ICAN

ACCURACY & INTEGRITY

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PATHFINDER

MAY 2017 DIET
SKILLS 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.

NOTES

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

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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – MAY 2017

FINANCIAL REPORTING

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

1. The following information relates to financial statements included in the annual report of Bello Professional Nigeria Limited.

Summarised Statement of Profit or Loss for the year ended March 31

	2015	2014
	₦'000	₦'000
Revenue	412,500	300,000
Cost of sales	(328,500)	(187,500)
Gross profit	84,000	112,500
Operating expenses	(90,000)	(45,000)
Finance expenses	(7,500)	(4,500)
Profit/(loss)before tax	(13,500)	63,000
Income tax credit/(expense)	5,250	(21,000)
Profit/(loss) for the year	(8,250)	42,000

Summarised Statement of Financial Position as at March 31

	2015	2014
	₦'000	₦'000
ASSETS:		
Non-current assets		
Property, plant & equipment	142,500	191,250
Current assets:		
Inventories	93,750	34,500
Trade receivables	33,750	15,000
Sundry receivables	3,750	-
Bank balance	-	11,250
Total assets	273,750	252,000

	2015	2014
	₦'000	**₦'000**
EQUITY & LIABILITIES		
Equity		
Ordinary shares of ₦1 each	75,000	60,000
Share premium	24,000	30,000
Retained earnings	33,750	47,250
	132,750	137,250
Non-current liabilities:		
10% loan notes	-	37,500
Finance lease obligations	36,000	15,000
Deferred tax liabilities	9,000	6,000
	45,000	58,500
Current liabilities:		
10% loan notes	37,500	-
Current income tax	-	18,750
Bank overdraft	10,500	-
Finance lease obligation	12,750	6,000
Trade payables	35,250	31,500
	96,000	56,250
Total equity and liabilities	273,750	252,000

The following additional information is also available:

(i) The finance expenses are made up of the following items:

	2015	2014
	₦'000	**₦'000**
Loan notes interest	3,750	3,750
Finance lease charges	2,250	750
Interest on overdraft	1,500	-
	7,500	4,500

(ii) The property, plant and equipment schedule included in the notes to the financial statements contained in the report are as follows:

	2015	2014
	₦'000	**₦'000**
Leased plant	48,750	18,750
Leasehold plant	-	66,000
Owned plant	93,750	106,500
	142,500	191,250

During the year Bello Professional Nigeria Limited sold its leasehold plant for ₦63.75million and entered into an agreement to rent it back from the purchaser. There were no additions to or disposals of owned Plant during the year. The depreciation charges which are included in the cost of sales for the year ended 31 March 2015 were as follows:

	₦'000
Leased plant	13,500
Leasehold plant	1,500
Owned plant	12,750
	27,750

(iii) On August 1 2014 there was a bonus issue of shares from share premium of one new share for every 10 held on May 1 2014. There was a fully subscribed cash issue of shares at par as at March 31, 2015

(iv) The 10% loan notes is due for repayment on June 30, 2016. Bello Professional Nigeria Limited is in negotiation with the loan providers, Accrual Bank Plc.

Required:

a. Prepare a statement of cashflow for Bello Professional Nigeria Limited for the year ended March 31, 2015 in accordance with IAS 7 using indirect method. (18 Marks)

b. One of the directors present at the annual general meeting of Bello Professional Nigeria limited where the financial statements were laid before members was of the view that direct method of preparing cashflow is more useful and provides better information to users than the indirect method.

Comment on the director's view stating whether you agree or not, giving reasons for your opinion. (7 Marks)

c. IAS 7 – Statement of cashflow allows some variation in the ways that the cashflow for interests and dividends are presented in the statement.

Explain the various ways of classifying the following items in a Statement of cashflow as permitted by IAS 7.

i. Interests paid
ii. Dividends received (5 Marks)

(Total 30 Marks)

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

QUESTION 2

Abuja Limited acquired 80% of Abaji Limited's ordinary shares on January 1 2015. The company paid an immediate ₦5.00 per share and a further payment of ₦19,440,000 in cash. The company only recorded the cash consideration of ₦5 per share. The two statements of financial position as at December 31 2015 are stated below:

	Abuja Limited ₦'000	Abaji Limited ₦'000
Non- current assets:		
Property, plant and equipment	75,600	57,600
Development costs	-	7,200
Investment	68,400	3,600
Current assets	23,940	16,380
Total assets	167,940	84,780
Equity and liabilities:		
Ordinary shares of ₦1 each	48,600	14,400
Share premium	14,400	7,200
Revaluation reserve	8,100	-
Retained earnings:		
January 1 2015	28,800	24,120
Year to December 31 2015	34,200	13,680
Non-current liability		
8% intercompany loan	-	10,800
Current liability	33,840	14,580
Total equity & liabilities	167,940	84,780

Additional information provided are:

(i) The parent company, Abuja Limited, value non-controlling interests (NCI) using the fair value at the acquisition date. The fair value of NCI at the acquisition date was ₦14,940,000. There is an impairment as at December 31 2015 resulting in the reduction of NCI to ₦14,220,000.

(ii) Abaji Limited revalued land and building using fair value which resulted in an increase of ₦3,600,000 at the acquisition date and a further ₦720,000 at December 31, 2015.

(iii) Abaji Limited have line of products with a brand name valued at ₦7,200,000 with an estimated life of 10 years as at 1 January 2015. The brand is not included in Abaji statement of financial position on this date.

(iv) A loan of ₦10,800,000 from Abuja Limited granted to Abaji Limited at acquisition date was included in Abuja Limited investment. Loan interest is payable annually in arrears. Abuja Limited did not receive the interest due and paid by Abaji for the year ended December 31, 2015 until after the year end. Therefore Abuja Limited has not accounted for the Abaji accrued interest.

(v) The development project of Abaji Limited was completed on June 30, 2015 at a cost of ₦9,000,000. As at December 31, 2015, ₦1,800,000 had been amortised. Abaji Limited had capitalised ₦3,240,000 at the acquisition date. However, the directors of Abuja Limited are of the opinion that Abaji Limited development costs cannot be recognised as an asset because it does not meet the requirement in IAS 38.

(vi) Abuja Limited bought goods from Abaji Limited. One third of the goods were still in the inventory of Abuja Limited at December 31, 2015. The goods was sold to Abuja Limited at a profit of ₦1,080,000.

Required:

Provide figures to be included in the consolidated statement of financial position as at December 31 2015 in respect of the following:

a. Non- controlling interest (7 Marks)

b. Goodwill (7 Marks)
(show your calculations of net assets as at date of acquisition and date of consolidation)

c. Consolidated reserves:
   i. Share premium
   ii. Retained earnings
   iii. Revaluation reserve (6 Marks)
   (Show your workings) **(Total 20 Marks)**

NB. You are not required to prepare a consolidated statement of financial position as at December 31 2015

QUESTION 3

You are a financial reporting consultant. The management of Bode Limited a well-diversified company with branches in all states of the federation has some transactions for which it requires advice from you. Bode Limited has a financial accountant who is not yet a qualified accountant.

These transactions are as listed below:

(a) The company recognised a cash generating unit during the year ended December 31, 2015 which is made up of the following assets.

	Costs
	₦'m
Property, plant and equipment	4,050
Goodwill	450
Other assets	2,700
	7,200

The management of Bode Limited estimated that the recoverable amount of the cash generating unit as at the end of the year will be ₦6.30billion.

The financial accountant of Bode Limited is aware of some of the provisions of IAS 36 on impairment of assets but he is confused as to how impairment (if any) on these assets should be allocated among the assets that make up the cash generating unit of the company.

(b) Also, on January 1, 2015 Bode Limited borrowed ₦300million to finance the production of two assets both of which were expected to take one year to build.

The work started on January 1, 2015. The loan facility was drawn down on the same day and was utilised as follows with the remaining funds invested temporarily.

	Asset X	Asset Y
	₦'000	₦'000
January 1, 2015	50,000	100,000
July 1, 2015	50,000	100,000

The loan interest rate is 9% per annum and Bode Limited can invest surplus funds at 7% per annum.

The financial accountant is not certain as to how these assets (X and Y) should be accounted for in the financial statement of Bode Limited as at December 31, 2015.

(c) The company owns a building which it has been using as head office in Abuja. In order to reduce cost, the company's management on June 30, 2015 decided to move the head office to the branch office at Abuja and has now let out its head office building.

The company's accounting policy is to use fair value model for Investment Property.

The head office building had an original cost on January 1, 2006 of ₦37.5million and was being depreciated over 50 years. As at December 31, 2015 the fair value of the head office building was assessed by an independent valuer to be ₦52.5million.

The financial accountant is confused as to how these transactions should be treated in the financial statements of the company.

Required:

Write a memo to the management of Bode Limited explaining how these transactions should be accounted for in their financial statements. Provide relevant calculations where necessary. **(Total 20 Marks)**

QUESTION 4

a. Explain the following, stating their importance to investors in the evaluation of financial performance:

   i. Earnings per share (EPS)
   ii. Price earnings ratio (PE-ratio) (6 Marks)

b. The issued and fully paid share capital of Almond Nigeria Limited which has remained unchanged since the date of incorporation until the financial year ended March 31, 2015 include the following:

   (i) 2,400,000,000 ordinary shares
   (ii) 600,000,000 6% participating preference share of ₦1 each.

   The company has been operating at a profit for a number of years. As a result of a very conservative dividend policy in the previous years, there is a large accumulated profit balance on the statement of financial position.

   On July 1, 2015, the directors decided to issue to all ordinary shareholders two bonus shares for every one previously held.

   The following is the extract of group statement of profit or loss and other comprehensive income for the year ended March 31, 2016.

Almond Nigeria Limited
Extract of Group Statement of Profit or Loss and other Comprehensive Income for the year ended March 31, 2016

	2016	2015
	₦'000	₦'000
Profit for the year	740,000	540,000
Other comprehensive income	--	(20,000)
Total comprehensive income	740,000	520,000
Total comprehensive income attributable to:		
Owners of parent	680,000	480,000
Non-controlling interest	60,000	40,000
	740,000	520,000

The following dividend have been paid or declared at the end of the period.

