerned about increased risk at lower levels of gearing. As gearing increases, both groups start to be concerned–higher returns are demanded and so WACC increases.

Thus, WACC decreases (value of equity increases) as gearing is introduced. It reaches a minimum and then starts to increase again. This is the optimal level of gearing.

Modigliani and Miller (M&M) view

Shareholders immediately become concerned by the existence of any gearing.

Ignoring taxes, the cost of 'cheap' loan finance is precisely offset by the increasing cost of equity, so WACC remains constant at all levels of gearing. There is no optimal level – managers should not concern themselves with gearing questions. M&M position in 1958 states that

$V_g = V_u$ (where V_g is value of geared company and V_u is value of ungeared company).

Taking taxation into account, interest is cheap enough to cause WACC to fall despite increasing cost of equity. This leads to an all-debt financing conclusion. M&M '63 position: $V_g = V_u + DT$(Tax shield).

Modern view

M&M are probably right that gearing is only beneficial because of tax relief.

At high levels of gearing, an investor worries about the costs of the business going into enforced liquidation ('bankruptcy'). This becomes significant as required returns (both equity and debt) would increase at high levels of gearing.

Conclusion–a business should gear up to a point where the benefits of tax relief are balanced by potential costs of bankruptcy and interest rate increases – here WACC will be at a minimum and value of the business at a maximum.

Presumably, the directors feel that the current level of gearing is beyond the optimum i.e. where the WACC is minimised and the company's value is maximised (perhaps because as an engineering company, its operational risk is very high and gearing adds additional financial risk). Alternatively, they are incorrectly looking at the book value gearing ratio, as the market value ratio doesn't look particularly bad.

							₦m
b)	Value of current ordinary shareholding	135m	x	₦2.65	=		357.750
	Rights issue (135m/9)	15m	x	₦1.80	=		27.000
	Theoretical ex-rights values	150m					384.750

Theoretical ex-rights share price (TERP) (₦384.75m/150m) ₦2.565
Value of a right (₦2.565 – ₦1.800) per new share ₦0.765
OR per existing share = ₦0.765/9 = ₦0.085

c)	Current earnings per share (EPS) = ₦32.4m/135m			=	₦0.240
	Current P/E ratio		₦2.65/₦0.24	=	11.04
					₦m
	Current earnings figure				32.400
	Savings on debenture interest = (₦45m x 60% x 4% x 79%)				0.853
	Adjusted earnings figure				33.253
	New EPS	=	₦33.253m/150m	=	₦0.222
	New P/E ratio (using TERP)	=	₦2.565/₦0.222	=	11.55

The earnings per share figure will fall by 7.5% (from ₦0.240 to ₦0.222).

The proposed rights issue will, as the Board suggests, cause a dilution of the EPS figure as the additional shares issued have a greater negative impact than the interest saved from the debenture redemption. Whilst in theory, (TERP) the market price of LL Plc's ordinary shares will fall, at least initially, it is very difficult to predict what will happen to the market value of the shares in practice.

As gearing reduces, the market may react favourably (i.e. there would be a share price increase). However, based on market values, the gearing level is currently not high (26.2% or 35.5%), and so the market may react negatively (i.e. there would be a share price decrease) if it considers that insufficient use is being made of the tax savings that gearing affords.

EXAMINER'S REPORT

The question tests candidates' knowledge of financial gearing, capital structure theories and basic calculations in rights issue.

More than 50% of the candidates attempted the question, but the level of performance was very low.

The key challenges identified include:

- **The book value of equity often excluded retained earnings.**
- **When calculating the market value, majority of candidates included retained earnings in the equity value.**
- **Several candidates included preference shares as equity.**
- **Some candidates made no reference to the theories of capital structure.**

It is important that students should always prepare adequately for the Institute's future examinations.

MARKING GUIDE

SOLUTION 2			MARKS	MARKS
(a)	i.	Calculation of gearing level using per value	2.0	
		Calculation of gearing level using market value	3.0	5.0
	ii.	Traditional view	2.0	
		Modigliani & Miller's (M & M) view	2.0	
		Modern view	1.0	
		Conclusion	1.0	6.0
(b)		Theoretical ex-rights share price (TERP)	2.0	
		Value of a right per new share	1.0	3.0
(c)		Calculation of current P/E ratio	1.0	
		Calculation of New EPS	2.0	
		Calculation of new P/E ratio (using TERP)	0.5	
		Calculation of the percentage fall in EPS	0.5	
		Discussion	2.0	6.0
		Total		20.0

SOLUTION 3

a) **Calculation of free cash flow to equity (FCFE)**

	₦'m
EBIT	1,836
Less tax at 30%	551
	1,285
Add depreciation	440
	1,725
Less interest, net of tax = ₦330 (1– 0.30) million	(231)
	1,494
Change in working capital (W1)	(264)
Purchase of non-current assets (W2)	(722)
Additional borrowings (W3)	404
FCFE	912

Alternative method

	₦'m
Profit after tax	1,054
Add depreciation	440
Change in working capital	(264)
Purchase of non-current assets	(722)
Additional borrowings	404
FCFE	912

Working Notes

1) **Changes in working capital***

			₦'m
Inventory	₦(2,078 – 2,542)	=	(464)
Receivables	₦(980 – 1,072)	=	(92)
Payables	₦(3,084 – 2,792)	=	292
Changes in working capital			(264)

* This calculation must exclude cash and bank balances. In addition, short-term loans are excluded because they represent financing items.

2) **Purchase of non-current assets**

	₦'m
Closing balance of NBV	6,224
Add depreciation	440
Less: opening NBV	5,942
Purchase of non-current assets	722

3) **Additional borrowings**

	₦'m	₦'m
Opening short-term loan	1,432	-
Opening non-current liabilities	2,500	3,932
Closing short-term loan	1,936	-
Closing non-current liabilities	2,400	4,336
Additional borrowings		404

b. The total market value of equity is given by the present value of FCFE. The appropriate discount rate to use is the cost of equity and **not** the WACC (since we are pricing equity rather than the company as a whole).

				₦'m
Year	1	$₦912m \times 1.18 \times \left(\frac{1}{1.15}\right)$	=	936
	2	$₦912m \times (1.18)^2 \times \left(\frac{1}{1.15}\right)^2$	=	960
	3	$₦912m \times (1.18)^3 \times \left(\frac{1}{1.15}\right)^3$	=	985
	4	$₦912m \times (1.18)^4 \times \left(\frac{1}{1.15}\right)^4$	=	1,011
	5	$₦912m \times (1.18)^5 \times \left(\frac{1}{1.15}\right)^5$	=	1,037
				4,929
	6 – infinity:			
	$\frac{₦912m \times (1.18)^5 \times 1.05}{0.15 - 0.05} \times \left(\frac{1}{1.15}\right)^5$		=	10,892
	Total value of equity			15,821

Note: The present value of FCFE for the first 5 years when the growth rate is 18% per annum could have been calculated using growing annuity as follows:

$$PV = \frac{FCFE_1}{r - g} \times \left[1 - \left(\frac{1+g}{1+r}\right)^n\right]$$

$$= \frac{₦912m(1.18)}{0.15 - 0.18} \times \left[1 - \left(\frac{1.18}{1.15}\right)^5\right] \quad = \quad ₦4,930\text{million}$$

VPS = Total value of equity/number of shares
= ₦15,821 million/600 million = ₦26.37

c. **The advantages of a company obtaining a stock exchange listing include:**

i. **Share transferability:** As mentioned above, shares that are listed on a Stock Exchange can be transferred with ease and this, in turn, should encourage investment.

ii. **Cost of capital:** Shares in listed companies are perceived by investors as being less risky than shares in equivalent unlisted companies because of their marketability. As the risks associated with listed shares are lower, the returns required by investors will also be lower. Hence, the cost of capital for listed companies will be lower.

iii. **Share price:** Shares that are traded on a stock exchange are closely scrutinized by investors, who will take account of all available information when assessing their worth. This results in shares that are efficiently priced, which should give investors confidence when buying or selling shares.

iv. **Company Profile:** Companies listed on a stock exchange have a higher profile among investors, and the wider business community than unlisted companies. This higher profile may help in establishing new contacts or in developing business opportunities.

v. **Credit rating:** A listed company may be viewed by the business community as being more substantial and, therefore, more creditworthy than an equivalent unlisted company. This may help in obtaining loans and credit facilities.

vi. **Business combinations:** A stock exchange listing can facilitate takeovers and mergers. A listed company can use its shares, as a form of bid consideration when proposing a takeover of another company.

Shareholders in a target company will usually be more prepared to accept a share-for-share exchange when the shares offered are marketable and have been efficiently priced. Furthermore, when two companies propose to combine, the shareholders of each company can assess the attractiveness of the proposal more easily if the shares are listed.

The disadvantages of obtaining a stock exchange listing include:

i. **Floatation costs:** The costs of floating a company on a stock exchange can be high. The fees paid to professional advisors, such as lawyers and accountants, as well as under writing fees, often account for a large part of the total cost incurred.

ii. **Regulatory costs:** Once the company is floated, the cost of maintaining a stock exchange listing can be high. An important reason for this is the cost of additional regulatory requirements surrounding listed companies. The regulations of modern stock exchanges require greater transparency between management and owners and this causes some of the additional costs.

iii. **Control:** A company seeking a stock exchange listing must normally ensure that a substantial quantity of its total issued share capital is available to new investors. This means that the existing shareholders may suffer loss of control.

iv. **Investors' expectations:** There is a widely-held view that investors' expectations often put the Directors of companies under pressure to produce gains over the short term. To do this, the Directors may take decisions that have an adverse effect on the long-term profitability of the business. However, the evidence to support this view is flimsy.

v. **Public scrutiny:** Listed companies attract much attention from investors, the financial press and the broadcasting media. Being in the public spot light makes it difficult for a company to engage in controversial activities or to conduct sensitive negotiations. It also makes it difficult for Directors to hide poor decisions.

vi. **Takeover target:** The existence of a ready market for shares in a listed company means that listed company is much more vulnerable to a takeover than an unlisted company. A listed company may be particularly vulnerable when there is a fall in its share price, perhaps caused by disillusionment with the level of returns that are being provided.

EXAMINER'S REPORT

The question tests candidates' knowledge of computing the ratio of Free Cash Flow to Equity (FCFE) and its use in valuation.

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

Key challenges identified include:

- **Confusing FCFE with Free Cash Flow to the Firm (FCFF).**
- **Inability to calculate additional non-current asset acquired during the period.**
- **Exclusion of additional borrowing.**
- **Inclusion of cash and short-term borrowings in changes in working capital.**

Candidates are advised to make comprehensive use of the Institute's Study Text in their preparations for the Institute's future examinations.

MARKING GUIDE

		MARKS	MARKS
(a)	EBIT less interest and tax	1.0	
	Depreciation	1.0	
	Change in working capital	2.0	
	Purchase of non-current assets	1.0	
	Additional borrowings	1.0	
	Free cash flow to equity (FCFE)	1.0	7.0
(b)	Calculation of the PV of FCFE using cost of equity for the first 5 years	3.0	
	Calculation of the PV of FCFE from the 6th year to infinity	1.0	
	Total value of equity	0.5	
	Calculation of value per share (VPS)	0.5	5.0
(c)	Advantages of obtaining stock exchange listing – 1 mark per valid point (max 4)	4.0	
	Disadvantages of obtaining stock exchange listing – 1 mark per valid point (max 4)	4.0	8.0
	Total		20.0

SOLUTION 4

a. i. The value of the convertible bond offer can be calculated by discounting the annual interest payments of ₦10 (1% of ₦1,000) for 6 years and the face value due in year 6. We discount at 2% (the coupon rate) YTM on the straight bond.

Price = 10 (5.601 + 1000 (5.601 – 4.713)

Price = ₦10 (5.601) + ₦1,000 (0.888) = ₦944

ii. This convertible bond, should not be considered as 'cheap' debt because by issuing a convertible bond the firm also sells an equity option to investors. Hence, the convertible bond consists of a debt and an equity component and the relative advantage reflects the value of the equity option.

b. i. Interest coverage before the transaction

$$= \frac{Estimated\ \ EBIT}{Interest\ \ Expenses}$$

$$= ₦\left\{\frac{2{,}200{,}000}{800{,}000}\right\} = 2.75$$

ii. We solve for the amount (rounded to ₦1,000) by which interest expense can rise without affecting the current BBB rating, i.e. at which the interest coverage ratio is 2.39.

$$2.39 = ₦\left\{\frac{2{,}200{,}000}{800{,}000 + x}\right\}$$

where x = maximum additional interest expenses allowed)

2.39 ₦ (800,000 + x) = ₦2,200,000

x = ₦120,502

With an annual coupon of 1% up to ₦12,050,000 (i.e. $\left(\frac{₦120{,}502}{0.01}\right)$ can be raised without threatening the current rating.

c. **Advantages of Convertible bonds to the company include:**

i. **Lower interest rate than on a similar debenture:** The firm can ask investors to accept a lower interest rate on convertibles because the investor values the conversion right.

ii. **The interest is tax deductible:** Because convertible bonds are a form of debt, the interest payment can be regarded as a cost to the business and can therefore be used to reduce taxable profit.

iii. **Self Liquidating:** When the share price reaches a level at which conversion is worthwhile, the bonds will (normally) be exchanged for shares so the company does not have to find cash to pay off the loan principal – it simply issues more shares. This has obvious cash flow benefits. However, the disadvantage is that the other equity holders may experience a reduction in EPS.

iv. **Fewer restrictive covenants:** The directors have greater operating and financial flexibility than they would, with a secured debenture. Investors accept that a convertible bond is a hybrid between debt and equity finance and do not tend to ask for high-level security, impose strong operating restrictions on managerial action or insist on strict financial boundaries.

v. **Underpriced shares:** A company which wishes to raise equity finance over medium term, but judges that the stock market is temporarily underpricing its shares, may turn to convertible bonds (if we do not believe in the efficient market hypothesis). If the firm does perform as the managers expect and the share price rises, the convertible will be exchanged for equity.