	2016	2015
	₦'000	₦'000
Ordinary	330,000	240,000
Preference	69,000	60,000

The participating preference shareholders are entitled to share profit in the same ratio in which they share dividends after payment of fixed preference dividend. The preference shareholders will share the same benefit as the ordinary shareholders of the company should the company be liquidated.

Required:

i. Calculate the earnings per share (EPS) in accordance with IAS 33 and the dividend per share (DPS) for the year ended March 31, 2015 and 2016. (10 Marks)

ii. What are the limitations of earnings per share (EPS) as a measure of a company's performance? (4 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 difference between debt and equity in an entity's statement of financial position is not easily distinguishable for preparers of financial statements. Debts and equity financial instruments may have similar characteristics, which may lead to inconsistency of reporting.

Required:

a. Discuss the main distinguishing features in the presentation of debt and equity under International Financial Reporting Standards (IFRS) with clear examples. (10 Marks)

b. Explain why it is important for entities to understand the impact of the classification of a financial instrument as debt or equity in the financial statement. (5 Marks)

(Total 15 Marks)

QUESTION 6

a. IFRS 5 - Non-Current Assets Held For Sale and Discontinued Operations set out requirements that specify the accounting treatment for assets held for sale and the presentation and disclosure of discontinued operations.

Required

Explain the conditions that must apply at the reporting date for an asset (or disposal group) to be classified as held for sale and how the assets can be measured. (5 Marks)

b. i. Explain how impairment of asset should be identified and accounted for at the end of a reporting period. (4 Marks)

ii. A company has decided to dispose off a group of its assets. The carrying amounts of the assets immediately before the classification as held for sale were as follows:-

	₦
Goodwill	800,000
Property, plant and equipment (at revalued amounts)	3,050,000
Property, plant and equipment (at cost)	3,200,000
Inventory	840,000
Other current assets	700,000
Total	8,590,000

The company estimates that the "fair value less cost to sell" of the disposal group is ₦6,400,000.

Required:

Calculate the impairment loss and its allocation to the non-current assets in the disposal group. (6 Marks)

(Total 15 Marks)

QUESTION 7

a. IAS – 37 applies to all provisions and contingencies apart from those covered by the specific requirement of other standards.

Therefore provisions differ from other liabilities because there is uncertainty about timing or amount of the future cashflow required to settle the liability.

Required:
Explain the criteria for recognition of provisions in the financial statements and distinguish between provisions and contingent liabilities. (6 Marks)

b. The following activities took place in **THREE** different companies:

(i) Otapiapia Plc a Rat Trap Company based in Nigeria has just secured exportation of rat killers to South Africa. The advertising slogan of the rat killers is "**KILL the BLACKS**". A South African anti-racist movement with representative in Nigeria is claiming ₦15,000,000 from the company as damages because the advertising slogan allegedly compromises the dignity of black people. The company's legal representative believes that the success of the claim will depend on the judge who presides over the case. They estimate however, that there is a 70 percent probability that the claim will be thrown out and a 30 percent probability that it will succeed.

(ii) Ire-Akari Motors Plc is a Nigerian company that specialises in the manufacture of "made-in-Nigeria cars".

During the current financial year 100 cars have been completed and sold. During the testing of the cars a defect was found in their steering mechanism.

All the 100 customers that bought the cars were duly informed of the defect and were told to bring their cars back to have the defects repaired at no cost. All the customers have indicated that this is the only remedy they require. The estimated cost of the recall is ₦10.5m.

The manufacturer of the steering mechanism, a quoted company with sufficient fund has accepted responsibility for the defect and has undertaken to reimburse Ire-Akari Motors Plc all cost that it might incur in this regard.

(iii) Abeokuta Electricity Company Plc sold a number of electricity transformers with a warranty in the year ended December 31, 2015. At the beginning of the year the provisions for warranty stood at ₦5,625,000.

A number of claims have been settled during the period for ₦3,000,000.

As at the year-end there were unsettled claims for 300 customers. Experience is that 40% of the claims submitted do not fulfil warranty conditions and can be defended at no cost. The average cost of settling other claims will be ₦52,500 each.

Required:

Explain how the matters in b(i) to b(iii) above should be accounted for in the financial statements of the three companies using figures to illustrate your points where appropriate. (9 Marks)

(Total 15 Marks)

SUGGESTED SOLUTION

SOLUTION 1

a. Bello Professional Nigeria Limited
Statement of cashflow for the year ended March 31, 2015

		₦'000
Cashflow from operating activities		
Loss Before Tax		(13,500)
Adjustments:		
Depreciation		27,750
Loss on disposal of leasehold plant (w1)		750
Finance cost		7,500
		22,500
Operating profit before working capital changes		
Increase in Inventory		(59,250)
Increase in trade receivables		(18,750)
Increase in sundry receivables		(3,750)
Increase in trade payables		3,750
Cash generated from operating activities		(55,500)
Income Tax Paid (w2)		(10,500)
		(66,000)
Net Cash used in operating activities		
Cashflow from investing activities		
Proceeds from disposal of leased hold plant	63,750	
Net Cash generated from investing activities		**63,750**
Cashflow used financing activities		
Issue of Shares (w4)	9,000	
Dividend paid (w5)	(5,250)	
Finance cost paid	(5,250)	
Finance Lease Repayment (w6)	(18,000)	
Net Cash generated from financing activities		**(19,500)**
Net Increase in cash and cash equivalent		**(21,750)**
Cash and cash equivalents b/f		11,250
Cash and cash equivalents c/f		**(10,500)**

Analysis of Cash and Cash Equivalents

	At March 31, 2014	Change in the year	At March 31, 2015
	₦'000	₦'000	₦'000
Cash at bank	11,250	(11,250)	-
Bank overdraft	-	(10,500)	(10,500)
	11,250	(21,750)	(10,500)

Working (Notes)

w1. **Leasedhold Plant**

	₦'000
Balance B/F	66,000
Depreciation	(1,500)
Carrying amount at disposal	64,500
Disposal proceeds	(63,750)
Loss on disposal	750

w2. **Taxation Account**

Balance B/F - Current Tax	18,750
- Deferred Tax	6,000
Income statement	(5,250)
Balance C/f - Current Tax	-
- Deferred Tax	9,000
Tax Paid	10,500

w3. **Leased Plant**

Balance B/f	(18,750)
Depreciation	13,500
	(5,250)
Balance C/F	48,750
Leased Plant(w6)	43,500

w4. **Ordinary Shares**

Balance as at March 31, 2014	60,000
Bonus Issue: 1 for 10 or (30,000 – 24,000)	6,000
	66,000
Balance as at March 31, 2015	75,000
Cash issue at Par	9,000

w5. **Retained Earnings**

Balance as at March 31, 2014	47,250
Loss for the year	(8,250)
	39,000
Balance as at March 31, 2015	(33,750)
Dividend paid	5,250

w6. **Finance Lease on Leasehold plant**

Balance as at March 31, 2014 (6,000 + 15,000)	21,000
Leased Plant(w3)	43,500
Finance lease charges	2,250
	66,750
Balance as at March 31, 2015 (36,000 + 12,750)	48,750
Finance Lease repayment	18,000

(b) **Direct method of statement of cash flow compared with indirect method**

In accordance with IAS 7, there are two methods of presenting the statement of cash flows with respect to operating activities. These methods are "Direct method" and "Indirect method".

i. Direct method of preparing cash flow disclose major class of gross receipts and gross cash payments.

ii. Direct method shows the items that affected cash flow and the size of those cash flows, cash received from and cash paid to specific sources such as customers and suppliers.

iii. Another observed advantage of direct method is that users see and understand the actual cashflows and how they relate to items of income and expenses.

iv. From the view point of the users, the direct method is preferable because it discloses information not available elsewhere in the financial statements, which could be used in estimating future cashflow while indirect method involves adjusting the net profit or loss for changes in non-cash expenditure and movement in working capital.

v. Direct method tells the reader whether cash collections from customers are increasing or decreasing.

vi. Direct method shows ability to compare similar types of cash receipts and payments across companies at least annually.

vii. Direct method gives better representation of an entity's cash cycle for credit guarantors and more user – friendly format for managers.

viii. Direct method highlights the differences between net income and net cash from operating activities whereas the indirect method is most useful in extracting the lead and lay between cashflows and income information.

ix. Direct method highlights the operating changes in non-cash working capital accounts.

x. Direct method assists the users in determining the reasons for the differences between net income and associated cash receipts and payments to provide a basis for evaluation.

xi. Indirect method reconciles operating profit to net operating cashflow.

xiii. Indirect method is easier to prepare.

xiv. It is simple for users to analyse.

<u>Conclusion</u>

Therefore, from the above analysis, I agree with the opinion of the directors that direct method would be more preferable and more useful to users of financial statements, although, the IFRS i.e. IAS 7 on statement of cashflow permits the use of both methods.

(c) **Ways of treating interest paid and dividend received in statements of cashflow as permitted by IAS 7**

i. **Interest payments**

Interest payment may be classified as either:

- An operating cashflow, because they are deducted when calculating operating profit before taxation or
- A financing cashflow, because they are cost of obtaining finance.

ii. **Dividend received**

- An operating cashflow, because they are added when calculating operating profit before taxation.
- An investing cashflow, because they represent return on investment.

EXAMINER'S REPORT

The question tests candidates knowledge of IAS 7 on statement of cashflow. Part (a) requires candidates to prepare a statement of cashflow using the indirect method. Part (b) involves an appraisal of the direct and indirect methods of presenting statements of cashflow and to give reasons why one method is more useful than the other. Part (c) requires candidates to explain the various methods of classifying cashflows relating to interest paid and dividend received.

All the candidates attempted the question but performance was very poor. Only about 20% of the candidates obtained up to 50% of the 30 marks allocated to the question.

Candidates' commonest pitfall was their inability to correctly classify cashflows in the statement of cashflow. Candidates did not address the question asked in part (b) and (c) which suggests inadequate knowledge of the provisions of IAS – 7 on statement of cashflows.

Candidates are advised to cover adequately all sections of the syllabus for this paper when preparing for the examination in future.

MARKING GUIDE

	Marks	Marks
Statement of cashflow		
- Determination of cashflows from operating activities	7	
- Determination of cashflows from investing activities	1	
- Determination of cashflows from financing activities	7	
- Analysis of cash and cash equivalent	3	18
Assessment of Director's comment:		
- Arguments in favour of Direct or Indirect method	3	
- Arguments against Direct or Indirect method	2	
- Conclusion	2	7
Ways of treating interest paid and dividend received in the statement of cashflow:		
- Classification of interest paid	2½	
- Classification of Dividend received	2½	5
Total marks		30

SOLUTION 2

(a)

Non controlling interest	**₦'000**
NCI value of acquisition	14,940
NCI shares of post acquisition reserves	
20% x (62,640 – 53,280)	1,872
	16,812
Impairment (Balancing figure)	(2,592)
NCI at reporting date	14,220

(bi)

Goodwill	**₦'000**
Abuja Limited parent	
Investment at fair value	57,600
Cash (80% x 14,400 x ₦5)	
Deferred consideration	19,440
	77,040
NCI value at acquisition	14,940
	91,980
Net assets at acquisition(bii)	(53,280)
	38,700
Less: Impairment ($\frac{2{,}592}{0.2}$ x 0.8)	(10,368)
Good will	28,332

(bii) **Net assets Abaji Limited**

	At Acquisition 1/1/15 ₦'000	At Reporting 31/12/15 ₦'000
Share capital	14,400	14,400
Share premium	7,200	7,200
Retained Earnings	24,120	37,800
	45,720	59,400
Fair value adjustments:		
Brand	7,200	7,200
Amortisation of brand	-	(720)
Research and Development unrealised	(3,240)	(7,200)
Unrealised profit (1/3 x 1,080)	–	(360)
	49,680	58,320
Land and building – revaluation	3,600	3,600
" " - further revaluation	-	720
	53,280	62,640

(c) **consolidated reserves**

		₦'000
i.	Consolidated share premium (parent company only)	14,400
		₦'000
ii.	Consolidated retained earnings – parent	63,000
	Add interest receivable (10,800 x 8%)	864
		63,864
	Group share of post acquisition in subsidiary excluding revaluation on land and building taken to revaluation reserve 80% x (58,320 – 49,680)	6,912
	Less impairment of investment & others 80% x(57,600 – 54,000) +12,960	15,840
		54,984

iii. **consolidated revaluation reserve**

Parent	8,100
Group share of fair value of land and building 80% (3,600 + 720)	3,406
	11,556

N.B: (i) Cost of investment less Loan to subsidiary = ₦54,000

(ii) All figures are stated in ₦'000

EXAMINER'S REPORT

This question tests candidates knowledge of group or consolidated financial statements. It requires candidates to calculate the non-controlling interest, goodwill and consolidated reserve figures to be included in the consolidated statement of financial position.

Most of the candidates attempted the question and their performance was below average. Only about 30% of the candidates obtained 50% of the 20 marks allocated to the question.

The candidates' commonest pitfall was their inability to adjust correctly for the fair value adjustments of some assets at the acquisition and reporting dates. Some candidates mixed- up the parameters for calculating goodwill with that of calculating non-controlling interest.

Candidates are advised to cover all aspects of group accounts when preparing for examination in this paper.

MARKING GUIDE

		Marks
(a)	Calculation of non-controlling interest	7
(b)	Calculation of goodwill	7
(c)	i. Calculation of consolidated share premium	1
	ii. Calculation of consolidated earnings	4
	iii. Calculation of consolidated reserve	1
	Total marks	20

SOLUTION 3

From:	XYZ (Financial Reporting Consultant)
To:	Management of Bode Limited
Date:	21/11/2016
Subject:	**Explanation of Accounting Treatment of some issues**

Please, find below details of our explanation on three main issues raised by you for the treatment of some accounting issues.

The issues required the applications of some International Financial Reporting Standards (IFRS) which I have taken time to explain below.

(a) The impairment loss should be allocated across the assets of the cash generating unit according to IAS 36 on impairments.

- The financial accountant should determine the total impairment loss which is (₦7.2billion less ₦6.3billion) i.e. ₦900million.
- Out of this impairment loss N450million should be allocated to Goodwill to write it down to Nil balance.
- The balance of ₦450million should be allocated to Property, Plant and Equipment and other assets as follows:

i. Property, Plant & Equipment ₦450million x $\frac{4,050m}{6,750m}$ = ₦270m

ii. Other Assets 450million x $\frac{2,700m}{6.750m}$ = 180million

450million

The carrying amount of the assets that should be shown in the financial statement of BODE Limited as at December 31, 2015 should be shown as follows:

	Cost	**Impairment**	**Carrying Amount**
	₦'m	**₦'m**	**₦'m**
Property, Plant & Equipment	4,050	(270)	3,780
Goodwill	450	(450)	Nil
Other assets	2,700	(180)	2,520
	7,200	900	6,300

(b) In a situation where the company, BODE Limited, borrowed money to finance the production of two assets. IAS 23 states that the borrowing costs that are directly attributable to acquisition, construction or production of qualifying assets must be identified and capitalised.

The borrowing cost that should be capitalised with cost of the asset X and Y as at December 31, 2015 are as follows:

	Asset X	**Asset Y**
Borrowing cost	**₦'000**	**₦'000**
X = (₦100m x 9%)	9,000	
Y = (₦200 x 9%)		18,000
Less: Investment Income		
X = (₦50m x 7% x 6/12)	(1,750)	
Y = (₦100m x 7% x 6/12)		(3,500)
Net borrowing cost	7,250	14,500

Therefore, the cost of assets X and Y of BODE Limited that should be shown in the statement of financial position as at December 31 is:

	X	**Y**
	₦,000	₦,000
Cost of assets	100,000	200,000
Borrowing cost to be capitalised	7,250	14.500
	107,250	214,500

(c) Reclassification of owner occupied property to investment property (on fair value model).

IAS 40 requires the following to be done when there is a change in use which necessitates that an owner occupied property be reclassified as investment property to be accounted for using the fair value model.

i. Ascertain the fair value of the property as at the date of change in use.

ii. The difference between the fair value ascertained in (i) and its carrying amount at the same date should be accounted for in accordance with IAS 16. This implies that a gain (excess of the fair value over the carrying amount) should be recognised in other comprehensive income from where it would be included in equity via revaluation surplus reserve. Conversely, a loss (excess of carrying amount over the fair value) should be recognised in profit or loss.

iii. From the date of reclassification, the property is no longer depreciable i.e. depreciation would no longer be charged thereon.

iv. Every reporting date therefore, the fair value of the property should be re-measured and gain or loss recognised in other comprehensive income from where it would be included in equity via revaluation surplus reserve. Conversely, a loss (excess of carrying amount over fair value) should be recognised in profit or loss.

The building was initially a non-current asset under IAS 16: Property, Plant and Equipment up to June 30 2015 when there was a change in use as investment property from this date, IAS 40 becomes applicable.

In view of the above, the company's building, investment property will be accounted for as shown below:

	₦'m	₦'m
Fair value as at 31/12/2015		52.5
Less:		
Fair value as at 30/06/2015 assumed equals to carrying value as at that date		
Cost	37.5	
Depreciation 1/1/2006 to 30/06/2015 ($\frac{37.5}{50}$ x 10½ years)	(7.9)	29.6
Fair value gain on investment property		22.9

Extract of statement of Profit or Loss and other Comprehensive Income

	₦'m
Depreciation	(0.4)
Fair value gain on investment property	22.9

Extract of Statement of financial position

Non-current assets	₦'m
Investment property	52.5

Conclusion

Please do not hesitate to contact us should you require further explanations on the above.

Thank you.

Mr. XYZ
Financial Reporting Consultant

EXAMINER'S REPORT

The question tests candidates' knowledge and understanding of the applications of three accounting standards: IAS 36 on impairment, IAS 23 on borrowing costs and IAS 40 on investment properties. The question requires candidates to apply the provisions of the different standards to three scenarios.

About 50% of the candidates attempted the question, candidates' showed lack of understanding of the requirements of the question as their overall performance was very poor.

Candidates' commonest pitfall was their inability to present their solutions in MEMO form as demanded by the question. Some candidates also lost vital marks due to non-denomination of the relevant amounts in million or thousand naira.

Candidates are advised to ensure adequate preparation by paying special attention to relevant financial reporting standards examinable at this level of the examination.

MARKING GUIDE

		Marks	Marks
(a)	Impairment of assets – IAS 36		
	- Determination of the impairment loss	1	
	- Allocation of impairment loss to goodwill	1	
	- Calculation and allocation of impairment loss to PPE and other assets	2	
	- Determination of carrying amount of assets which will appear in the financial statement	<u>2</u>	6
(b)	Borrowing cost – IAS 23		
	- Determination of borrowing cost to be capitalised	3	
	- Determination of cost of assets to be shown in the statement of financial position	<u>3</u>	6
	Investment property – IAS 40		
(c)	Reclassification of owner occupied property to investment property (on fair value model):		
	- Ascertain the fair value of the property at the date of change in use	1	
	- Determine the gain or loss in fair value i.e. excess of carrying amount over the fair value	3	
	- Extract of statement of profit or loss and other comprehensive income	1	
	- Extract of statement of financial position	<u>1</u>	6
	Memo format conclusion		<u>2</u>
	Total marks		<u>20</u>

SOLUTION 4

(a) i. **Earnings Per Share**

- Earnings are profits available for equity holder. Earnings per share is a measure of the amount of earnings in a financial period for each equity share.

$$EPS = \frac{\text{Net profit attributable to ordinary shareholders}}{\text{Weighted average no of ordinary shares outstanding during the period}}$$

Importance

- EPS is used by investors as a measure of the performance of companies in which they invest or wish to invest.
- It reveals a lot about the financial health of the company.
- It helps in the choice of shares or stocks to acquire.
- It serves as input in the calculation of Price Earnings Ratio.
- It gives a more accurate picture of the actual returns to investors than reported profits.
- EPS can have a significant effect on a company's share price.
- EPS serves as a means of assessing the stewardship and management of the company.

ii. **Price Earnings Ratio (P/E) Ratio**

- Price Earnings Ratio is a measure of the company's current share price (market price) in relation to the EPS.