Advantages of Convertible Bonds to the Investors include:

i. They are able to wait and see how the share price moves before investing in equity.

ii. In the short term, there is greater security for their principal, compared with equity investment, and the annual coupon (interest) is usually higher than the dividend yield.

iii. Investors receive a minimum annual income up to the conversion date in the form of fixed interest.

iv. In addition, investors in convertible bond, will be able to benefit from a rise in the company's share price, and hope to make an immediate capital gain on conversion.

EXAMINER'S REPORT

The question tests candidates' knowledge of the analysis of convertible bonds.

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

Common mistakes include:

- Inability to identify the relevant cash flows.
- The use of wrong discount rates
- In part (c), failure to distinguish between advantages of convertible bond to the company and to the investors.

We recommend adequate coverage of the syllabus and judicious use of the Institute's Study Text and other relevant texts.

MARKING GUIDE

			MARKS	MARKS
(a)	i.	Calculation of the value of the convertible bond offer	5.0	
	ii.	Discussion	3.0	8.0
(b)	i.	Calculation of interest coverage ratio		1.0
	ii.	Calculation of max. additional interest expenses allowed	3.0	
		Calculation of the amount to be raised	1.0	4.0
(c)		Advantages of convertible bonds to the company		
		– 1 mark per valid point (max 4)	4.0	
		Advantages of convertible bonds to the investors		
		– 1 mark per valid point (max 3)	3.0	7.0
		Total		20.0

SOLUTION 5

(a) **A large conglomerate spinning off its Divisions**

Large conglomerates may sometimes have a market capitalisation which is less than the total realisable value of the subsidiaries ('conglomerate discount'). This arises because more synergy could occur by the combination of the group's businesses with competitors than by running a diversified group where there is no obvious benefit from remaining together.

The stakeholders involved in potential conflicts include.

i. **Shareholders**
They will see the chance of immediate gains in share price if subsidiaries are sold.

ii. **Subsidiary company Directors and employees**
They may either gain opportunities (e.g. if their company becomes independent) or suffer the threat of job loss (e.g. if their company is sold to a competitor).

(b) **A private company converting into a public company**

When a private company converts into a public company, some of the existing shareholders/managers will sell their shares to outside investors. In addition, new shares may be issued. The dilution of ownership might cause loss of control by the existing management.

Stakeholders involved in potential conflicts include:

i. Existing shareholders/managers
They will want to sell some of their shareholding at a price as high as possible. This may motivate them to overstate their company's prospects. Those shareholders/managers who wish to retire from the business may be in conflict with those who wish to stay in control - the latter may oppose the conversion into a public company.

ii. New outside shareholders
Most of these will hold minority stakes in the company and will receive their rewards as dividends only. This may put them in conflict with the existing shareholders who receive dividends. On conversion to a public company, there should be clear policies on dividends and Directors' remuneration.

iii. Employees, including managers who are not shareholders
The success of the company depends partly on the efforts put in by employees.

They may feel that they should benefit when the company goes public. One way of organising this is to create employee share options or other bonus schemes.

iv. **Regulatory agencies**

(c) **Japanese car manufacturer building new car plants in other countries**

The stakeholders involved in potential conflicts include:

i. **The shareholders and management of the Japanese company**
They will be able to gain from the combination of advanced technology with a cheaper workforce.

ii. **Local employees and managers engaged by the Japanese company**
They will gain enhanced skills and better work prospects.

iii. **The government of the local country, representing the tax payers**
The reduction in unemployment will ease the taxpayers' burden and increase the government's popularity (provided that subsidies offered by the government do not outweigh the benefits!).

iv. **Shareholders, managers and employees of local car-making firms**
These will be in conflict with the other stakeholders above as existing manufacturers lose market share.

v. **Employees of car plants based in Japan**
These are likely to lose their jobs if car-making is relocated to lower wage areas. They will need to compete on the basis of higher efficiency.

EXAMINER'S REPORT

This question tests candidates' knowledge of the stakeholders' groups and possible inter-group conflict of interest.

More than 75% of the candidates attempted the question and surprisingly the performance is very disappointing.

Two major mistakes were identified:

- **Generic solutions were produced thereby ignoring the specific scenario of each part of the question.**
- **The same sets of stakeholders were repeated in the three different parts of the question.**

Students are advised to make use of the past editions of the Institute's Pathfinders when preparing for future examinations.

MARKING GUIDE

SOLUTION 5		**MARKS**	**MARKS**
	Stakeholders involved in potential conflicts in respect of the following:		
(a)	Large conglomerate 'spinning off its division'		5.0
(b)	A private company converting into a public company		5.0
(c)	Japanese manufacturing companies building new parts in other countries		5.0
	Total		15.0

SOLUTION 6

(a) **Reasons why a company might enter into an interest rate swap include:**

i. To obtain a lower rate of interest on its preferred type of debt by exploiting the quality spread differential between two counterparties.
ii. To achieve a better match of assets and liabilities
iii. To access interest rate markets that might otherwise be closed to the firm (or only accessible at excessive cost)
iv. To hedge interest rate exposure by converting a floating rate commitment to a fixed rate commitment (or vice versa).
v. To restructure the interest rate profile of existing debts (avoiding new loans/fees)
vi. To speculate on the future course of interest rates
vii. Availability for longer terms than other methods of hedging interest rate exposure

(b) LP has a comparative advantage in floating rate borrowing, whilst TK Plc. has a comparative advantage in fixed rate borrowing – so LP should borrow ₦200 million at PLR + 2.25% whilst TK Plc. should borrow ₦200 million at 5.50%.

The quality spread differential = 1.00% - 0.75% = 0.25% (each company saving 0.125% i.e. 0.25%/2).

LP:

- Pay PLR + 2.25% to lenders
- Pay TK Plc. 5.5%
- Receive from TK Plc. PLR + 1.375%
- Net borrowing cost 6.375% (saving 0.125% on its own fixed rate borrowing).

TK Plc.:

- Pay 5.5% fixed to lenders
- Pay LP PLR + 1.375% toLP
- Receive from LP 5.5%
- Net borrowing cost PLR + 1.375% (saving 0.125% on its own floating rate borrowing cost).

(c) LP will be disadvantaged as it has contracted to make fixed rate payments under the interest rate swap agreement and will, therefore, not see its payments benefit from the reduction in interest rates during the term of the swap agreement.

(d) i. The risk that the other counterparty to the swap agreement will default on their commitment before completion of the swap agreement.

ii. The risk of unfavourable changes in market interest rates after entering into the swap.

iii. Transparency risk, that is, the risk that the impact of swap transaction will undermine the clarity and transparency of the firm's financial statements.

EXAMINER'S REPORT

The question tests candidates' knowledge of the mechanism involved in the Interest Rate Swap.

Less than 30% of the candidates attempted the question. There is evidence that most of the candidates do not have sufficient knowledge of Interest Rate Swap.

Virtually all the candidates who attempted the question could not produce the required elementary calculations in part (b).

We recommend that students should create more time to cover the syllabus adequately.

MARKING GUIDE

SOLUTION 6			MARKS	MARKS
(a)		Reasons - 1 mark per valid point (max 5)		5.0
(b)	-	Amount to be borrowed and the rate (both companies)	2.0	
	-	Quality spread differential (both companies)	1.0	
	-	Transaction details re LP	2.0	
	-	Transaction details re TK	2.0	7.0
(c)		Identification of the company		1.0
(d)		Identification of risks (both companies)		
		1 mark per valid point (max 2)		2.0
		Total		15.0

SOLUTION 7

Notes for the Divisional Manager

Discounting

Discounting of future cash flows is a technique used to place less value on cash flows which are received further into the future. This reflects the fact that our investors would rather receive money now than in the future. This preference for money now, which is known as the time value of money, is increased if there is inflation in the economy, as investors also need to be compensated for the buying power of their money being reduced in the future.

Therefore, the discount rate is a combination of both the time value of money and inflation. Even if inflation is negligible, cash flows still need discounting to reflect the time value of money.

Discount rate/Capital Asset Pricing Model

Finding the correct discount rate can be a difficult exercise and this is where the Capital Asset Pricing Model (CAPM) can be very useful.

The use of CAPM considers the returns paid on shares on the stock market, compared to the risk or variation in returns of those shares. Because investors in general are risk averse, they will expect a higher average return by way of dividends and capital gains to compensate for a higher risk.

The logic then follows that if shareholders can earn a given return on the stock market for a certain level of risk, then any project that may be undertaken must, at least, satisfy that target return.

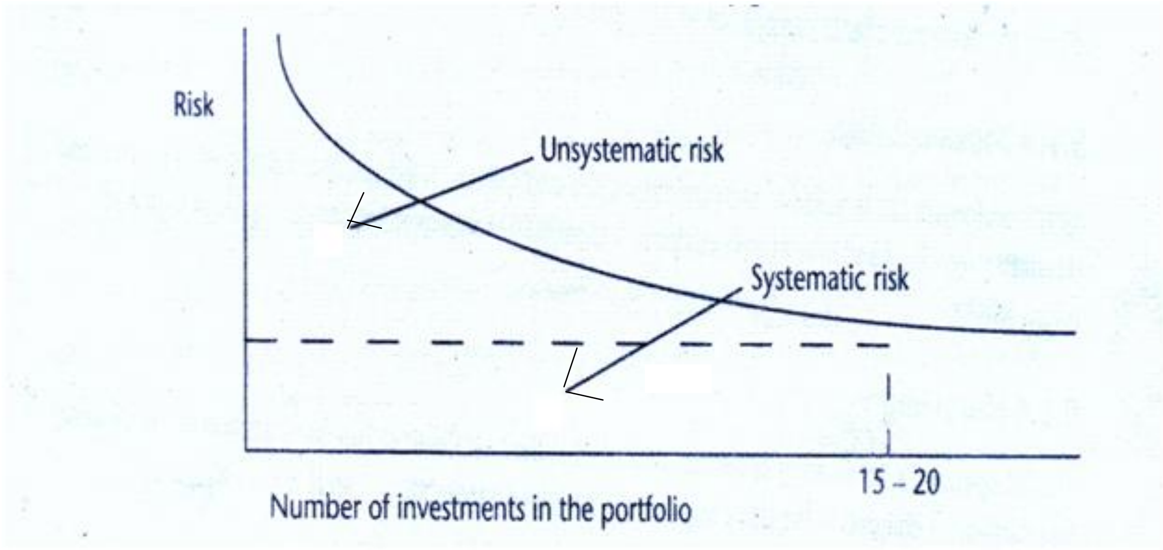
Where CAPM is special, is in the way it considers risk. A company or project looked at on its own may have a very high level of risk. However, if it is added to the shareholders' portfolio of investments, some of the investment risks will be removed or diversified away.

This is because two different causes of the total risk of a company can be identified.

Systematic risk – Due to the economy, such as interest rates, exchange rates, etc. which affect all companies.

Unsystematic risk – Due to events specific to a company, such as new product developments, fires, strikes, etc.

Systematic risk cannot be diversified away; however, the unsystematic risk will cancel out across companies, as bad events in one company are evened out by good events in another.



Therefore as shareholders suffer only systematic risk if they hold a wide-ranging or well-diversified portfolio, a company only needs to pay a return based on that risk.

CAPM measures the systematic risk as a beta. A beta of 1 indicates that the company has the same level of risk as the average of all shares in the stock market, called the market portfolio. A beta of 0.5 would indicate that it has only half the risk of the market portfolio, and therefore does not need to give such a high return.

This can be expressed in the following equation:

Required return $= R_f + \beta(R_m - R_f)$

where R_f = return on risk-free investments such as treasury bills

R_m = average return on the market portfolio.

β = level of risk

Using CAPM to derive a cost of capital to be used in investment decision is entirely logical. Since betas are typically derived from published equity performance, they reflect a market determined risk/return trade off for a particular type of business.

CAPM is only logical where the shareholders are well-diversified.

When using CAPM to derive a discount rate, it is the beta of the project which should be used, rather than that of the company.

Payback

Payback is a good technique in that it uses earlier cash flows which are more certain and useful if a company is short of cash. However, it has the following drawbacks:

i. It ignores the time value of money
ii. It ignores cash flows after the payback period
iii. It does not measure the change in shareholder wealth
iv. Target paybacks are chosen subjectively.

The technique of using discounted cash flows, although more complicated, overcomes all of these problems.

EXAMINER'S REPORT

The question tests candidates' knowledge of some elementary concepts in finance like, discounting, discount rate, CAPM, payback period.

Most of the candidates attempted the question and the performance level was most disappointing.

Most of the candidates could not explain the above elementary terms in a non-technical manner as required by the question.

Students need to improve on their question-answering skills using the Institute's Pathfinders and Study Text as a guide.

MARKING GUIDE

SOLUTION 7	MARKS	MARKS
Discounting – Discussion	3.0	
Discount rate: CAPM discussion	2.0	
- Systematic risk discussion	2.0	
- Unsystematic risk discussion	2.0	
- CAPM formula for calculating required Return	2.0	
Payback – the drawbacks – 1 mark per valid point (max 3)	3.0	
Conclusion	1.0	15.0

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2017

ADVANCED AUDIT AND ASSURANCE

Time Allowed: 3 hours

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

SECTION A: COMPULSORY (30 MARKS)

QUESTION 1

You are Aremu Ana, an Audit Partner at Danda Audit firm who has kept pace with the International Auditing and Assurance Standards Board's (IAASB) new and revised reporting standards which lay the foundation for the future of global auditor's reporting and improved auditor communication.

You have concluded arrangements with the Human Capital Department of the firm to train the firm's audit team which includes trainees, supervisors and managers. The training programme has been fixed to hold in two months' time. You are now preparing notes which will assist to educate the audit team and make them appreciate the new standards.

Required:

Prepare a training briefing note which:

a. Clarifies the intended benefits of the IAASB's new auditor reporting project. (5 Marks)

b. Identifies and describes the different sections of the new auditor's report as required by ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements.* (20 Marks)

c. Explains the term 'Key Audit Matters' (KAM), stating any **TWO** matters an auditor is required to take into account in the determination of KAM in accordance with ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report.* (5 Marks)

(Total 30 Marks)

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

QUESTION 2

Home Care is a charity that provides accommodation for unemployed young people. The constitution of the charity explains how the charity's income could be spent and also contains a requirement that administrative expenditure cannot exceed 10% of income in any year.

The charity's income is mainly derived from voluntary cash donations collected by volunteers from members of the public. Recently, the charity's income has been impacted by the current global economic and financial meltdown.

Required:

a. Describe the term 'audit risk' and explain the **THREE** elements of risk that contribute to total audit risk. (8 Marks)

b. Using the information provided in the question, identify **FOUR** areas of inherent risk to be taken into account in planning the audit of Home Care and explain the effect of each of these risks on the audit approach. (12 Marks)

(Total 20 Marks)

QUESTION 3

Your firm has been external auditors of Specific Processors Plc for some years. Specific Processors Plc. has an Internal Audit Department which is engaged in both compliance and operational auditing within the company. You have a good opinion of the quality of work of the internal auditors and you have established a good relationship with Mr. Lucky Suleiman, FCA, the head of the Internal Audit Department and he has invited you to give a talk to staff of his department during their annual training week. He would like your talk to focus on the roles of external and internal auditors, the type of work they carry out and their specific responsibilities.

Required:

a. Develop a suitable presentation for your talk, paying particular attention to the differences and similarities of the following features of the external and internal auditors:

   i. General role
   ii. Independence
   iii. The work carried out in the following areas

- systems of internal control
- operational auditing

iv. Reporting responsibilities (10 Marks)

b. Explain what evidence you would seek as external auditor to satisfy yourself that you can rely on the work of internal auditors. (4 Marks)

c. Give **THREE** examples of internal audit activity reports that might be used by the external auditor. (6 Marks)

(Total 20 Marks)

QUESTION 4

a. In most cases, the role of the practising accountant is the provision of statutory audit of the annual financial statements of a company. However, the practising accountant may be contracted for assurance engagement other than a statutory audit.

Required:

Explain 'assurance engagement'. (4 Marks)

b. Alhaji Chukwudi is the Chairman and majority shareholder of Talking Drums Limited, a telecommunications company operating in Nigeria. The company had experienced considerable growth in the past. However, over the last three years, there has been noticeable increase in cost of operations which is slowing down the growth of the company. Management had explained that the increasing cost is as a result of expansion of coverage area which management believes will lead to further expansion and growth of the company in the nearest future. Alhaji Chukwudi wants to get a certain level of assurance that there is value for the increased expansion costs the company was incurring. As a result, the Board of Directors resolved to engage a practitioner for a 'value for money' evaluation of the coverage expansion costs.

Required:

i. Explain 'value for money'. (2 Marks)

ii. Explain the 3Es of achieving value for money. (6 Marks)

c. Traditionally, the role of the auditor has focused on providing assurance on 'historical' events, for example on financial statements relating to a period of time in the past. As business and economic environments have changed, demand has grown for practising accountants to provide assurance on prospective financial information (PFI).

Required:

i. Explain 'Prospective Financial Information'. (2 Marks)

ii. State and explain **SIX** procedures you will perform in a PFI assurance engagement on Profit Forecast of a company. (6 Marks)

(Total 20 Marks)

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

QUESTION 5

You are an Audit Manager of Lobito James & Co., a firm of Chartered Accountants. You are aware of some significant changes and new requirements in the Revised ISAs as a result of IAASB Clarity Project issued in October 2008 that are expected to impact on the following audit procedures:

(a) Communicating with those charged with governance (ISA 260).

(b) Materiality in planning and performing an audit (ISA 320).

(c) Audit considerations relating to an entity using a service organisation (ISA 402).

(d) Evaluation of misstatements identified during an audit (ISA 450).

(e) External confirmation (ISA 505).

(f) Auditing accounting estimates, including fair value, accounting estimates and related disclosures (ISA 540).

(g) Related parties (ISA 550).

You are required to:

i. Explain the objective of the IAASB Clarity Project. (1 Mark)

ii. Explain **TWO** new requirements in each of the revised ISAs listed above. (14 Marks)

(Total 15 Marks)

QUESTION 6

You are an Audit Senior in ABC firm of Chartered Accountants, a Pan-African audit firm. You just resumed from your examination leave and received the following email from Mrs. Chidi, an Audit Manager in your firm.

Dear Audu,

Welcome back from leave and best of luck in your examination.

We have just been appointed as financial statements auditor to Gbogbonise Plc., a conglomerate having its head office in Lagos. Our preliminary discussion with the group Chief Financial Officer (CFO) indicates that the company has five subsidiaries and two associates. One of the subsidiaries is incorporated and operates in Ghana while one of the associates is incorporated and operates in The Gambia. The other members of the group are incorporated and operate in Nigeria. The group operations cover automobiles, agriculture and manufacturing.

We will be meeting with the audit committee in three weeks to present our audit plan and strategy for the assignment.

Required:

Prepare a draft memorandum for Mrs. Chidi, describing:

a. Challenges that may be encountered in this engagement. (5 Marks)

b. General procedures that may be performed on significant and non-significant components. (3 Marks)

c. Salient items to be included in the group audit instructions. (3 Marks)

d. Procedures to be performed relating to consolidation of the group. (4 Marks)

(Total 15 Marks)

QUESTION 7

The need for auditor's rotation has been a topic of discussion following various major corporate failures in recent years. The Central Bank of Nigeria (CBN) in 2006 introduced mandatory audit firm rotation as part of effective corporate governance of banks in Nigeria. The board of Aluwo Bank Plc has complied with this policy and are now reviewing its implementation. Some of the directors are not clear about the form that auditor's rotation takes. While some have argued in favour of the Central Bank of Nigeria (CBN) policy on audit firm rotation, others are against it, claiming it has not achieved the desired objective.

Required:

Draft a memo to the board of Aluwo Bank Plc. which sets out clearly.

a. Two different suggestions about how auditor rotation could be achieved. (5 Marks)

b. Arguments in favour of audit firm rotation. (4 Marks)

c. Arguments against audit firm rotation. (6 Marks)

(Total 15 Marks)

SOLUTION TO QUESTION 1

a. **The intended benefits of IAASB's new auditor reporting project are:**

i. Enhanced communication between auditors and investors, as well as those charged with corporate governance;
ii. Increased user confidence in audit reports and financial statements';
iii. Increased transparency, audit quality, and enhanced information value;
iv. Increased attention by management and financial statements preparers to disclosures, referencing the auditor's report;
v. Renewed auditor focus on matters to be reported that could result in an increase in professional scepticism; and
vi. Enhanced financial reporting in the public interest.

b. **Identification and description of the different sections of the new auditor's report as required by IAS 700 (Revised),** ***Forming an Opinion and Reporting on Financial Statements.***

Sections of the New Auditor's Report

(i) The auditor's report shall be in writing.

(ii) **Title**
The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor.

(iii) **Addressee**
The auditor's report shall be addressed, as appropriate, based on the circumstances of the engagement.

(iv) **Auditor's Opinion**
The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."

The Opinion section of the auditor's report shall:

- Identify the entity whose financial statements has been audited;
- State that the financial statements have been audited;
- Identify the title of each statement comprising the financial statements;
- Refer to the notes, including the summary of significant accounting policies; and

- Specify the date of, or period covered by, each financial statement comprising the financial statements.

(v) **Basis for Opinion**

The auditor's report shall include a section, directly following the Opinion Section, with the heading "Basis for Opinion", that:

- States that the audit was conducted in accordance with International Standards on Auditing;
- Refers to the section of the auditor's report that describes the auditor's responsibilities under the ISAs;
- Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall identify the jurisdiction of origin of the relevant ethical requirements or refer to the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code); and
- States whether the auditor believes that the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

(vi) **Going Concern**

Where applicable, the auditor shall report in accordance with ISA 570 (Revised) the going concern status of the entity.

(vii) **Key Audit Matters**

For audits of complete sets of general purpose financial statements of listed entities, the auditor shall communicate key audit matters in the auditor's report in accordance with ISA 701.

When the auditor is otherwise required by law or regulation or decides to communicate key audit matters in the auditor's report, the auditor shall do so in accordance with ISA 701.

(viii) **Responsibilities for the Financial Statements**

The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements."

The auditor's report shall use the term that is appropriate in the context of the legal framework in the particular jurisdiction and need not refer specifically to "management".

In some jurisdictions, the appropriate reference may be to those charged with governance.

(ix) **Auditor's Responsibilities for the Audit of the Financial Statements**

The auditor's report shall include a section with the heading "Auditor's Responsibilities for the Audit of the Financial Statements."

This section of the auditor's report shall:

- State that the objectives of the auditor are to:
  - Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatements, whether due to fraud or error; and
  - Issue an auditor's report that includes the auditor's opinion.

The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report shall further:

- State that, as part of an audit in accordance with ISAs, the auditor exercises professional judgment and maintains professional skepticism throughout the audit; and
- Describe an audit by stating that the auditor's responsibilities are:

  (i) To identify and assess the risks of material misstatements of the financial statements.

  (ii) To obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control.

  (iii) To evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management;

  (iv) To conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

(v) When the financial statements are prepared in accordance with a fair presentation framework, to evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

- When ISA 600 applies, there is a need to further describe the auditor's responsibilities in a group audit engagement by stating that:

(i) The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the group to express an opinion on the group financial statements;

(ii) The auditor is responsible for the direction, supervision and performance of the group audit; and

(iii) The auditor remains solely responsible for the auditor's opinion.

Location of the description of the auditor's responsibilities for the audit of the financial statements:

The description of the auditor's responsibilities for the audit of the financial statements required by the ISA shall be included:

- Within the body of the auditor's report;
- Within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix; or
- By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, where law, regulation or national auditing standards expressly permit the auditor to do so.

When the auditor refers to a description of the auditor's responsibilities on a website of an appropriate authority, the auditor shall determine that such description addresses, and is not inconsistent with, the requirements of the ISA.

(x) **Other Reporting Responsibilities**

If the auditor addresses other reporting responsibilities in the auditor's report on the financial statements that are in addition to the auditor's responsibilities under the ISAs, these other reporting responsibilities shall be addressed in a separate section in the auditor's report with a heading titled "Report on Other Legal and Regulatory Requirements" or otherwise as appropriate to the content of the section, unless these other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the ISAs in which case the other reporting responsibilities may be presented in the same section as the related report elements required by the ISAs.

If other reporting responsibilities are presented in the same section as the related report elements required by the ISAs, the auditor's report shall clearly differentiate the other reporting responsibilities from the reporting that is required by the ISAs.