$$P/E\ Ratio = \frac{\text{Market Price of Share}}{EPS}$$

Importance

- It can be used by investors to determine whether the share is expensive or cheap.
- It is an indication of the future strength of the company's performance.
- A high P/E Ratio gives the investors confidence in the stock, and they are prepared to pay high price for the stock.
- Higher P/E Ratio is an indication of a strong corporate governance in a company.
- It indicates the ability of the company to pay high and stable dividends to shareholders.

b. i. **EARNINGS PER SHARE (EPS)**

	March, 31 2016 ₦'000	March 31, 2015 ₦'000
Profit attributable to ordinary shareholders (wk 2)	640,000	440,000
Weighted No of shares (w3)	7,800,000	3,000,000
Earnings per share (EPS)	₦0.082	₦0.147

Dividend Per Share (DPS)

Ordinary Shares:		
Dividend (w1)	330,000	240,000
No of Ordinary Shares (w3)	7,200,000	2,400,000
DPS	₦0.046	₦0.1
Preference shares:		
Dividend (w1)	69,000	60,000
No. Or ordinary shares (w3)	600,000	600,000
DPS	₦0.115	₦0.10

WORKINGS

W1 Percentage of Profit attributable to class of equity shares

	2016 ₦'000	2015 ₦'000
Total pref. Dividend	69,000	60,000
Fixed portion (6% of 600,000)	(36,000)	(36,000)
	33,000	24,000
Dividend paid to ordinary shareholders	330,000	240,000

Therefore, the participating preference shareholders will share profit in the ratios of 1:10 (33,000 : 330,000) or (24,000 : 240,000) with ordinary shareholders after payment of the fixed preference dividend out of the profit.

W2

Earning per each class of share

	2016 ₦'000	**2015 ₦'000**
Net profit for the year	740,000	520,000
Fixed Pref. Dividend	(36,000)	(36,000)
	704,000	484,000

	2016		2015
	₦'000		₦'000
Net profit attributable to ordinary shareholders ($^{10}/_{11}$ of 704,000)	640,000	($^{10}/_{11}$ of 484,000)	440,000
Net profit attributable to participating shareholders ($^{1}/_{11}$ of 704,000)	64,000	($^{1}/_{11}$ of 484,000)	44,000
Fixed dividend	36,000		36,000
	100,000		80,000

W 3

Weighted number of shares in issue

Ordinary shares:	2016	2015
	'000	'000
Balance April 1, 2014	2,400,000	2,400,000
Capitalization (Bonus)	4,800,000	-
	7,200,000	2,400,000
Participating Preference shares	600,000	600,000
	7,800,00	300,000

ii. **Limitations of Earnings Per Share (EPS)**

- Not all entities use the same accounting policies. It may not always be possible to make meaningful comparison between EPS of different companies.
- EPS does not take account of inflation, so that, growth in EPS over time might be misleading.
- EPS measures an entity's profitability, but this is only part of an entity's overall performance.
- Diluted EPS is based on current and not on forecast earnings, therefore not a reliable predictor of future EPS.
- EPS is relied on by investors as the main measure of an entity's performance. Hence, management try to make EPS appear as high as possible by attempting to manipulate the figures using "creative accounting" as well as making decisions which will increase EPS in the short term, but which damage the entity in the longer term.

EXAMINER'S REPORT

The question tests candidates' knowledge of the performance ratios: Earnings Per Share (EPS), Price Earnings Ratio (P/E) and Dividend Per Share (DPS). Part (a) requires candidates to explain and state the importance of EPS and PE ratios to the investor. Part (b) requires the calculation of EPS and outlining its limitations as a measure of company's performance.

About 30 percent of the candidates attempted the question and demonstrated fair understanding of the requirements of the question and performance was fairThe commonest pitfall was candidates inability to determine correctly the ratio of participation in the residual profit by the participating preference shareholders. Some other candidates could neither explain the ratios as required nor correctly state the limitations of the ratios.

Candidates are advised not to undermine any aspect of the syllabus or focus on some particular ratios. Adequate coverage of the syllabus is therefore recommended.

MARKING GUIDE

			Marks
(a)	Explanation and importance of ratios		
	- Explanation of Earnings Per Share	1	
	- Explanation of Price Earnings Ratio	1	
	- Importance of EPS in performance evaluation (any 4 points at ½ mark each)	2	
	- Importance of PE Ratio in performance evaluation (any 4 points at ½ mark each)	2	6
(b)	i. Calculation of Earnings Per Share (EPS)	1½	
	- Calculation of Dividend Per Share - Ordinary	1½	
	- Calculation of Dividend Per Share - Preference	1½	
	- Workings for Dividend per share	2	
	- Workings for Earnings per share	3½	10
(c)	Limitations of Earnings Per Share (any 4 points at 1 mark each)		4
	Total marks		20

SOLUTION 5

(a)

- IAS 32 Financial Instruments Presentation establishes principles for presenting financial instruments as liabilities or equity. To determine whether a financial instrument should be classified as debt or equity, IAS 32 uses principles-based definitions of a financial liability and of equity. In contrast to the requirements of generally accepted accounting practice in many jurisdictions around the world, IAS 32 does not classify a financial instrument as equity or financial liability on the basis of its legal form. The key feature of debt is that the issuer is obliged to deliver either cash or another financial asset to the holder. The contractual obligation may arise from a requirement to repay principal or interest or dividends.

- Such a contractual obligation may be established explicitly or indirectly through the terms of the agreement. For example, a bond which requires the issuer to make interest payments and redeem the bond for cash is classified as debt. In contrast, equity is any contract which evidences a residual interest in the entity's assets after deducting all of its liabilities. A financial instrument is an equity instrument only if the instrument includes no contractual obligation to deliver cash or another financial asset to another entity and if the instrument will or may be settled in the issuer's own equity instruments. For example, ordinary shares, where all the payments are at the discretion of the issuer, are classified as equity of the issuer. The classification is not quite as simple as it seems. For example, preference shares required to be converted into a fixed number of ordinary shares on a fixed date or on the occurrence of an event which is certain to occur, should be classified as equity.

- A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. The classification of this type of contract is dependent on whether there is variability in either the number of equity shares delivered or variability in the amount of cash or financial assets received. A contract which will be settled by the entity receiving or delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument. However, if there is any variability in the amount of cash or own equity instruments which will be delivered or received, then such a contract is a financial asset or liability as applicable.

- For example, where a contract requires the entity to deliver as many of the entity's own equity instruments as are equal in value to a certain amount of cash, the holder of the contract would be indifferent whether it received cash or shares to the value of that amount. Thus this contract would be treated as debt.

Other factors, which may result in an instrument being classified as debt, are:

i. redemption is at the option of the instrument holder;
ii. there is a limited life to the instrument;
iii. redemption is triggered by a future uncertain event which is beyond the control of both the holder and issuer of the instrument; and
iv. dividends are non-discretionary;

Similarly, other factors, which may result in the instrument being classified as equity, are whether the shares are non-redeemable, whether there is no liquidation date or where the dividends are discretionary.

(b) **The importance of entities understanding the impact of the classification of a financial instrument as debt or equity in the financial statements.**

When an entity issues a financial instrument, it must determine its classification either as a liability (debt) or as equity. That determination has an immediate and significant effect on the entity's reported results and financial position.

i. Liability classification affects an entity's gearing ratios and typically results in any payments being treated as interest and charged to earnings.
ii. Equity classification avoids these impacts but may be perceived negatively by investors if it is seen as diluting their existing equity interests.
iii. Understanding the classification process and its effects is therefore a critical issue for management and must be kept in mind when evaluating alternative financing options.
iv. This may in turn affect the entity's ability to pay dividends on its equity shares (depending upon the requirements of local law).
v. Equity classification avoids the negative impact that liability classification has on reported earnings and gearing ratios. It also results in the instrument falling outside the scope of IAS 39 Financial Instruments: Recognition and measurement, thereby avoiding the complicated ongoing measurement requirements of that standard.

EXAMINER'S REPORT

The question tests the Provisions of IAS 32 – Financial Instrument presentation. Candidates are required to discuss the main distinguishing features in the presentation of debt and equity as well as state the importance of the impact of classification of debt or equity in the financial statements.

Less than forty percent (40%) of the candidates attempted the question and performance was poor.

Candidates' commonest pitfalls include the following:

- **Explaining the differences between equity holders and debenture holders instead of stating the distinguishing feature in the presentation of debt and equity as stated in International Financial Reporting Standards (IFRS).**

- **Inability of candidates to explain the importance of understanding the impact of classification of financial instruments as debt or equity in the financial statements.**

The failure to make use of ICAN Study texts as well as familiarising themselves with all relevant accounting standards at this level of the Institute examinations, led to the poor performance, hence candidates are advised to pay more attention to recommended study texts and ensure that they cover the syllabus for better performance in future examinations.

MARKING GUIDE

		Marks
(a)	Discussion on the main distinguishing features in the presentation of debt and equity under IFRS (any 10 points at 1 mark each)	
		10
(b)	Explanation of the importance for entities to understand the impact of the classification of financial instrument as debt or equity. (any 5 points at 1 mark each)	5
	Total marks	15

SOLUTION 6

(a) The following conditions must apply at the reporting date for an asset (or disposal group) to be classified as held for sale:

(i) It must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal group);

(ii) The sale must be highly probable i.e:
- The appropriate level of management must be committed to a plan to sell the asset (or disposal group);
- An active programme to locate a buyer and complete the plan must have been initiated; and
- The asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value.

(iii) The sale must be expected to be completed within one year from the date of classification (except in limited circumstances) and actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

If the criteria are met for a non-current asset (or disposal group) after the reporting date but before the authorization of the financial statements, that asset must not be classified as held for sale as at the reporting date. However, the entity is required to make certain disclosures in respect of the non-current asset (or disposal group).

(b) **How Impairment of assets should be identified and accounted for**

(i) At the end of each reporting period, the entity should assess whether there are any indications that an asset may be impaired.

(ii) If there are such indications, the entity should estimate the assets recoverable amounts.

(iii) When the recoverable amount is less than the carrying value of the assets the entity should reduce assets' carrying value to its recoverable amount. The amount by which the value of the assets is written down is an **impairment loss.**

(iv) The impairment loss is recognized as loss for a period.