If the auditor's report contains a separate section that addresses other reporting responsibilities, the requirements of the ISA shall be included under a section with a heading "Report on the Audit of the Financial Statements." The "Report on Other Legal and Regulatory Requirements" shall follow the "Report on the Audit of the Financial Statements."

(xi) **Name of the Engagement Partner**
The name of the engagement partner shall be included in the auditor's report for audits of complete sets of general purpose financial statements of listed entities, unless, in the rare circumstances that such disclosure may reasonably be expected to lead to a significant personal security threat.

(xii) **Signature of the Auditor**
The auditor's report shall be signed.

(xii) **Auditor's Address**
The auditor's report shall state the location in the jurisdiction where the auditor practices.

(xiv) **Date of the Auditor's Report**
The auditor's report shall be dated not earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements.

- **Key audit matters (KAM)** are those matters that, in the auditor's professional judgement were of most significance. In the audit of the financial statements of the current period, key audit matters are selected from matters communicated with those charged with governance.

  The purpose of including these matters is to assist users in understanding the entity, and to provide a basis for the users to engage with management and those charged with governance about matters relating to the entity and the financial statements.

Each key audit matter should describe why the matter was considered to be significant and how it was addressed in the audit. The auditor should make sure each KAM refers to how the matter relates to the specific entity.

Key audit matters include:

- ✓ Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315;
- ✓ Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty; and
- ✓ The effect on the audit of significant events or transactions that occurred during the period.

Specific examples include:

- ✓ Significant fraud risk;
- ✓ Goodwill;
- ✓ Valuation of financial instruments;
- ✓ Fair values;
- ✓ Effects of new accounting standards;
- ✓ Revenue recognition;
- ✓ Material provisions such as a restricting provision; and
- ✓ Implementation of a new IT system, or significant changes to an existing system.

EXAMINER'S REPORT

The question tests candidates understanding of: (a) IAASB's new auditor reporting project; (b) ISA 700 (Revised): forming an opinion; Reporting on Financial Statements; and (c) Key Audit Matters. ISA 701.

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

The commonest pitfall of the candidates was their misinterpretation of the question. They answered the question based on the old auditor's report and opinion. They also lacked understanding of the International Standards on Auditing – ISA (700 and 701).

Candidates are enjoined to study the International Standards on Auditing (ISA) very well.

MARKING GUIDE

		MARKS	MARKS
a.	Intended benefits of IAASB's new auditor reporting project		
	- Enhances communication between auditors and investors		
	- Increases users confidence in the report		
	- Increases transparency, audit quality		
	- Increases attention by management		
	- Renews auditor focus on matters to be reported		
	- Enhances financial reporting in public		
	1 mark each for any five points		5
b.	Identifying and describing the different sections of the new auditor's report which are		
	- To be in writing		
	- Must have a title		
	- Addressee		
	- Audit opinion		
	- Basis of opinion		
	- Going concern issues		
	- Key audit matters		
	- Responsibility for financial statements		
	- Auditors responsibility		
	- Other reporting responsibility		
	- Name of engagement partner		
	- Signature of auditor		
	- Auditor's address		
	- Date of audit report		
	1 mark each for mentioning of each heading and 1 mark for development for any ten		20
c.	Definition of key audit matters	3	
	- Stating some key matters such as areas of higher assessed risk of material misstatement		
	- Effect on the audit of significant event		
	1 mark each for any two points	2	5
			30

SOLUTION TO QUESTION 2

(a) Audit risk is the probability that the auditor would draw an invalid audit conclusion and therefore, express an invalid audit opinion. It is the probability of reporting that financial statements present a true and fair view whereas they do not and vice versa.

Audit Risk includes the following:

(i) **Inherent Risk (IR)**
Inherent risk is the probability that material misstatements of financial information will occur assuming that internal control measures are absent. It is the risk attached to any particular population because of its type, size and nature. An example of inherent risk is that the stock of a computer manufacturer has a high risk of obsolescence because of rapid technological change;

(ii) **Control Risk (CR)**
Control risk is the probability that material misstatement of financial Information may occur, the internal controls fail to prevent or correct them. Where internal controls are weak, there is a higher risk of fraud and error, so the control risk will be high. Example of control risk is lack of integrity by top management staff; and

(iii) **Detection Risk (DR)**
Detection risk is the probability that the auditor's substantive procedures will not detect material misstatements that exist within a class of transactions or an account balance. The level of detection is determined by the uncertainties that are due to sampling risk.

(b) The table below shows the key areas of inherent risk the auditor of Home Care should consider in planning the audit of the charity and the effect of each risk on the audit approach.

S/N	Inherent Risk	Effect of Risk on Audit Approach
1.	Constrained source of income being voluntary donations from members of the public. The donors have no obligations to make donations and this makes the charity's income to be at risk. If donors encounter difficulties their agreed donations may not be forthcoming. Example is the impact of the recent financial meltdown on donations received. The limited source of income therefore creates going concern risk for the charity. Uncertainty	Uncertainty of future income suggests a need to rigorously evaluate the going concern status of the charity. It is necessary to assess the extent to which the material uncertainty created by the impact of the financial meltdown affects the basis of preparation of the financial statements, i.e., the appropriateness of preparing the financial statements on the going concern basis and the effect on the reporting of the key audit matter under the newly issued ISA 701.

	of future income suggests a need to rigorously evaluate the going concern status of the charity.	
2.	The income streams from voluntary donation is unpredictable and bears no relationship with the Home Care's expenditure.	The lack of identifiable relationship between the expenditure and income renders analytical review procedure less appropriate/useful.
3.	Income in the form of cash collected by volunteers through donations by members of the public. Cash should therefore be significant in the charity, where controls are also limited. The risk of suppression, diversion and conversion of such cash by the volunteers is high.	The limited controls that exist in a small charity like Home Care suggests that the auditor will only place limited reliance on controls particularly over cash. This calls for more substantive tests over completeness of income.
4.	The current declining income from donations creates sensitivity for key statistics like the proportion of the charity's income that is spent on administrative expenditure which must be mandatorily maintained. The 10% mandatory threshold may be exceeded because the admin expenditure is usually fixed, despite the income reduction being experienced due to the impact of the meltdown.	The current threat to income from donations calls for detailed testing of the compliance with the restricted spending limit for administrative expenditure.

EXAMINER'S REPORT

The question tests candidates' understanding of audit risk and identification of inherent risk in a given scenario.

About 90% of the candidates attempted the question and performance was good in part (a) but poor in part (b).

The commonest pitfall of the candidates was the misinterpretation of the (b) part. They prepared audit programmes instead of identification of inherent risk.

Candidates are enjoined to read questions and interprete them properly before attempting them.

MARKING GUIDE

SOLUTION 2		MARKS	MARKS
a	Defining Audit Risk	2	
	Defining Inherent Risk	2	
	Defining Control Risk	2	
	Defining detection risk	2	8
b.	Giving key areas of Inherent Risk and its effect on audit approach e.g. - Constrained source of income - Unpredictability of income from voluntary donors - Cash collection - Low income due to economic meltdown - Proportion of expenditure to income (1½marks for each key area and 1½marks for each effect on the four areas		12
			20

SOLUTION TO QUESTION 3

Internal audit is defined as the independent appraisal function established within an organisation to examine and evaluate its activities as a service to the organisation. The objective of internal auditing is to assist members of the organisation in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, counsel and information concerning the activities reviewed (IIA, 1991).

Differences between external and internal auditor

S/N	Factor	External Auditor	Internal Auditor
1	General Role	Expresses an opinion on the truth and fairness of the annual financial statements	Examines systems and controls and assesses risks in order to make recommendations to management for improvement.
2	Independence	The external auditor is independent of directors or management of the company.	The internal Auditor is independent of staff and departments of the company.
3	System of Internal Control	Confirms whether the internal control is adequate.	Monitors compliance with the internal control
4	Operational Auditing	Carry out sample review of the entity's transactions to obtain the necessary audit evidence.	Carries out detailed review that is 100% of transactions within an entity.
5	Reporting Responsibility	Reports to the shareholders	Reports to the board of directors.

Similarities between external and internal auditor

S/N	Factor	External Auditor	Internal Auditor
1	General Role	Acts as a check on the activities of others.	Acts as a check on the activities of others.
2	Independence	They are independent of those whose work they review, that is, they are independent of the directors.	They are independent of those whose work they review, that is, they are independent of the staff and the management.
3	System of Internal Control	They are interested in the adequacy and compliance with the internal control system that is in existence within the entity	They are interested in the adequacy and compliance with the internal control system that is in existence within the entity

S/N	Factor	External Auditor	Internal Auditor
4	Operational Auditing	They use various audit techniques and tests to obtain audit evidence. Such as compliance tests, substantive tests, calculations, enquiry etc.	They use various audit techniques and tests to obtain audit evidence. Such as compliance test, substantive test, calculations, enquiry, etc.
5	Reporting Responsibility	They issue report on the work performed, that is audit report.	They issue report on the work performed, that is internal audit report

(b) **An external auditor should seek the following evidence before relying on the work of the internal auditor:**

(i) The extent to which the internal auditor has access to higher level management within an entity. If the internal auditor can contact the higher level authority directly, either to report his observations or advise the management, then reliance can be placed on the internal auditor;

(ii) The professional competence and experience of the internal audit staff, given the nature and complexity of the operations and control of audit work in the department;

(iii) The quality of training given to the audit staff to enable them meet the changing requirements of the business;

(iv) The quality of the internal audit reports as well as recognition accorded to the report by top management of that entity;

(v) The scope of responsibilities assigned to the department and the extent of any limitation therein; and

(vi) The adequacy of audit work documentation.

(c) **Internal audit reports that might be used by the external auditor include the following:**

(i) Documentation of the accounting and internal control systems of an entity;

(ii) Report of the review of the entity's accounting and internal control systems;

(iii) External confirmation of receivables and payables;

(vi) Report on an inventory count and work in progress carried out;

(iv) Preparation of schedules, breakdowns and analyses required by the external auditors; and

(v) Reports on the implementation of the external auditor's recommendations.

EXAMINER'S REPORT

The question tests candidates understanding on Internal Audit.

About 90% of the candidates attempted the question, but performance was only average.

The commonest pitfall of the candidates was their poor presentation skills. They also lacked understanding of part (c) of the question.

Candidates are advised to read the Study Text thoroughly before taking future examinations.

MARKING GUIDE

SOLUTION 3

A Stating the differences between external and internal auditor under the features listed
- The general role - Expression of opinion
- Independence
- Adequacy of internal control
- Operational methodology
- Reporting line

½ mark for the each of five points on the differences between the External Auditor and Internal Auditor 5

Stating similarities between external and internal auditor
- Check on activities
- Independence
- Adequacy and compliance with control
- Use of audit techniques, compliance and substantive tests
- Issuance of report on work done

½ mark for each of the five points on External and Internal Auditor issues 5

10

b. Evidence needed to be able to rely on the work of internal auditor
- Access to higher level of management
- Professional competence
- Quality of training given to audit staff
- Scope of responsibility assigned to audit department
- Adequacy of audit work documentation

1 mark each of any four points 4

c. Report of internal audit that might be applied by external audit
- External confirmation on receivables and payables
- Inventory count report
- Preparation of schedules and breakdowns
- Documentations of the accounting and internal control system — 6

2 marks for each of any 3 points — 20

SOLUTION TO QUESTION 4

(a) **Assurance engagement**:

According to ISA 100, an assurance engagement is "one where a practising accountant evaluates or measures a subject matter that is the responsibility of another party against suitable criteria and expresses an opinion which provides the intended user with a level of assurance about the subject matter".

(b) **Value for money**

(i) 'Value for money' means using resources in the best way in order to achieve intended objectives.

(ii) The 3Es of achieving value for money include
Economy
Efficiency and
Effectiveness

(1) **Economy**. This means spending money prudently, and not paying more than necessary for resources such as materials and labour.

(2) **Efficiency.** Efficiency means using resources in such a way that they produce the greatest possible amount of 'output'. It means getting more from the use of available resources.

(3) **Effectiveness**. Effectiveness means using resources in such a way as to achieve the desired objectives. Efficiency is of little value unless the output from the system is what the entity wishes to achieve.

(c) (i) **Prospective Financial Information**

Prospective financial information (PFI) is financial information based on assumptions about events that may occur in the future, and possible actions by an entity.

(ii) **List of Procedures relating to a profit forecast**

- Understand the basis of the forecast and test the calculation of the forecast according to its method. For example, if it has been extrapolated from previous results, re-perform the arithmetic of the extrapolation.

- Consider whether the assumptions in the forecast are consistent with one other. For example, will sales grow at that rate without additional marketing costs?

- Consider whether the forecast is reasonable in the light of known facts such as current economic circumstances and past trading history.

- Discuss the key variables and sensitivities with management and establish the basis on which these estimates have been made.