(v) However, if the impairment loss relates to an asset that has previously been re-valued upward. It is first off-set against any remaining revaluation surplus for that asset, when this happens, any difference is charged to other comprehensive income for the period.

(vi) Depreciation charges for the impaired assets in future periods should be adjusted to allocate the assets revised carrying amount minus any residual value, over its remaining useful life (revised if necessary).

b(ii) Impairment loss

	Carrying Amount before Allocation	**Impairment loss**	**Carrying amount after allocation**
	₦	**₦**	**₦**
Goodwill	800,000	800,000	-
Property, plant and equipment (at revalued amount) – w 2	3,050,000	678,320	2,371,680
Property, plant and equipment (at cost) – w3	3,200,000	711,680	2,488,320
Inventory	840,000	-	840,000
Other current assets	700,000	-	700,000
Total	8,590,000	2,190,000	6,400,000

WORKINGS

(W 1) **Impairment Loss:**

₦8,590,000 less ₦6,400,000 = ₦2,190,000

(W 2) **Allocations** ₦

- Goodwill = 800,000

- Property, plant & equipment (revalued asset)

$$\frac{3{,}050{,}000 \times (2{,}190{,}000 - 800{,}000)}{6{,}250{,}000} = 678{,}320$$

- Property, plant and equipment (at cost)

(W 3) $$\frac{3{,}200{,}000 \times (2{,}190{,}000 - 800{,}000)}{6{,}250{,}000} = 711{,}680$$

2,190,000

EXAMINER'S REPORT

The question is made up of two parts. Part (a) tests candidate's knowledge of IFRS 5 – Non Current Assets held for sales and discontinued operations, while Part (b) of the question required the explanation of how impairment of assets should be identified and accounted for as well as computation of impairment loss and its allocation to non- current assets in the disposal group.

About 70% of the candidates attempted the question and performance was above average. Majority of the candidates were able to calculate and allocate the impairment loss, but only few of them could explain how impairment of assets are identified and accounted for. Also, some candidates could not explain the conditions that must apply at the reporting date, for an asset or disposal group to be classified as held for sale as required by IFRS 5.

Candidates are advised to study the ICAN Study text very well while preparing for the Institute's examination as question b(ii) was adopted from ICAN Financial Reporting Study text.

MARKING GUIDE

			Marks	Marks
(a)		Explanation of the conditions that must apply at the reporting date for an asset (or disposal group) to be classified as held for sale: (any 5 points at 1 mark each)		5
(b)	(i)	Explanation of how impairment of assets should be identified and accounted for: (any 4 points at 1 mark each)		4
	(ii)	Calculation of impairment loss and its allocation to non-current assets:		
		- Determination of impairment loss	½	
		- - Allocation of impairment loss	1½	
		- - Determination of carrying amount of assets	4	6
		Total marks		15

SOLUTION 7

(a) i **Criteria For Recognition Of Provisions**

A provision should be recognised when:

- A company has a present obligation (legal or constructive) as a result of past events.
- It is probable that outflow of economic benefit will be required to settle the obligation.
- A reliable estimate can be made of the amount of the obligation.

Please note that if one of these conditions is not met then provision cannot be recognized.

ii. **Differences between Provisions and Contingent Liabilities**

Provisions: Are recognised as liabilities (assuming that a reliable estimates can be made) because they are present obligations and it is probable that an outflow of resources embodying economic benefit will be required to settle the obligation.

Contingent Liabilities: Are not recognised as liabilities because they are either:

- Possible obligations
- Present obligations that do not meet recognition criteria for provisions because *either:*
- It is not probable that an outflow of resources embodying economic benefit will be required to settle the obligation; or
- A sufficiently reliable estimate of the amount of the obligation cannot be made.

(b)

i. **Otapiapia Plc**

- The present obligation is as a result of a past event. The available evidence provided by expert indicates that it's more likely that no present obligation exist at statement of financial position date because there is a 70 percent probability that the claims will be thrown out. Hence no obligation event has taken place.
- In view of the above no provision should be recognised.
- The matter may be disclosed as a contingent liability unless the 30 percent probability is regarded as being improbable.

ii. Ire Akari Motors Plc

This is in two folds

Contingent Liability

There is an obligation between Ire Akari Motors Plc and its 100 customers as it has acknowledged the defects and has also notified the customers and accepted to repair the cars with an estimate of ₦10.5m repair costs.

This satisfies the recognition criteria of IAS 37:

- There is a present obligation
- It is probable that economic benefit will flow out
- There is a reasonably reliable estimate of the cost.

In view of the above, Ire Akari Motors should recognise a contingent liability of ₦10.5m and make the provision accordingly in the financial statement by debiting profit or Loss with ₦10.5m and crediting Contingent Liability with ₦10.5m.

Contingent Assets

There is a probable asset because the manufacturer of the defective steering mechanism has accepted responsibility for the defect with an undertaking to reimburse Ire Akari Motors Plc accordingly for all costs incurred in respect thereof. This is a demonstration of the manufacturer's willingness to meet the obligation. Where some or all the expenditure required to settle a provision is expected to be reimbursed by another party (in this case with an equal sum of the estimated cost of ₦10.5million), the reimbursement shall be recognised when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation.

The reimbursement shall be treated as a separate asset. The amount recognised for the reimbursement shall not exceed the amount of the provision.

It is also virtually certain that economic resources will flow out to Ire Akari Motors Plc as the manufacturer is a quoted company with sufficient fund. This is evidential of the ability to meet the obligation.

In view of the above, Ire Akari Motors Plc should recognise contingent assets of N10.5m by debiting Contingent assets and crediting Profit or loss with the same amount of ₦10.5m.

Iii. **Abeokuta Electricity Company Plc**

IAS 37 states clearly that a warranty is a constructive obligation and satisfies all the recognition criteria. As such Abeokuta Electricity Company Plc should provide for the warranty claims as follows:

- Provide for 40% of 300 customers at ₦52,500 each as at the reporting date, amounting to ₦6,300,000.
- Recognise the claims of ₦3,000,000 paid during the year in the provision for warranty account with the brought forward of ₦5,625,000. The current year provision will be ₦6,825,000.

This is a provision. The provision account will be shown in the Statement of Financial Position and details shown in a note to the account as follows:

WARRANTY

	₦'000
At January 1, 2015	5,625
Used in the year	(3,000)
	2,625
Charged to:	
Statement of Profit or Loss	6,825
Balance as at December 31, 2015 (w1)	9,450

Workings

(W1) 300 x (100-40) 60% x 52,500 ₦9,450,000

The company grant warranties on certain categories of goods. The measurement of the provision is on the company's experience of likelihood and cost of paying out under the warranty.

EXAMINER'S REPORT

The question tests candidates understanding of the provisions of IAS 37- Provisions and Contingencies. Candidates are required to explain the criteria for recognition of provisions in the financial statements as well as distinguish between provisions and contingent liabilities. They are also required to apply the provisions of IAS 37 to three different scenarios.

Majority of the candidates did not attempt the question and performance was very poor. The commonest pitfall was the inability of the candidates to apply the provisions to the scenarios provided in the question .

Most of the candidates lack understanding of the topic and could not determine whether provisions should be made in the financial statement or not. Few of them that applied the provisions could not justify their claims with appropriate figures to illustrate their points and this led to loss of valuable marks.

Candidates are advised to familiarize themselves with all relevant Accounting Standards at this level of the Institute examinations for better performance in future.

MARKING GUIDE

		SOLUTION 7	Marks	Marks
(a)	(i)	Explanation of criteria for recognition of provisions (any 3 points at 1 mark each)		3
	(ii)	Differences between provisions and contingent liabilities (any 6 points at ½ mark each)		3
(b)		Explanation of the treatment of provisions and contingent liabilities in the given scenarios:		
	(i)	Otapiapia Plc Review of scenario and conclusion (any 3 points at 1 mark each)	3	
	(ii)	Ire Akari Motors Plc Review of scenario and conclusion (3 points at 1 mark each)	3	
	(iii)	Abeokuta Electricity Company Plc Review of scenario and conclusion (any 3 ticks at 1 mark each)	3	
				<u>9</u>
		Total marks		<u>15</u>

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – MAY 2017

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

Damilola Adewunmi is the Human Resources Manager of Mighty Steel Nigeria Limited. He is married and blessed with three children.

(i) The following details relate to Damilola Adewunmni for the year ended December 31, 2015:

	₦
Salary	3,144,000
Commission	525,000
Rent received	1,350,00
Gain from sale of shares	300,000
Pension received from employment	450,000
Benefits-in-kind (all assessable)	225,000
Interest on Fixed Deposit (gross)	180,000

(ii) Damilola contributes ₦22,500 monthly towards the upkeep of his aged mother. His elder brother, Adekunle, also contributes ₦37,500 monthly.

(iii) Damilola took an insurance policy on his life and pays a premium of ₦15,000 monthly.

(iv) The children are University undergraduates and enjoy scholarship for only tuition from his State Government.

(v) Damilola took a loan to build an owner-occupied house on which he pays ₦90,000 annual interest.

(vi) For an outstanding performance, he was given an end-of-year bonus in the sum of ₦90,000.

(vii) Withholding Tax of ₦18,000 was deducted in respect of interest on Fixed Deposit.

You are required to:

a. Calculate the income tax payable for the relevant year of assessment. (10 Marks)

b. Calculate the income tax payable for the relevant year of assessment, assuming 2015 is the year of assessment with the following additional information:

	₦
Contribution to National Housing Fund	78,600
Contribution to National Health Insurance Scheme	210,000
Contribution to Pension Scheme	235,800

(10 Marks)

c. Explain briefly the following:

i. Itinerant worker (1 Mark)
ii. Non-resident individual (1 Mark)
iii. Earned income (1 Mark)
iv. Resident individual (1 Mark)
v. Unearned income (1 Mark)

d. List **FIVE** dividends exempted from tax. (5 Marks)

(Total 30 Marks)

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

QUESTION 2

a. Mr. Bull Dozer has just submitted his application for export license to Nigerian Export Promotion Council. The Council demanded a Tax Clearance Certificate before granting him an export license.

Mr. Bull Dozer was worried and had approached you to explain whether or not the presentation of this document is a condition precedent for all government transactions in Nigeria.

Required:

State **TEN** transactions in respect of which a Tax Clearance Certificate may be demanded by a government agency. (10 Marks)

b. The Tax Appeal Tribunal has power to adjudicate on tax disputes and controversies where appeal is not discontinued by the Appellant.

Required:
State **TEN** of the procedures for hearing the appeal before the Tax Appeal Tribunal. (10 Marks)

(Total 20 Marks)

QUESTION 3

Muyiwa, Seyi and Akpan are Partners in an Accounting Firm in Lagos; Museak & Co (Chartered Accountants). The Statement of Profit or Loss for the year ended December 31, 2015, is as shown below:

	₦	₦	₦
Gross Profit			65,000,000
Salaries and wages		5,100,000	
Office expenses		4,000,000	
Provision for bad debts		2,000,000	
Depreciation		1,500,000	
Repairs and maintenance		2,500,000	
Donations		400,000	
Training of staff		2,000,000	
Medical expenses		1,200,000	
Travelling expenses		500,000	
Interest on loan granted by Seyi		400,000	
Interest on Capital Accounts:			
Muyiwa	1,200,000		
Seyi	600,000		
Akpan	250,000		
		2,050,000	
			21,650,000
Net Profit for the year			43,350,000

Additional information is as follows:

(i) Donation was for laying of foundation of the new St Peter's Church;

(ii) The vehicle of Muyiwa's wife involved in an accident was repaired at a cost of ₦550,000 and this was included in repairs and maintenance;

(iii) Medical expenses in the sum of ₦500,000 representing the cost of flying the principal partners' father-in-law abroad for treatment was funded by the partnership;

(iv) Akpan made a voluntary contribution of ₦500,000 under the Pension Reforms Act 2004 (as amended);

(v) Capital allowances agreed with the tax authority was ₦4,000,000; and

(vi) Partners' sharing profit: Muyiwa 6; Seyi 4; Akpan 2.

You are required to compute:

a. The Adjusted Income of Museak & Co (Chartered Accountants) for tax purposes. (6 Marks)

b. The Chargeable Income of each Partner (6 Marks)

c. The tax payable by each of the Partners (8 Marks)

(Total 20 Marks)

QUESTION 4

Jandon is a Nigerian who lived abroad for so many years. He came back few years ago to set up a business in Nigeria and appointed your firm to audit his financial statements.

You are a trainee Chartered Accountant and your firm has also just completed its audit of Jandon's financial statements for the year ended December 31, 2014.

Jandon prepared his own tax computations for the year ended December 31, 2014 and sent the returns to the Revenue Authority. The tax returns have, however, been disputed by the Revenue Authority.

You are required to explain the following to Jandon:

a. The options open to the Revenue Authority on receipt of a Letter of Objection. (2 Marks)

b. The content of a Notice of Objection (3 Marks)

c. The jurisdiction of the Tax Appeal Tribunal (6 Marks)

d. The conditions to be fulfilled for an appeal to the Federal High Court to be valid. (4 Marks)

e. The options open to an aggrieved taxpayer who is not satisfied with the decision of the Federal High Court. (5 Marks)

(Total 20 Marks)

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

QUESTION 5

Alhaji Oluwambe is the trustee of a Settlement created by late Chief Jongbo in favour of his four children, grandchildren and others. He submitted the following information to Okun State Board of Internal Revenue for assessment purposes for the fiscal year ended December 31, 2014:

	₦	₦
Interest received		3,500,000
Dividend (Net)		14,000,000
Rental income		10,500,000
Business profit		31,500,000
Miscellaneous income		5,600,000
Trustee's remuneration:		
Fixed	787,500	
Variable: 3% of Gross Income		
Fixed Annuity to grandchildren:		
Ojo	87,500	
Gbenga	52,500	
Administrative expenses	4,550,000	

Additional information:

(i) The Trustee made discretionary payments in line with the Trustee Deed to the beneficiaries as follows:

	₦
Banke	262,500
Abidemi	350,000
Sunkanmi	437,500
Olajire	315,000

(ii) Each beneficiary is entitled to $^1/_6$th share of $^1/_3$rd of the distributable income.

(iii) Capital allowance agreed with relevant tax authority was ₦7,350,000.

You are required to compute:

a. Assessable income in the hands of each beneficiary (14 Marks)

b. The Net Assessable Income in the hands of the Trustee (1 Mark)

(Total 15 Marks)

QUESTION 6

Campbell Limited located in Arama Town has been in business since 1994 and is involved in manufacturing of plastic containers. The company's accounts for the year ended December 31, 2014 showed the following results:

	₦	₦
Turnover		1,909,425
Less Expenses:		
Transport and travelling	93, 000	
Salaries and wages	224,000	
Printing and stationery	25,000	
Donation to ICAN building fund	5,000	
Audit fees	20,000	
Stamp duty on increase in share capital	75, 000	
Rent	50,000	
Depreciation	234,450	
Tertiary Education Tax	37, 325	763,775
Net profit		**1,145,650**

The following additional information was extracted from the computations of Capital Allowance and Income Tax for Assessment Year 2014:

(i) Unutilised Capital Allowance brought forward ₦70,000

(ii) Tax Written Down Values of the following assets purchased in 2011:

	₦
• Motor vehicles	40,000
• Furniture and Fittings	60,000
• Plant	70,000

(iii) In year 2014, the company purchased the following assets:

	₦
• 2 Motor vehicles	840,000
• 4 Furniture and Fittings	160,000
• 1 Generating set	300,000

You are required to:

a. Compute Capital Allowances assuming that assets purchased in 2011 have been used for two years. (7 Marks)

b. Compute the Total Profits, Companies Income Tax (CIT) and Tertiary Education Tax (TET) for the relevant year of assessment. (8 Marks)

(Total 15 Marks)

QUESTION 7

The recently employed Accounts Officer of Oriade Limited understands that the company must report Withholding Tax information to the Revenue Authority according to the provisions of the law. Being a fresh graduate, he does not know how Withholding Tax is reported to the Revenue Authority.

You are required to explain:

a. The peculiarities of Withholding Tax (3 Marks)

b. Where international transactions are involved:
   - i. The rate of Withholding Tax (1 Marks)
   - ii. Types of income involved (3 Marks)

c. The currency of payment where the currency of transaction is not in Naira (3 Marks)

d. **FIVE** particulars contained in the Withholding Tax Payment Schedule. (5 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 had 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%

SUGGESTED SOLUTIONS

SOLUTION 1

a. Damilola Adewunmi
Computation of Income Tax Payable for 2015 Year of Assessment

	₦	₦
Basic Salary		3,144,000
Commission		525,000
Bonus		90,000
Benefits-in-kind		225,000
GROSS INCOME		3,984,000
Consolidated Relief Allowance(see working)		(996,800)
		2,987,200
Tax Exempt Items:		
Insurance	180,000	
Mortgage Interest	90,000	(270,000)
Chargeable Income		**2,717,200**

Income Tax Payable

	₦
1st ₦300,000 @ 7%	21,000
Next ₦300,000 @ 11%	33,000
Next ₦500,000 @ 15%	75,000
Next ₦500,000 @ 19%	95,000
Next ₦1,117,200 @21%	234,612
₦2,717,200	
	458,612

b. **Damilola Adewunmi**
Computation of Income Tax Payable for 2015 Year of Assessment

	₦	₦
Basic Salary		3,144,000
Commission		525,000
Bonus		90,000
Benefits-in-kind		225,000
GROSS INCOME		3,984,000
Consolidated Relief Allowance (See Working)		(996,800)
		2,987,200
Tax Exempt Items:		
Insurance Premium	180,000	
National Housing Fund Contribution	78,600	
National Health Insurance Scheme	210,000	
Pension Contribution	235,800	
Mortgage Interest	90,000	
		(794,400)
Chargeable Income		**2,192,800**

Income Tax Payable	₦
1st ₦300,000 @ 7%	21,000
Next ₦300,000 @11%	33,000
Next ₦500,000 @ 15%	75,000
Next ₦500,000 @ 19%	95,000
Next ₦592,800 @ 21%	124,488
₦2,192,800	
	348,488

c.

i. Itinerant Worker

An itinerant worker means an individual irrespective of his status, who works at any State during a year of assessment (other than a member of the armed forces) for wages, salaries or livelihood by working in more than one State, and work for a minimum of twenty (20) days in at least three (3) months of every assessment year.

ii. Non-resident Individual

A non-resident individual is a person who is not domiciled in Nigeria or who stays in Nigeria for less than 183 days in a 12-month period but derives income or profit from Nigeria.

iii. Earned Income

This refers to an income derived from a trade, business, profession, vocation or employment carried on or exercised by him and a pension derived by him in respect of a previous employment. It includes profits, salaries, wages, commissions, bonuses, etc.

iv. Resident Individual

An individual is regarded as resident in Nigeria if he

- is domiciled in Nigeria;
- sojourns in Nigeria for a period or periods all amounting to 183 days or more in a 12-month period; and
- serves as a diplomat or diplomatic agent of Nigeria in a country other than Nigeria.

v. Unearned income

This is income derived from a source other than trade, business, profession or employment e.g. dividend, rental income, royalty, interest, etc.

d. The following dividends are excluded from tax:

i. Dividend paid out of pioneer profit;
ii. Dividend paid by issue of bonus shares;
iii. Dividend from small companies (revenue less than ₦2,000,000);
iv. Dividend paid by companies assessed under Petroleum Profits Tax;
v. Dividend from companies in petrochemical and liquefied natural gas;
vi. Dividend earned from abroad and brought into Nigeria by a Nigerian resident in convertible currency and paid into a domiciliary account in a bank approved by the government; and
vii. Dividend distributed by a Unit Trust.

Working:

Consolidated Relief Allowance

Higher of ₦200, 000 or 1% of Gross Income + 20% of Gross Income
= ₦200,000 + ₦796,800 = ₦996,800

EXAMINER'S REPORT

The question tests candidates' understanding of the assessment of an individual.

Candidates had a good understanding of the question and performance was above average.

The commonest pitfall was the inability of the candidates to recognise the fact that investment incomes are taxed on preceding year basis.

Candidates are advised to pay attention to incomes assessable on preceding year basis.