- Review internal consistency of forecast. For example, has the same interest rate been used throughout the forecast, has the same growth rate been applied to sales and purchases?

- Compare assumptions and bases for forecasting with information used internally by other departments in the organization. For example, by the marketing department.

- Compare figures with other forecasts to ensure consistency. For example, depreciation should appear in both profit forecast and capital expenditure forecast.

- Compare figures with available evidence and assess for reasonableness. For example, if the profit forecast includes estimates of advertising and marketing costs, do these seem reasonable in comparison with the value of sales turnover and other operating costs?

- Consider whether all items of cost have been included. For example, if the profit forecast involves the launch of a new product, have all the initial running costs been included, such as initial marketing costs and set-up costs for operations.

- Consider whether the forecast of the amount of finance required allows for working capital.

EXAMINER'S REPORT

The question tests candidates understanding in respect of: (a) assurance engagement (b) 'value for money'; evaluation and (c) Prospective Financial information (PFI).

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

The commonest pitfall of the candidates was their interpretation of procedure in respect of PFI to mean historical financial records.

Candidates are advised to cover the syllabus more effectively when preparing for future examinations.

MARKING GUIDE

SOLUTION 4			**MARKS**	**MARKS**
A	Defining assurance engagement			4
b.	i.	Defining value for money		2
	ii.	Mentioning the three Es of achieving value for money and explaining them		
	-	Economy, Efficiency and Effectiveness		
	2 marks for each point			6
C	i.	Defining Prospective financial information		2
	ii.	Procedures relating to a profit forecast		
	-	Understand the basis of the forecast		
	-	Consider assumptions		
	-	Consider reasonableness of forecast		
	-	Discuss key variables		
	-	Compare figures with available evidence		
	-	Consider whether all items of cost have been included		
	-	Consider consistency of figures,		
	-	Compare assumptions and bases with available information		
	1 mark for each of any 6 points			<u>6</u>
				<u>20</u>

SOLUTION TO QUESTION 5

(i) The objective of the IAASB Clarity Project is to improve the clarity of ISAs and ISQCs and also the consistency of their application.

(ii) The changes and new requirements in each of the revised ISAs listed above are as follows:

(a) ISA 260: Communication with those charged with governance

The revisions to ISA 260 were intended to reflect significant developments to regulatory and auditing standards in several jurisdictions and shifts in the expectations of those charged with governance and other stakeholders.

Additional requirements include:

- explaining why significant accounting practices, which are acceptable under the applicable financial reporting framework, are not the most appropriate in the circumstances.
- documenting matters communicated orally.
- communicating any significant difficulties encountered during the audit.
- communicating any significant matters arising from the audit that were discussed, or subject to correspondence with management.

(b) ISA 320: Materiality in planning and performing an audit

In revising ISA 320 the IAASB:

- updated the definition of materiality to make it clearer that materiality depends on the size and nature of an item, judged in the surrounding circumstances.
- introduced guidance on the use of benchmarks for the initial setting of materiality, but did not set formulaic rules.
- indicated that during the audit, the auditor should be alert for possible management bias – such that when evaluating whether the financial statements as a whole are free of material misstatements, the auditor is required to consider both uncorrected misstatements and qualitative aspects of the entity's accounting practices.

The IAASB concluded that it would be better to address materiality and the evaluation of misstatements in separate ISAs – which led to the creation of ISA 450.

New requirements include:

- determining a lower amount called "performance materiality" for the purpose of assessing risk and deciding on appropriate audit procedures
- revising materiality during the audit if the auditor becomes aware of information that would have caused him to initially have set a different threshold
- specific documentation requirements for thresholds determined and any changes made during the audit.

(c) **ISA 402: Audit considerations relating to an entity using a service organisation**

ISA 402 was revised to reflect:

- the increased use of service organisations
- the need to bring the ISA in line with the risk assessment ISAs.

Requirements include:

- specifying matters to be included in the auditor's understanding of how the entity uses the services of a service organization;
- where the auditor has concluded that controls at the service organization operate effectively, specifying procedures to be performed in testing the operating effectiveness of controls, including:
  - obtaining a Type 2 report;
  - testing controls at the service organization; and
  - using another auditor to test controls at the service organization

- specifying procedures to be performed if the auditor plans to use a report from another auditor as audit evidence, including:
  - being satisfied with the other auditor's professional competence and independence and the standards followed; and
  - procedures to determine whether a Type 2 report provides sufficient evidence about the effectiveness of controls at the service organisation.

(d) **ISA 450: Evaluation of misstatements identified during an audit**

ISA 450 is a new ISA which emerged from the revision of ISA 320 on audit materiality. There are a number of new requirements which include:

- accumulating all identified misstatements other than those that are clearly trivial;
- prior to evaluating the effect of uncorrected misstatements, reassessing materiality determining whether uncorrected

misstatements are material, considering their nature as well as their size;

- documenting:
  - the amount below which misstatements would be regarded as trivial;
  - all misstatements accumulated during the audit and whether they have been corrected; and
  - the auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion.

(e) ISA 505: *External confirmations*

The revision of ISA 505 was in response to concerns that requirements in this area needed to be more rigorous. Compared to the previous version of ISA 505 there are more detailed requirements in relation to:

- maintaining control over the confirmation requests;
- obtaining further evidence to resolve doubts over the reliability of responses; and
- conditions which must be present if negative confirmations are to be used.

(f) ISA 540: Auditing accounting estimates, including fair value accounting estimates, and related disclosures

ISA 540 was revised in order to improve the rigor of the auditing of accounting estimates, particularly in view of the potential for management bias/earnings management by manipulation in this area.

The revised ISA introduces requirements for greater rigor and scepticism in the audit of accounting estimates. It encompasses a risk based approach, focusing on those estimates that have high estimation uncertainty.

New requirements include:

- obtaining an understanding as to how management identify the need for accounting estimates and how they make those estimates;
- reviewing the outcome of accounting estimates made in prior periods ;
- evaluating estimation uncertainty and whether high estimation uncertainty leads to significant risks;
- for identified significant risks:
  - evaluating how management has considered alternative assumptions or outcomes; and
  - obtaining sufficient appropriate evidence about whether

management decisions are in accordance with the applicable financial reporting framework evaluating the adequacy of disclosure of the estimation uncertainty; and

- reviewing management's judgment and decisions in order to identify possible management bias.

(g) ISA 550: *Related parties*

ISA 550 was revised in response to major corporate scandals (e.g. Enron and WorldCom in 2002) which often involved related parties; a need to focus more on a risk-based approach, in line with other ISAs.
The revised ISA 550 which also seeks to assist auditors with the difficult task of identifying related parties and undisclosed related party transactions.

New requirements include:

- considering the susceptibility of the financial statements to material misstatements due to fraud or error arising from the entity's related party relationships and transactions;
- obtaining an understanding of the controls put in place to identify, account for and disclose related party relationships and transactions and to approve significant transactions outside the normal course of business;
- treating significant related party transactions as giving rise to "significant risks";
- specifying procedures to be performed if the auditor identifies related parties or significant related party transactions that management has not previously disclosed to the auditor;
- specifying procedures to be followed for significant related party transactions outside the normal course of business; and
- obtaining sufficient appropriate evidence about a management assertion that a related party transaction was conducted on normal commercial terms.

EXAMINER'S REPORT

The question tests candidates understanding of the application of ISAs.

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

The commonest pitfall of the candidates was their lack of familiarity with ISAs.

Candidates need to read the Study Text thoroughly before embarking on future examinations.

MARKING GUIDE

SOLUTION 5	MARKS	MARKS
i. Explaining the objective of IAASB Clarity Project		1
ii. Explaining two new requirements in each of the revised ISAs		
- Documenting matters communicated orally		
- Communicating any significant difficulties encountered during the audit		
- Testing controls at the service organisation		
- Using another auditor to test controls at the service organisation		
- Reviewing management's judgement and decisions in order to identify possible management bias, etc		
- Determining a lower amount called "performance materiality"		
- Obtaining a Type 2 report		
2 marks for each of any seven points		14
		15

SOLUTION TO QUESTION 6

Date: 20 May, 2017

To: Mrs. Chidi (Audit Manager)

From: Audu (Audit Senior)

Subject: Audit planning for Gbogbonise Group

Introduction

Thank you for your email and your good wishes for my examination. I enumerate below some of the relevant issues for the audit planning and strategy for the audit of our new client, Gbogbonise Group which should aid our discussion at the planned meeting with the Group's Audit Committee on our role as the auditor of the parent company and the group.

(a) **The challenges that we are likely to encounter in this engagement**

i. The organisation and planning of a group audit is significantly more complex than for a single company.

ii. Gbogbonise Group includes a large number of companies – 5 subsidiaries including a foreign subsidiary based in Ghana and two associates including one foreign associate based in The Gambia. These foreign components are companies that report in their own currencies and perhaps, also use their national accounting practices to prepare their financial statements, rather than IFRS.

iii. Some of the companies in the group may have different year-end accounting dates from others in the group. This creates a challenge for consolidating the financial statements of all the group members.

iv. Group financial statements require numerous and potentially complicated consolidated adjustments. It will therefore be necessary to make audit adjustments to the financial statements of individual group companies in the consolidated financial statements.

v. Some of the companies in Gbogbonise group may be audited by other audit firm(s).

(b) **The general procedures that need to be performed on the significant and non-significant components**

The procedure to be performed on each component depends on whether the component is significant or non significant.

Significant components are those that either (a) are of individual financial significance to the group, or (b) have been identified as likely to include significant risks of material misstatement of the group financial statements.

The general procedures to be followed are as follows:

i. For a component that is of individual financial significance to the group, the group auditor or a component auditor must perform audit using the component materiality;

ii. For a component that is significant because of the likely significant risk of material misstatement to the group financial statement, the group auditor or a component auditor must perform one or more of the following procedures:

    (a) an audit using component materiality;

    (b) an audit of one or more account balances, classes of transactions or disclosures (depending on where the risk of material misstatement lies); and

    (c) specified audit procedures to address the risk of material misstatement.

iii. For non significant component, the group auditor should perform analytical procedure at the group level.

(c) **The salient items to be included in the group audit instructions**

The group auditor's letter of instruction to the component auditor should set out the following:

i. the work required to be done by the component auditor;
ii. the use to be made of that work by the group auditor;
iii. the form and content of the component auditor's communication with the group engagement team. This may be in the form of a memo or report of work performed;
iv. a request for cooperation;
v. ethical requirements;
vi. component materiality;
vii. identified significant risks; and
viii. a list of known related parties.

(d) The procedures to be followed relating to the consolidation of the group

The underlisted procedures should be followed on the different areas of the group consolidation:

(i) **Clerical accuracy**

- ✓ Confirm the figures have been transferred accurately from the components' financial statements to the consolidation schedules;
- ✓ Check the arithmetical accuracy of all consolidation calculations, such as the consolidation total balances and total transaction values.

(ii) **Status of investments**

- ✓ Confirm that the parent company has correctly classified investments as a subsidiary, associate, joint venture or simple investment, in accordance with standard accounting practice;
- ✓ Confirm that the appropriate accounting treatment has been adopted for each of these classifications of investment in the group accounts.

(iii) **Changes in the group**

- ✓ For acquisitions: Confirm fair values, the calculation of purchased goodwill and accounting treatment in accordance with IFRS 3 and any other relevant standards;
- ✓ Where there has been an acquisition during the year involving deferred consideration as part payment, check that the amount of the deferred consideration has been included in the cost of the acquisition at discounted present value, using a current pretax cost of capital as the discount rate;
- ✓ When there has been an acquisition during the year involving a possible contingent consideration as part-payment, check the reasonableness of the assumption that the recent value of the contingent consideration should be included in the cost of the acquisition; and
- ✓ For disposals: confirm the sale proceeds, and the calculation of the gain or loss on sale.

- ✓ Check that the correct accounting treatments of items are applied in the consolidated statement, statement of comprehensive income and the consolidated statement of financial position. For example, when a subsidiary has been acquired during the year, check that the calculation of pre-acquisition and post-acquisition profit is correct.

(iv) **Consolidation adjustments**

- ✓ Reconcile the inter-company transactions and balances or review the reconciliation of the intercompany transactions and balances that have been made by the client's staff.
- ✓ Confirm the inter-company balances.
- ✓ Check calculations of the adjustments for unrealized profit.
- ✓ Check the calculations and disclosure of non-controlling interests.
- ✓ Check the accounting treatment of inter-company dividends and other dividends.

(v) **Loss-making investments**

- ✓ Consider whether any goodwill on acquisition has suffered an Impairment.
- ✓ Consider whether a write down of the investment in the books of the parent company is needed.
- ✓ If a subsidiary makes losses consistently, its going concern status may be in question, so request a comfort/support letter from the directors of the parent company to provide comfort.

(vi) **Related parties**

- ✓ Ensure the provisions of IAS 24 - Related Party Disclosures, are complied with, as many components of the group will be related to other components.