MARKING GUIDE

		MARKS	MARKS
a.	Computation of Chargeable Income:		
	8 points raised @ 1 mark each	8	
	4 points in Computation of Tax liability @¼ mark each	1	
	Tax payable	1	10
b.	Computation of Chargeable Income:		
	The first 5 points @ ½ mark each	2½	
	The five Exempt Items @ 1 mark each	5	
	Chargeable Income @ ½ mark	½	
	5 points in Computation of Tax liability @ ¼ mark each	1¼	
	Tax Payable	¾	10
c.	The 5 definitions @ 1 mark each		5
d.	The first 5 dividends exempted from tax @ 1 mark each		5
			30

SOLUTION 2

a. TRANSACTIONS IN RESPECT OF WHICH A TAX CLEARANCE CERTIFICATE MAY BE DEMANDED BY GOVERNMENT AGENCY

The requirement to obtain a Tax Clearance Certificate on an annual basis places the onus on the taxpayers to ensure full compliance with the requirements of the tax laws.

The following are transactions in respect of which a Tax Clearance Certificate may be demanded by a government agency:

i. Application for Government loan for industry or business;
ii. Registration of motor vehicles;
iii. Application for firearms license;
iv. Application for foreign exchange or exchange control permission to remit funds outside Nigeria;
v. Application for Certificate of Occupancy;
vi. Application for award of contracts by governments, their agencies and registered companies;
vii. Application for approval of building plans;
viii. Application for trade license;
ix. Application for transfer of real property;
x. Application for import or export license;
xi. Application for agent license;
xii. Application for pools or gaming license;
xiii. Application for registration as a contractor;
xiv. Application for distributorship;
xv. Confirmation of appointment by government, as chairman or member of public board, institution, commission, company or to any other similar position made by the government;
xvi. Stamping of guarantor's form for Nigerian Passport;
xvii. Application for registration of a limited liability company or of a business name;
xviii. Application for allocation of market stalls;
xix. Appointment or election into public office;
xx. Change of ownership of vehicle by vendor; and
xxi. Application for a plot of land.

b. PROCEDURES FOR HEARING AN APPEAL BEFORE A TAX APPEAL TRIBUNAL

Where an appeal is not discontinued, the procedures for hearing the appeal before the Tax Appeal Tribunal are as follows:

i. The Tax Appeal Tribunal gives seven (7) days notice to the appellant and Federal Inland Revenue Service (FIRS) of the date and place fixed for hearing of the appeal;
ii. An appeal should be heard by not less than three members of the Tax Appeal Tribunal in attendance with the Chairman or any other member, (in the absence of the Chairman), presiding;
iii. A member with vested interest in any matter before the Tax Appeal Tribunal must disclose such interest and abstain from attending any sitting at which the matter is to be heard;
iv. All appeals before the Tax Appeal Tribunal are heard in public;
v. Appellant may be represented by a professional adviser or may give his evidence by written notice;
vi. Appellant leads the case, by proving that the assessment is excessive, that is, onus of proof is put on the appellant;
vii. If the representative of the FIRS can prove to the Tax Appeal Tribunal that:

    - The appellant failed to file returns, audited accounts etc. as required by the provisions of Companies Income Tax (CITA) C21 LFN 2004 (as amended); or
    - The appeal is frivolous, vexatious or an abuse of appeal process; or
    - It is expedient to require the appellant to pay a security deposit:

        - The Tax Appeal Tribunal may make an order that the appellant pay deposit to the tax authority on account of tax being disputed before the matter could be heard; and
        - The deposit payable, is the lower of tax paid in the immediately preceding year and half of the tax charged (which is on an appeal), plus 10% of the deposit.

viii. The Tax Appeal Tribunal can confirm, reduce, increase, or annul the assessment, as deemed necessary;
ix. The Tax Appeal Tribunal's decisions are recorded in writing, by the Chairman, and a Certified True Copy is supplied to the appellant or the FIRS on request, within 3 months of the decision;
x. Particulars of the extent to which the Tax Appeal Tribunal is dissatisfied with the appellant's accounts, books, etc, non-compliance with precepts representative and refusal to answer questions put, should all be noted in the decision of the Tax Appeal Tribunal; and
xi. Notice of the amount of tax chargeable, as determined by the Tax Appeal Tribunal, shall be served on the company by FIRS.

The tax payable as determined by the Tax Appeal Tribunal is payable within one month of the date of Notice of Assessment notwithstanding that an appeal may be pending on same before the Federal High Court.

EXAMINER'S REPORT

The question tests candidates' knowledge of issues relating to Tax Clearance Certificate and procedures for hearing an appeal before the Tax Appeal Tribunal.

Candidates had a fair understanding of the question and performance was average.

The commonest pitfall was the inability of the candidates to differentiate between Objection and Tax Appeal.

Candidates are advised to read wider for future examinations by reading ICAN Study Text and other relevant study materials.

MARKING GUIDE

		MARKS
a.	1 mark each subject to a maximum of any 10 transactions	10
b.	1 mark each subject to a maximum of any 10 procedures	10
		20

SOLUTION 3

(a) COMPUTATION OF ADJUSTED INCOME OF MUSEAK & CO (CHARTERED ACCOUNTANTS) FOR 2016 ASSESSMENT YEAR

	₦	₦
Net Profit for the year		43,350,000
Add: Disallowable expenses:		
Provision for bad debts	2,000,000	
Depreciation	1,500,000	
Repairs and Maintenance	550,000	
Donations	400,000	
Medical expenses	500,000	
		4,950,000
Adjusted Income		48,300,000
Agreed Capital allowances		(4,000,000)
Distributable Income		44,300,000

(b) Computation of Partners' Chargeable Income

	Muyiwa	Seyi	Akpan	Total
	₦	₦	₦	₦
Interest on Capital	1,200,000	600,000	250,000	2,050,000
Share of Profit (6:4:2)	22,150,000	14,766,667	7,383,333	44,300,000
	23,350,000	15,366,667	7,633,333	46,350,000
Interest on Loan	0	400,000	0	400,000
Partners' Assessable Income	23,350,000	15,766,667	7,633,333	46,750,000
Consolidated Relief Allowance	(4,903,500)	(3,353,333)	(1,726,667)	(9,983,500)
	18,446,500	12,413,334	5,906,666	36,766,500
Tax Exempt Items:				
Contribution to Pension Scheme	(0)	(0)	(500,000)	(500,000)
Chargeable Income	**18,446,500**	**12,413,334**	**5,406,666**	**36,266,500**

(c) Computation of Tax Payable by Partners:

	Muyiwa	Seyi	Akpan
	₦	₦	₦
Chargeable Income	18,446,500	12,413,334	5,406,666
First ₦300,000@7%	21,000	21,000	21,000
Next ₦300,000@11%	33,000	33,000	33,000
Next ₦500,000@ 15%	75,000	75,000	75,000
Next ₦500,000@19%	95,000	95,000	95,000
Next ₦1,600,000@21%	336,000	336,000	336,000
Above ₦3,200,000@24%			
Muyiwa:₦18,446,500 – ₦3,200,000@24%	3,659,160		
Seyi: ₦12,413,334 – ₦3,200,000@24%		2,211,200	
Akpan: ₦5,406,666 – ₦3,200,000@24%			529,600
	4,219,160	2,771,200	1,089,600

NOTES:

i. Consolidated Relief Allowance is the higher of ₦200,000 or 1% of Gross Income plus 20% of Gross Income.

ii. The deduction of Capital allowances from the Adjusted Income before arriving at the Distributable Income is preferable to sharing of Capital Allowances amongst the partners.

EXAMINER'S REPORT

The question tests candidates' knowledge of taxation of partners in partnership business.

Many candidates attempted this question and performance was average.

The commonest pitfall was the inability of the candidates to calculate Consolidated Relief Allowance and identify disallowable expenses.

Candidates are advised to pay attention to computation of tax liabilities of partners.

MARKING GUIDE

		MARKS	MARKS
a.	Heading	½	
	Net profit	½	
	5 disallowable expenses @ ½ mark each	2½	
	Sub-total	1	
	Adjusted income	½	
	Agreed Capital allowances	½	
	Distributable Income	½	6
b.	Heading	1½	
	Interest on Capital	½	
	Share of Profit	½	
	Sub-total	½	
	Interest on loan	½	
	Partners' Assessable Income	½	
	Consolidated Relief Allowance	½	
	Sub-total	½	
	Contribution to Pension Scheme	½	
	Chargeable Income	½	6
c.	Heading	1	
	First ₦300,000@7%	½	
	Next ₦300,000@11%	½	
	Next ₦500,000@ 15%	½	
	Next ₦500,000@19%	½	
	Next ₦1,600,000@21%	½	
	Above ₦3,200,000@24%	1½	
	Tax payable by the 3 partners @ 1 mark each	3	8
			20

SOLUTION 4

(a) Options Open to the Revenue Authority on Receipt of Letter of Objection

On receipt of the Notice of Objection, the tax authority has the following options:

(i) Review and revise the assessment to an amount that is mutually-agreeable to the taxpayer and the Federal Inland Revenue Service. If this occurs, the tax authority will amend the assessment and serve on the company a notice of revised tax payable; or

(ii) Review and refuse to revise the assessment to the amount claimed by the taxpayer.

In a situation where the taxpayer fails to agree with the tax authority on the amount of tax payable, and the Federal Inland Revenue Service does not see any reason to further revise the assessment, then it will issue a Notice of Refusal to Amend its assessment.

(b) Content of a Notice of Objection

In line with the provision of Section 69 of Companies Income Tax Act Cap C21 LFN 2004 (as amended), for a Notice of Objection to be valid, it must:

i. be in writing and addressed to the Chairman, Federal Inland Revenue Service;

ii. state the grounds of objection, namely:

- Amount of Assessable and Total Profit of the company for the relevant assessment year; and
- Amount of tax which the taxpayer claims is payable for the year of assessment.

iii. be raised within thirty days of the date of service of the Notice of Assessment.