(vii) **Reporting**

- ✓ Reach a conclusion about whether the group financial statements present a true and fair view.

Conclusion

The above notes provide general key issues that are peculiar to a typical group audit and some procedures that need to be performed. It is important that these guide our discussions during the scheduled meeting with the group audit committee. More specific issues will be considered within the context of the above after the meeting and when full details of the group would have been obtained.

Thank you.

Regards.

Audu

EXAMINER'S REPORT

The question tests candidates understanding of group audits.

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

The commonest pitfall of the candidates was lack of knowledge of the question and also not being able to prepare the memo.

Candidates are enjoined to cover the syllabus and read the Study Text properly before embarking on future examinations.

MARKING GUIDE

SOLUTION 6		**MARKS**	**MARKS**
	Proper heading of memo		1
a.	Challenges		
	- Different accounting date		
	- Complexity		
	- Foreign associates, with different accounting practice		
	- Consolidated adjustments		
	- Different audit firm for other associates		
	1 mark for each point		5
b.	General procedures that may be performed		
	- Analytical		
	- Component materiality		
	- Noticing risk of material misstatement		
	1 mark each		3
c.	Salient items include		
	- Ethical requirement		
	- Component materiality		
	- Identification of significant risks		
	- Related parties		
	- Use of their work by group auditor		
	- Work to be done by component auditor		
	½ mark for each of any 4 points		2
D	Procedures to be performed relating to consolidation of the group		
	- Clerical accuracy		
	- Status of investments		
	- Changes in the group		
	- Consolidation adjustments		
	- Related partners		
	- Reporting		
	- Loss-making investment		
	½ mark for each of any 6 points		3
	Conclusion and proper closing of memo		1
			15

SOLUTION TO QUESTION 7

Date: 20 May, 2017

To: The Board of Directors, Aluwo Bank

From: Thomas Abuja

Subject: Clarification on Auditor Rotation

Introduction

I am happy to provide some clarifications on auditor rotation, particularly on the strategy adopted by the regulators of the banking industry in Nigeria as stated in the CBN Code of Corporate Governance – Post Consolidation, which was issued in 2006. Below are the required clarifications.

(a) Suggestions made about how auditor rotation could be achieved: Two different suggestions have been made about how auditor rotation could be achieved i.e. either by audit partner rotation or audit firm rotation.

i. **Audit partner rotation**: Audit partner rotation is where the accounting firm may remain as auditors of the same client company for an unlimited number of years, or until the company decides to change its auditors. However, the 'lead' engagement partner and other key members of the audit team should be 'rotated' regularly. Audit partner rotation has been adopted by most jurisdictions of the world.

ii. **Audit firm rotation**: Audit firm rotation is where the accounting firm itself remains as auditor of a client company but for no longer than a specified number of years. The CBN Code of Corporate Governance-Post Consolidation, issued effective 1st April, 2006 requires audit firm rotation after 10 years.

Please note that in many countries, including Nigeria, audit firm rotation would require legislative amendment as the law frequently provides that auditor's appointment is for one year renewable indefinitely.

(b) **Arguments in favour of audit firm rotation**

The arguments in favour of the rotation of firms providing independent audit include:

i. Audit firm rotation limits the effect of over-familiarity of the firm over an extended period of relationship. In a long-term audit relationship, the auditors may become too close to management of the client company. This may weaken their professional scepticism and independence. They may be more likely to compromise when disagreements with management occur, in order to preserve the relationship, the audit, and their fees.

ii. Audit firm rotation improves the public perception of independence, and so may increase confidence in the quality of external audits.

(c) **Arguments against audit firm rotation**

The underlisted are the arguments against the rotation of audit firms:

i. Audit firm rotation may have negative effects on audit quality and effectiveness in the years immediately following a change. This is because the new auditors may take several years to familiarize themselves with their new client and its procedures. There is some evidence to suggest that there may be a higher instance of audit failures in the years immediately following a change of auditors. If this evidence is valid, the connection between company failures and a change of auditors might reflect an inability of the newly-appointed auditor to identify problems in the client company.

ii. The costs of changing auditors regularly are substantial as the auditor attempts to familiarize himself with the new client. More management time is also needed to assist the new auditor to learn about the client company, its operations and its systems. This also adds to the cost of firm rotation.

iii. There is no evidence yet that compulsory audit firm rotation has a positive impact on auditor independence and audit quality.

iv. The market for auditing listed companies is dominated by the 'Big Four' accountancy firms. If this domination of the audit market continues (which is probable), it may be difficult to change auditors easily. The other large firms may not have available resources to take on the audit, or may not be 'independent' because of other non-audit services that they already provide.

Conclusion

Considering the above, audit firm rotation has its pros and the cons, and it has not yet been established empirically if the CBN's adoption of this strategy improves auditor independence and quality. I hope the above clarifies your understanding of auditor rotation. I am happy to provide further clarifications if necessary.

Thank you.

Regards.

Thomas Abuja

EXAMINER'S REPORT

The question tests candidates understanding of rotation of auditors.

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

The commonest pitfall of the candidates was their inability to distinguish between the arguments for and against auditor rotation.

Candidates are enjoined to read the Study Text exhaustively when preparing for future examinations.

MARKING GUIDE

SOLUTION 7		MARKS	MARKS
	Proper formatting of memo		1
a.	Suggestion for audit rotation		
	- Partner rotation		
	- Firm rotation		
	1 mark for mentioning and 1 mark for developing each point		3
b.	Argument in favour of rotation		
	- Over-familiarity		
	- Improves public perception		
	2 marks each		4
	Argument against rotation		
	- Cost of changing auditors		
	- Lack of resources of some firms		
	- Domination by the big four		
	- Inability of new firm to identify problem		
	1½ marks each		6
	Conclusion and proper closing of memo		1
			15

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PROFESSIONAL LEVEL EXAMINATION – MAY 2017

CASE STUDY

Time Allowed: 4 hours (including reading time)

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

JagaJaga Technologies Plc

Requirement

You are Tijani Obu who has recently been promoted to Assistant Finance Manager position at JagaJaga Technologies Plc (JJT). JJT is a Nigerian multinational technology company headquartered in Victoria Island, Lagos.

JJT develops, designs and sells consumer electronics with its main products being smartphones, personal computers and smart TVs.

You are working with Chike Barama, the Chief Financial Officer, JJT, on a very important report with tight reporting deadline and have been requested to draft a report for shareholders' briefing based on the email **(Exhibit 1)** from Chike Barama.

The following overall time allocation is suggested:

Reading	1 hour
Planning and calculations	1 hour
Drafting report	2 hours

LIST OF EXHIBITS

Exhibit	Description
1	Email from Chike Barama (Chief Financial Officer, JJT) to you, Tijani Obu.
2	Email from Dele Shinkafi, Chief Operating Officer (COO), JJT to Chike Barama.
3	Meeting Notes by Chike Barama.
4	Current year draft financial statements of JJT for the year ended 30 June, 2016.
5	Accounting Policies and Selected Notes to Financial Statements.
6	Financial Data on J-Phone 7.

EXHIBIT 1

JagaJaga Technologies Plc

Email

From: Chike Barama

To: Tijani Obu

Subject: Re: JagaJaga Technologies Plc – Smartphone fire incidents

Date: ***8 October, 2016***

Kindly review the attached documents (**Exhibits 3-5**) and email from Dele, the Chief Operating Officer (COO) (**Exhibit 2**) and prepare a report for our meeting today. Kindly address the issues I have highlighted and let us discuss your draft report.

As a bit of background and further to what was discussed in our meeting this morning, some units of our flagship smartphone, J-Phone 7, have caught fire and some cars of customers who have purchased these 'affected' units also caught fire. Another report received a few minutes ago has it that a house has caught fire due to the malfunctioning of the J-Phone 7.

This is a major disappointment as this was supposed to be the phone that will 'clinch' it for our company as the leading smartphone company in Sub-Saharan Africa and this would have been a superb achievement, considering that we have only been around for just under 20 years.

At this time, we are staring at potential losses, damage to our reputation and lawsuits running into millions of Naira (**Exhibit 6**). To put it simply, this is the most difficult challenge this company has had to face since incorporation in 1997. I can tell you, as a matter of fact, having been around JJT long enough that "heads will roll".

I have had a brief phone conversation with the Chief Internal Auditor this morning and he informed me that the IT department have retrieved a report from the missing laptop of one of his former staff. Basically, the draft internal audit report states that some of the storage locations for our phone batteries have temperature levels higher than allowed by regulators. This report was never issued as the laptop went 'missing' and the affected staff has been dismissed. The IT department has just recovered the report and other related documents/reports from this laptop.

At this time, it is too early to know the cause of the malfunctioning of these units, however, this is being investigated. We do not know exactly if these batteries were the cause of these fire incidents or explosions but this discovery by the IT department raises immediate concerns and we do not know more at this time.

I have been in several meetings over the past few days, trying to understand all that have taken place regarding the J-Phone 7. A few meetings notes have been "scribbled" for reference **(Exhibit 3).**

The COO is expecting us to assess the business and financial impact, as much as possible and report this in a timely manner. This is also important as the external auditors are looking forward to the completion of the company's 2016 financial statements' audit in a fortnight. The board meeting is scheduled to hold at the end of the month to approve the 2016 financial statements.

Regards.

Chike Barama
Chief Financial Officer, JagaJaga Technologies Plc

Required

Using the attached information, draft a report for shareholders' briefing to Chike Barama, Chief Financial Officer, JagaJaga Technologies Plc.

Your report should comprise:

1. An analysis of JJT's value chain (using Porter's Value Chain model) and the three (3) key risks JJT is facing and advise the company on risk management techniques it will employ.

   In conducting your risk analysis, your report should concentrate on the key risks and issues identified in the case, and should provide a clear explanatory commentary together with your judgements and conclusions on the key risks which you identify; and

2. Advise the management of JJT Plc on the financial reporting implications of the key events and issues identified in the scenario.

   Please show your workings where relevant to support your answers in requirement 2.

EXHIBIT 2

JagaJaga Technologies Plc

Email

From: Dele Shinkafi, Chief Operating Officer (COO)

To: Chike Barama

Subject: JagaJaga Technologies Plc – Smartphone fire incidents

Date: *8 October, 2016*

Dear Chike,

As discussed, I want you to please treat this as urgent as we have to go into an emergency meeting on this very pressing issue.

It is no longer news to you that our newly released 'latest and greatest' smartphone has literally been exploding by the minute. The J-Phone 7 is no longer permitted on trains and has been banned by certain airlines. We have currently recalled all units sold and made arrangements to issue replacement handset till the problem is resolved. I am very worried about these developments.

Manufacturing

We have recently made wholesale changes to our manufacturing processes. Unlike previous years, we have just started sourcing smartphone screens and certain panels from 'third party' companies. This has become necessary in our industry today as demand has grown so rapidly that we are unable to either keep up with demand for our products or ensure our phones are released/launched on time. We have to ensure that we are ahead of our competitors. Adura Limited, a newly incorporated entity, supplied 63% of our smartphone screens. Adura Limited is owned by Dede Yisuf, the step-son of the new Chief Executive Officer (CEO) of JJT.

There is a current internal investigation about alleged long hours being worked by some of the workers in the factory of one of our micro-chip manufacturers. Workers are alleged to be working 18-20 hours daily with lateness of more than 5 minutes resulting in 20% of their salaries being deducted. There are also whispers about the working conditions which leave these employees exposed to 'dangerous' chemicals without appropriate health considerations. Regulators have recently expressed concerns.

Marketing and Distribution

Our advertising model has been focusing on the 21 – 34 age group. Our data analysis has shown that this smartphone range has typically been more appealing to the over 34's and business people. The new dust and water resistant features as well as enhanced security features are also expected to appeal to this 'target' demography. Although research into this new feature was quite advanced, introducing them into this phone model may certainly have been premature. A lot of funds have been expended on social media ad campaigns and famous artists and entertainers have been contracted as brand ambassadors. Our distribution model is similar to that being used by our major competitors and we still use our branded retail outlet stores as well as third party retail outlets which stock our products.

J-Phone 7 recall

We have announced an expanded voluntary recall on all original and replacement J-Phone 7 sold in the country in cooperation with the Consumer Protection Council (CPC) and in partnership with retailers. Since the affected devices can overheat and pose a safety risk, we are asking consumers with a J-Phone 7 to power it down and contact the nearest JJT outlet or the retail outlet where they purchased their phones.

Consumers who have a J-Phone 7 can now exchange their phones for another JJT smartphone, or receive a refund, under the terms of our Refund and Exchange Programme.

News and Internet Reports

One of the prominent smartphone bloggers has tweeted that "the phones present an obvious danger to passengers in enclosed spaces aboard mass transit vehicles, so it makes sense that they have been banned on trains and airlines. It seems like only an insane person would continue using JJT's new J-Phone 7 at this point, since the device puts the user and anyone around him or her at risk. We have seen people's cars and even homes destroyed by fire caused by malfunctioning handsets".

Another source puts it that an unnamed man has spoken to his lawyers about bringing a lawsuit against the smartphone maker after his car was engulfed in fire when his newly acquired J-Phone 7 exploded.

According to another recent report, more than 1 million people are still in possession of potentially explosive J-Phone 7 phones even after the nationwide recall. The report concluded that JJT 'panicked' and recalled its smartphone too soon as this was done before the CPC had issued a notice to JJT. Perhaps, JJT could have managed the situation better and a 'wholesale' recall may not have been necessary.

There have been suggestions that we should kill off the “tainted” J-Phone 7 brand and move on. Other reports have suggested that we should focus on our other smartphone lines or just start using a different name while hoping no one notices.

However, I disagree with both suggestions. I think we would be better off weathering the storm, working to rebuild our brand, as it is my view that the J-Phone 7 smartphone line is still one of the leading brands in the smartphone industry and you don’t abandon something that took years to build until you are left with absolutely no choice.

Remember no one has died because of our malfunctioning J-Phones.

Dele Shinkafi

Chief Operating Officer (COO)
JagaJaga Technologies Plc

EXHIBIT 3

Meeting Notes

Product development

JJT Plc, due to its expansion has recently started outsourcing certain processes during the manufacturing of its products. JJT still ensures that its engineers first visit relevant sites of outsourcing companies or the subsidiaries and it is after discussions with the engineers, at these sites, that we agree that manufacturing process should commence. JJT's engineers are still recognised as the best in the industry, and customers agree that they are able to produce the most effective solutions in an increasingly complex smartphone industry. This stage of the process is seen as a very collaborative process between the engineers employed by JJT and the engineers employed by the outsourcing companies and their subsidiary companies.

In the laboratories at JJT, the product design goes through a fairly complicated process. Prototypes are developed, based on the discussions at every stage of the process. These prototypes are then tested. Once a final design is agreed, the designs are passed to the manufacturing department for production.

User acceptance testing

It was noted in three of our storage sites, in April 2016, that there were reported fire incidents which were 'appropriately' dealt with – These sites are used to store finished smartphones before they are distributed to our branded outlet stores and retail outlets. Two weeks later, it was noticed by one of the smartphone 'testers', during a user acceptance testing, that the phones were overheating and he was told it was just a 'minor' problem. This overheating only seemed to occur when the battery is fully charged. Later that same day, two units being tested overheated and caught fire. There is no record of this problem being addressed or investigated and no official report of this fire was made. These sites account for over 90% of the J-Phones sold to date.

JJT's Brand

As expected there is increased concern about how this will affect JJT's brand. I have been asked to confirm the effect of impairment on our brand. Our brand has been built over the years and has especially been enhanced since our J-Phone 7 was launched in the market. This has been a hugely popular phone series and particularly, the highly anticipated J-Phone 7 was expected to blow our competitors out of the market, building on the huge strides this company has made with the J-Phone 5 and J-Phone 6 smartphones.

The uneasy launch and recall of the J-Phone 7 due to its exploding battery units may cause many owners of the J-Phone 7 phones not only to switch phones but also companies. A new survey published by a reputable research firm says that half of the J-Phone 7 owners they talked to have or will choose a rival company's product instead.

EXHIBIT 4

JagaJaga Technologies Plc
(Extracts from company accounts)
Income Statement
Year ended 30 June, 2016

	Notes	2016 ₦'Million	2015 ₦'Million
Revenue		668.6	648.3
Cost of Sales		(408.4)	(415.2)
Gross Profit		**260.2**	**233.1**
Selling and distribution expenses		(45.2)	(44.0)
Administration expenses		(103.2)	(105.2)
Operating profit		**111.8**	**83.9**
Financing charges		(17.5)	(14.6)
Interest income		1.7	3.5
Share of results of associates		20.6	15.5
Profit before tax		**116.6**	**88.3**
Tax	3	(19.8)	(17.3)
Profit for the year		**96.8**	**71.0**
Earnings per share			
-basic		**9.61**	**7.08**
-diluted		**9.59**	**7.06**

JagaJaga Technologies Plc

(Extracts from company accounts)
Statement of financial position
Year ended 30 June, 2016

Net assets	**Notes**	**2016 ₦'Million**	**2015 ₦'Million**
Intangible assets	1	42.6	42.1
Tangible assets		440.0	1,055.5
Associates		110.8	108.6
Loans receivable		23.7	18.4
Deferred tax assets		3.1	4.7
Non-current assets		**620.2**	**1,229.3**
Inventory		1,007.0	6.3
Receivables and prepayments		73.7	78.2
Current tax assets		1.0	0.7
Cash at bank		316.4	453.7
Current assets		**1,398.1**	**538.9**
Payables and accruals		147.0	135.8
Current borrowings		556.2	9.7
Current tax liabilities		12.1	10.6
Current liabilities		**715.3**	**156.1**
Net current (liabilities)/assets		**682.8**	**382.8**
Long-term borrowings		238.7	580.5
Deferred tax liabilities		65.5	64.1
Other non-current liabilities		4.1	16.1
		308.3	**660.7**
		994.7	**951.4**
Total equity:			
Share capital	3	50.2	50.2
Share premium		186.6	182.1
Retained earnings		752.2	713.8
Other reserves		5.7	5.3
		994.7	**951.4**

EXHIBIT 5

Principal Accounting Policies

A. Basis of preparation

The financial statements have been prepared in accordance with International Financial Reporting Standards, including International Accounting Standards and Interpretations as issued by the International Accounting Standards Board. The financial statements have been prepared under the historical cost convention except as disclosed in the accounting policies below.

Standards, amendments and interpretations effective in 2016 which are relevant to the Group's operations:
Amendments to IAS 19 Defined Benefit Plans: Employee Contributions
Annual Improvements to IFRSs 2010 – 2012 Cycle
2011 – 2013 Cycle

The following standards and amendments which are effective after 2016, relevant to the Group's operations are yet to be adopted:

		Effective for accounting periods beginning on or after
IFRS 9*	Financial Instruments	1st January 2018
IFRS 15	Revenue from Contracts with Customers	1st January 2018
IFRS 16	Leases	1st January 2019
Amendments to IAS 7	Disclosure Initiative: Statement of Cash Flows	1st January 2017

*A complete set of IFRS 9 'Financial Instruments' has been published which replaces IAS 39 'Financial Instruments: Recognition and Measurement'. This complete version includes revised guidance on the classification and measurement of financial assets and liabilities. It also includes a new expected credit loss model that replaces the incurred loss impairment model used presently. A substantially-reformed approach to hedging accounting is also introduced. It also carries forward the guidance on recognition and derecognition of financial instruments from IAS 39.

B. Foreign currencies

Transactions in foreign currencies are accounted for at the exchange rates ruling at the transaction dates

C. Impairment of non-financial assets

Assets that have indefinite useful lives are not subject to amortisation and are tested for impairment annually and whenever there is an indication that the assets may be impaired. Assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

D. Loans receivable

Loans receivable are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and are carried at amortised cost using the effective interest method. Loans receivable are classified as non-current assets unless their maturities are within 12 months after the statement of financial position date.

E. Inventory

Inventory which principally comprise smartphones, personal computers and televisions, are stated at the lower of cost or net realisable value. Cost is determined by applying the first-in, first-out method.

F. Cash and cash equivalents

For the purposes of the statement of cash flow, cash and cash equivalents comprise deposits with banks and financial institutions and bank and cash balances, net of bank overdrafts. In the statement of financial position, bank overdrafts are included in current borrowings.

G. Provisions

Provisions are recognised when the Group has present legal or constructive obligations as a result of past events and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations, and a reliable estimate of the amount of the obligations can be made.

H. Earnings per share

Basic earnings per share are calculated on profit attributable to shareholders and on the weighted average number of shares in issue during the year.

I. Dividends

Dividends proposed or declared after the statement of financial position date are not recognised as a liability in the statement of financial position.

J. Revenue recognition

i. Revenue is measured at the fair value of the consideration received and receivable and represents amounts receivable for goods and services provided in the normal course of business, net of discounts and sales related taxes.

ii. Revenue from the rendering of services is recognised when services are performed, provided that the amount can be measured reliably. Revenue from the sale of goods is recognised on the transfer of significant risks and rewards of ownership, which generally coincides with the time when the goods are delivered to customers and title has passed.

iii. Interest income is recognised on a time proportion basis taking into account the principal amounts outstanding and the interest rates applicable.

iv. Dividend income is recognised when the right to receive payment is established

Selected Notes to the Financial Statements

1. **Intangible Assets**

	Goodwill	Computer software	Development costs	Total
	₦'m	₦'m	₦'m	₦'m
Cost	23.9	24.5	12.8	61.2
Amortisation and Impairment		(16.3)	(2.3)	(18.6)
Carrying amount 30 June, 2016	**23.9**	**8.2**	**10.5**	**42.6**

2. **Share Capital**

	Ordinary shares in millions			
	2016	**2015**	**2016**	**2015**
Authorised			₦'m	₦'m
Shares of 100k each	7,500	7,500	75	75
Issued and fully paid				
1st July	5,018.5	5,015	50.2	50.2
Carrying amount 30 June, 2016	**5,018.5**	**5,015**	**50.2**	**50.2**

3. **Tax**

The charge for tax is based upon the Nigerian companies income tax rate of 30% (2015 30%) and tertiary education tax rate of 2% (2015 2%).

4. **Related Party Disclosures**

Adura Limited is a company owned by Dede Yisuf, the step-son of the new Chief Executive Officer (CEO) of JJT.

In the normal course of business, the Group undertakes a variety of transactions with its associates and its subsidiaries.

Details of directors' emoluments (being the key management personnel compensation) are shown under the heading of 'directors' appointment, retirement, remuneration and service contracts'.

EXHIBIT 6

Financial Data on J-Phone 7

1. **Analysis of J-Phone 7 production and sales:**

Total production in units	2,000,000
Total sales in units	1,780,000
Total units returned by customers	475,000
Total units returned by retails shops	270,000
Total units reported to have exploded	5,000

2. **Price and cost of production per unit of J-Phone 7**

	Per Unit (₦)
Materials	25,000
Labour	5,000
Overheads:	
Variable	2,500
Fixed	2,000
	34,500
Mark up	15,500
Selling price	50,000

3. **Other details**

a.	Cost per unit of changing the storage location of J-phone 7 batteries:	₦5,000 per unit
b.	Media awareness to sensitise customers on the safety of the rework J-phone 7	₦1.5 m
c.	Likely compensation for out of court settlement with customers	₦100 m

4. The probability of customers returning the over 1,000,000 units currently in the hands of customer is 85%

SOLUTIONS

REQUIREMENT 1 – Porter's Value Chain Analysis & Risk Analysis

USES OF DATA AND INFORMATION APPROPRIATELY	IDENTIFIES ISSUES AND OPTIONS
• Uses information provided in Exhibit 1 • Uses information provided in Exhibit 2 • Uses information in financial statements • Uses information on notes to the financial statements • Uses other information provided in the case	• Identifies potential issues in the sourcing for quality components in the manufacturing of J-Phones • Identifies the new changes and issues in the newly outsourced components process • Identifies issues relating to the marketing and sales of the units • Identifies the relevant issues with outsourcing the manufacturing of phones to 'third parties' companies – possible security threats, phone hacking sabotage by competitors etc • Identifies issues/options for other outsourcing/manufacturing arrangements to meet customers' demand • Identifies the after sales/customer service by JJT – Quick response to J-Phone malfunctioning, offer of alternative phone to customers, communication with customers etc
V NC BC CA SA	V
USES PROFESSIONAL TOOLS AND KNOWLEDGE	**APPLYING PROFESSIONAL SCEPTICISM AND ETHICS**
• Recognises the appropriate model • Performs appropriate Porter's Value Chain analysis • Performs a risk analysis • Considers accuracy of the information provided • Consider wider issues	• Evaluates the overall value chain of JJT • Recognises the issues and options and proffer possible solutions for improvement • Evaluates the ethical issues in the case • Considers issue of releasing confidential information and details to third parties • Considers issue and options for managing the risks identified
V NC BC CA SA	V
USE ANALYTICAL SKILLS (material points)/ written report	**EVALUATIVE SKILLS AND JUDGEMENT**
• Identifies the issues in the Value Chain – Inbound Logistics • Identifies the issues in the Value Chain – Operations • Identifies the issues in the Value Chain – Outbound Logistics • Identifies the issues in the Value Chain – Marketing & Sales • Identifies the issues in the Value Chain – Service • Identifies key risks – legal, regulatory, operational and reputational risks	• Recognises the issues with fast growing companies and growing demand • Recognises the issues with JJT's approach to meeting its fast growing demand and quest to gain more market share • Recognises the risks with outsourcing companies not meeting regulatory standards in the manufacturing process • Recognises that JJT is ultimately responsible for the final products and bears all the risks – legal, regulatory, reputation etc
V NC BC CA SA	V

CONCLUSIONS	
(Draws distinct conclusions under a heading)	
• Concludes on overall value chain analysis • Concludes on risk analysis conducted • Concludes on other general issues identified in the scenario	
V NC BC CA SA	V NC BC CA SA
RECOMMENDATIONS (commercial/relevant)	
• JJT should consider expanding its manufacturing floors to be able to accommodate production of more units and take control of its manufacturing process • Considers that JJT may have settled/invested further on the few reported cases rather than a wholesale recall of its smartphones • Advises on how best to deal with all the risks identified • Considers alternatives available to the management of JJT	
V NC BC CA SA	V NC BC CA SA

REQUIREMENT 2 – Advice on Financial Reporting Implications

USES OF DATA AND INFORMATION APPROPRIATELY	IDENTIFIES ISSUES AND OPTIONS
• Uses JJT's Financial Statements - Income Statement - Statement of Financial Position • Uses additional financial information provided • Uses information in emails provided in Exhibit 1 • Uses information in emails provided in Exhibit 2 • Identifies wider issues • Uses information provided in Exhibit 6	• All issues should be discussed in the context of the relevant accounting standards • Identify possible issues and options and possible financial reporting implications • Identifies/Discusses briefly background of the relevant accounting standards • Explain and relate relevant accounting standards to the scenario provided
V NC BC CA SA	V
USES PROFESSIONAL TOOLS AND KNOWLEDGE	**APPLYING PROFESSIONAL SCEPTICISM AND ETHICS**
• Performs appropriate calculation of potential losses • Performs other appropriate calculations to highlight points • Considers other calculations • Considers the accuracy of estimates made	• Considers the other options and its financial reporting implications • Considers potential losses calculated and how to account for this • Considers tax implications (if any) • Considers other analysis & evaluation necessary • Considers ethical issues in the company's operational processes
V NC BC CA SA	V
USE ANALYTICAL SKILLS (material points) written report	**EVALUATIVE SKILLS AND JUDGEMENT**
• Identifies the financial reporting implications – IAS 2 Inventories • Identifies the financial reporting implications – IAS 10 Events After the Reporting Period • Identifies the financial reporting implications – IAS 37 Provisions, Contingent Liabilities and Contingent Assets • Identifies the financial reporting implications – IAS 38 Intangible Assets	• Considers all stock market implications – share dumping, share price declining • Considers effect on EPS and other market related ratios • Considers possible effect on JJT's profits and cashflow • Considers JJT's inventory in current year which it may not be able to sell off and may therefore need to write off
V NC BC CA SA	V

CONCLUSIONS	
(Draws distinct conclusions under a heading)	
• Concludes on Financial reporting issues identified and discussed • Concludes on losses calculated • Concludes on other financial factors not considered • Concludes on other issues identified	
RECOMMENDATIONS (commercial/relevant)	
• JJT should ensure it gets appropriate professional advice • JJT should have ensured proper investigation into the cause or the malfunctioning J-Phone 7 • JJT should ensure it keeps its auditors up to date on recent happenings • JJT should consider how best to communicate with investors (existing and potential)	
V NC BC CA SA	V NC BC CA SA

Appendices R1: Content and style

- Shows the value chain model.
- Shows the list of identified risks.
- Shows appropriate ratios.

V		NC BC CA SA

Appendices R2: Content and style

- Shows appropriate ratios.
- Shows the computation of potential contingent liability.

Report: Structure

- Sufficient appropriate headings
- Appropriate use of paragraphs/sentences
- Legible
- Correctly numbered pages

V		NC BC CA SA

Report: Style and language

- Use of appropriate style
- Suitable language for the board

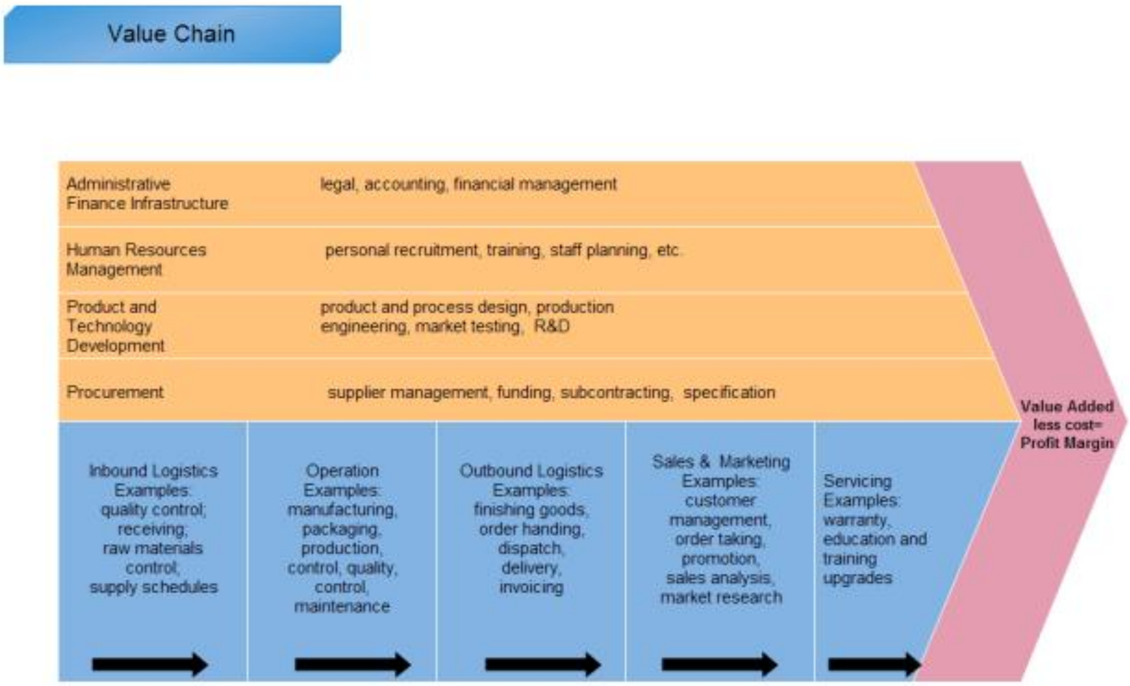
- Shows the computation of potential loss.

V		NC BC CA SA

- Tactful / ethical comments
- Acceptable spelling and punctuation

V		NC BC CA SA

APPENDIX 1


Value Chain
Administrative
Finance Infrastructure
legal, accounting, financial management
Human Resources
Management
personal recruitment, training, staff planning, etc.
Product and
Technology
Development
product and process design, production
engineering, market testing, R&D
Procurement
supplier management, funding, subcontracting, specification
Value Added
less cost=
Profit Margin
Inbound Logistics
Examples:
quality control;
receiving;
raw materials
control;
supply schedules
Operation
Examples:
manufacturing,
packaging,
production,
control, quality,
control,
maintenance
Outbound Logistics
Examples:
finishing goods,
order handing,
dispatch,
delivery,
invoicing
Sales & Marketing
Examples:
customer
management,
order taking,
promotion,
sales analysis,
market research
Servicing
Examples:
warranty,
education and
training
upgrades

APPENDIX 2

<u>Risk Identified</u>

1.	Reputational Risks-	Loss of Goodwill
2.	Market Risk -	Loss of customers
3.	Financial Risks -	Law suits, loss of revenue, cost of rework, etc
4.	Safety Risks-	Law suits from injured customers
		Law suits as a result of customers' loss of properties

APPENDIX 3 – RATIO ANALYSIS

1.	**Short-term liquidity and Solvency Ratio**			
			2016	**2015**
	(a)	$Current\ Ratio = \frac{CA}{CL}$	$\frac{1,398.1}{715.5} = 1.95$	$\frac{538.9}{156.1} = 3.45$
	(b)	$\text{Acid test} = \frac{CA - 1}{CL}$	$\frac{391.1}{715} = 0.55$	$\frac{532.6}{151.1} = 3.52$
	(c)	Stock turnover		
		$= \frac{Cost\ of\ goods\ sold}{Average\ stock}$	$\frac{403.4}{506.65} = 0.796$	$\frac{415.2}{6.3} = 65.9$
2.	**PROFITABILITY RATIOS**			
	(i)	$\text{Net profit} = \frac{NP}{Sales}$	$\frac{96.8}{668.6} x \frac{100}{1} = 14.48\%$	$\frac{71}{648.3} x \frac{100}{1} = 10.95$
	(ii)	$\text{Gross profit} = \frac{GP}{Sales}$	$\frac{260.2}{668.6} x \frac{100}{1} = 38.92\%$	$\frac{233.1}{648.3} x \frac{100}{1} = 35.96$
	(iii)	$\text{Profit Margin} = \frac{PBIT}{Sales}$	$\frac{111.8}{668.6} x \frac{100}{1} = 16.72\%$	$\frac{83.9}{648.3} x \frac{100}{1} = 12.94$
	(iv)	ROCE $= \frac{PBIT}{CE} x \frac{100}{1}$	$\frac{111.8}{1,303} x \frac{100}{1} = 8.58\%$	$\frac{83.9}{1,612.1} x \frac{100}{1} = 5.20\%$
	(v)	ROE $= \frac{PAT}{Equity} x \frac{100}{1}$	$\frac{96.8}{994.7} x \frac{100}{1} = 9.73\%$	$\frac{71}{951.4} x \frac{100}{1} = 7.46$
	(vi)	Asset Turnover $= \frac{Sales}{Tangible\ Asset}$	$\frac{668.6}{440} = 1.52 times$	$\frac{648}{1,055.5} = 0.61$times
3.	**LONG-TERM SOLVENCY/DEBTOR**			
	(i)	Proprietary Ratio $= \frac{SHF}{Total\ Tangible\ Asset}$	$\frac{994.7}{440} = 2.26$	$\frac{952.1}{1,055.5} = 0.90$
	(ii)	Debt Equity Ratio $= \frac{Debit}{Equity}$	$\frac{308.3}{994.7} = 0.31$	$\frac{660.7}{951.4} = 0.69$
		Or		
	(iii)	$Gearing = \frac{Debit}{CE}$	$\frac{308.3}{1,303} = 0.24$	$\frac{660.7}{1,612.1} = 0.41$
	(iv)	Fixed Interest Cover $= \frac{PBIT}{Fixed\ Interest}$	$\frac{111.8}{17.5} = 6.39$	$\frac{83.9}{14.6} = 5.75$
4.	**Investment Ratio**			
		$E.P.S. = \frac{Pat - Pref.Div}{Nos\ of\ share\ capital}$	$\frac{96.8}{50.2} = 1.93$	$\frac{71}{50.2} = 1.41$

CALCULATION OF POTENTIAL LOSS AND CONTINGENT LIABILITY

Cost of changing the battery location:

Total J – Phone 7 to be reworked:

Total units produced		2,000,000
Less: units exploded	5,000	
units customers are not likely to return	154,500*	159,500
		1,840,500
Cost of changing battery location per unit		₦5,000
Total cost of changing battery location		₦9,202,500,000
Media awareness campaign		₦1,500,000
Potential compensation		₦100,000,000
Total potential loss/ Contingent liability		₦9,304,000.000

	Units
*Total sales in unit	1,780,000
Total units returned (475,000 + 270,000)	(745,000)
Total units exploded	(5,000)
Total units remaining with customers	1,030,000
Expected units to be returned (1,030,000 x 85%)	875,500
Units unlikely to be returned	154,500

EXAMINER'S REPORT

The case study has two requirements:

- Analysis of the value chain and three key risks facing the company; and
- Analysis of financial reporting implications of events after the end of the year's financial reporting date together with calculation of potential loss and contingent liability.

To perform well in this case, candidates were expected to prepare the following appendices:

(i) Porter's value chain model;

(ii) Key financial ratios from the company's 2015 and 2016 financial reports included in the case

(iii) List of the key risks the company is facing

(iv) Calculation of potential loss and contingent liability as a result of the recall and planned rework of J-Phone 7 phones.

Candidate's performance was poor as majority of the candidates could not draw up the value chain model. Also, most of the candidates could not calculate the potential loss and contingent liability from simple financial data given in exhibit 6 to the case. Therefore, only about 10 percent of the candidates scored at least 50 percent.

The commonest pitfall of the candidates are their inability to:

(i) Draw up the Porter's value chain model and relate it to the situation described in the case;

(ii) Prepare potential loss and contingent liability from simple financial data;

(iii) See the events surrounding the J-Phone 7 phones explosions as post-financial position's events that must be reported as a note in the 2016 financial report being prepared by the auditors;

(iv) Prepare a good report expected from the case.

Therefore, to perform well in future examination, candidates are advised to:

(i) Learn the art of report writing and the various types of reports and their structure;

(ii) Study past case studies in the Pathfinder to be able to understand the right approach to Case Study examinations.

(iii) Make use of the Institute's Study Pack in preparation for future examinations.