(c) Jurisdiction of the Tax Appeal Tribunal

i) The Tribunal shall have power to adjudicate on disputes, and controversies arising from the following tax laws (hereinafter referred to as “the tax laws”):

- Companies Income Tax Act CAP C21 LFN 2004 (as amended)
- Personal Income Tax Act CAP P8 LFN 2004 (as amended)
- Petroleum Profits Tax Act CAP P13 LFN 2004 (as amended)
- Value Added Tax Act CAP V1 LFN 2004 (as amended)

- Capital Gains Tax Act CAP C1 LFN 2004 (as amended)
- Any other law contained in or specified in the First Schedule to this Act or other laws made from time to time by the National Assembly.

ii) The Tribunal shall apply such provisions of the tax laws referred to in sub-paragraph (1) of the paragraph as may be applicable in the determination or resolution of any dispute or controversy before it.

(d) The conditions to be fulfilled for an Appeal to the Federal High Court to be valid

For such appeals to be valid, the following conditions must be satisfied:

(i) Amount involved must not be less than ₦400;

(ii) The appeal must be on points of law;

(iii) Notice of appeal must be given to the Tax Appeal Tribunal within 30 days after the date of the judgement of the Tax Appeal Tribunal; and

(iv) The grounds of law on which the decision of the Tax Appeal Tribunal is being challenged should be stated.

(e) Option open to an aggrieved taxpayer who is not satisfied with the decision of the Federal High Court

Further appeal against the decision of the Federal High Court shall lie with the Court of Appeal and from there to the Supreme Court.

EXAMINER'S REPORT

The question tests candidates' knowledge of Objections and Appeals before a Tax Appeal Tribunal.

Many candidates attempted the question and performance was average. Candidates had a fair understanding of the question.

The commonest pitfall was the inability of the candidates to state the Jurisdiction of the Tax Appeal Tribunal.

Candidates are advised to pay attention to Objections and Appeals before a Tax Appeal Tribunal as contained in ICAN Study Text.

MARKING GUIDE

		MARKS	MARKS
(a)	(i) Review and revise the assessment	1	
	(ii) Review and refuse to revise the assessment	1	2
(b)	(i) Be in writing	1	
	(ii) State the grounds of objection	1	
	(iii) Be raised within 30 days	1	3
(c)	(i)Companies Income Tax	1	
	(ii) Personal Income Tax	1	
	(iii) Petroleum Profits Tax	1	
	(iv) Value Added Tax	1	
	(v) Capital Gains Tax	1	
	(vi) Any other law	1	6
(d)	Amount involved must not be less than ₦400	1	
	Must be on points of law	1	
	Notice within 30 days	1	
	Grounds of law stated	1	4
(e)	Court of Appeal	2½	
	Supreme Court	2½	5
			20

SOLUTION 5

a. CHIEF JONGBO SETTLEMENT
ASSESSABLE INCOME IN THE HANDS OF BENEFICIARIES

	Banke	Abidemi	Sunkanmi	Olajire	Ojo	Gbenga	Total
	₦	₦	₦	₦	₦	₦	₦
Discretionary Income	262,500	350,000	437,500	315,000	-	-	1,365,000
Annuity Received	-	-	-	-	87,500	52,500	140,000
Share of distributable Income	2,815,772	2,815,772	2,815,772	2,815,772	2,815,772	2,815,772	16,894,632
Assessable Income in the hands of the beneficiaries	3,078,272	3,165,772	3,253,272	3,130,772	2,903,272	2,868,272	18,399,632

See Workings i and ii

WORKINGS

		₦	₦
i.	Interest received		3,500,000
	Dividend (Gross)		15,555,556
	Rental Income		10,500,000
			29,555,556
	Business Profit	31,500,000	
	Capital Allowance	(7,350,000)	24,150,000
	Miscellaneous income		5,600,000
	Gross Income		59,305,556
	Less: Allowable Expenses		
	Trustee's remuneration:		
	Fixed	787,500	
	Variable: 3% of ₦59,305,556	1,779,167	
	Fixed Annuity for grandchildren:		
	Ojo	87,500	
	Gbenga	52,500	
	Administrative expenses	4,550,000	(7,256,667)
	Computed Income		52,048,889
	Discretionary Payments:		
	Banke	262,500	
	Abidemi	350,000	
	Sunkanmi	437,500	
	Olajire	315,000	(1,365,000)
	Distributable Income		50,683,889

		₦	₦
Less: Amount available for distribution			
$^1/_3$ of ₦50,683,889 = ₦16,894,632			
ii. Distribution as follows:			
Ojo ($^1/_6$ x ₦16,894,632)	=	2,815,772	
Gbenga ($^1/_6$ x ₦16,894,632)	=	2,815,772	
Banke ($^1/_6$ x ₦16,894,632)	=	2,815,772	
Abidemi ($^1/_6$ x ₦16,894,632)	=	2,815,772	
Sunkanmi ($^1/_6$ x ₦16,894,632)	=	2,815,772	
Olajire ($^1/_6$ x ₦16,894,632)	=	2,815,772	(16,894,632)

b. **COMPUTATION OF NET ASSESSABLE INCOME IN THE HANDS OF THE TRUSTEE**

	₦
Distributable Income	50,683,889
Amount available for distribution	16,894,632
	33,789,257
Dividend (Gross)	(15,555,556)
Net assessable income in the hands of the Trustee	18,233,701

EXAMINER'S REPORT

The question tests candidates' knowledge of the assessment of Trustees, Estates and Settlements.

Most of the candidates that attempted the question did not understand its requirements. Consequently, performance was poor.

The commonest pitfall was the non-grossing up of the dividend.

Candidates should pay attention to computation of net assessable income in the hands of Trustees.

MARKING GUIDE

		MARKS	MARKS
a.	Discretionary Income	$1\frac{1}{3}$	
	Annuity received	$\frac{2}{3}$	
	Share of distributable income	2	
	Assessable income in the hands of the beneficiaries	2	
	Workings:		
	Interest received	$\frac{1}{3}$	
	Dividend Gross	$\frac{1}{3}$	
	Rental Income	$\frac{1}{3}$	
	Sub-total	$\frac{1}{3}$	
	Business Profit	$\frac{1}{3}$	
	Capital Allowance	$\frac{1}{3}$	
	Sub-total	$\frac{1}{3}$	
	Miscellaneous Income	$\frac{1}{3}$	
	Gross Income	$\frac{1}{3}$	
	Trustee's remuneration – Fixed	$\frac{1}{3}$	
	– Variable	$\frac{1}{3}$	
	Fixed Annuity – Ojo	$\frac{1}{3}$	
	– Gbenga	$\frac{1}{3}$	
	Admin expenses	$\frac{1}{3}$	
	Discretionary Payments – Banke	$\frac{1}{3}$	
	– Abidemi	$\frac{1}{3}$	
	– Olasunkanmi	$\frac{1}{3}$	
	– Olajire	$\frac{1}{3}$	
	Distribution to beneficiaries	$\underline{2}$	14
b.	4 entries @ ¼ mark each		$\underline{1}$
			$\underline{15}$

SOLUTION 6

CAMPBELL COMPANY LIMITED

(a) COMPUTATION OF CAPITAL ALLOWANCES FOR 2015 YEAR OF ASSESSMENT

Accounting Date or Basis Period 1/1/2014 - 31/12/2014

	Motor Vehicle	Furniture & Fittings	Plant	Total
Initial Allowance	50	25	50	
Annual Allowance	25	20	25	
	₦	₦	₦	₦
TWDV b/f	40,000	60,000	70,000	
Cost – Additions	840,000	160,000	300,000	
Initial	(420,000)	(40,000)	(150,000)	610,000
Annual – Old	(20,000)	(20,000)	(35,000)	75,000
Annual – New	(105,000)	(24,000)	(37,500)	166,500
				851,500
Investment allowance				30,000
				881,500

Workings

Initial: MV — 50% x 840,000 = 420,000; F&F — 25% x 160,000 =40,000; PLANT — 50% x 300,000 =150,000

Annual 1 $\frac{TWDV}{V-n}$ $\frac{40{,}000}{2years}=20{,}000$ $\frac{60{,}000}{3years}=20{,}000$ $\frac{70{,}000}{2years}=35{,}000$

Annual 2 cost – TWDV

$\frac{840{,}000-420{,}000}{4}$ $\frac{160{,}000-40{,}000}{5}$ $\frac{70{,}000}{2years}=35{,}000$

=**105,000** =**24,000** = **37,500**

CAMPBELL COMPANY LIMITED

(b) COMPUTATION OF TOTAL PROFIT, COMPANIES INCOME TAX (CIT) AND TERTIARY EDUCATION TAX (TET)

	₦	₦
Net profit		1,145,650
Add:		
Stamp duty on increase in Share Capital	75,000	
Depreciation	234,450	
Tertiary Education Tax	37,325	346,775
Assessable Profit		1,492,425
Capital allowances:		
Brought forward	70,000	
For the year	881,500	
Relieved		(951,500)
TOTAL PROFIT		**540,925**

Companies Income Tax (30% of Total Profit) = ₦162,277.50

Tertiary Education Tax (2% of Assessable Profit) = ₦29,848.50

EXAMINER'S REPORT

The question tests candidates' knowledge of Capital Allowances and Companies Income Tax Computations

Many candidates that attempted the question did not understand its requirements. Consequently, the performance was below average.

The commonest pitfall was the poor presentation of the solution.

It is recommended that attention should be paid to the presentation of solutions.

MARKING GUIDE

		MARKS	MARKS
a.	$^1/_3$ mark each for 21 entries		7
b.	Heading	½	
	Net Profit	½	
	Stamp duty	½	
	Depreciation	½	
	Tertiary Education Tax	½	
	Total of disallowable expenses	½	
	Assessable Profit	½	
	Capital allowances	1½	
	Total Profit	1	
	Companies Income Tax	1	
	Tertiary Education Tax	<u>1</u>	<u>8</u>
			<u>15</u>

SOLUTION 7

(a) Withholding Tax is a tax deducted at source from payments made to a taxable person for the supply of goods and services.

It is not another form of tax, but simply an advance payment of tax, as the withholding tax deducted at source is off-settable against any subsequent tax liability that may be due in respect of other income.

In certain cases, the Withholding Tax deducted at source is the final tax in the hands of the recipients.

(b) (i) The Withholding Tax rate is reduced to 7.5% for dividend, interest, and royalty for recipients of a country which has double tax treaty with Nigeria at the rates contained in the double taxation treaty.

(ii) The types of income involved are royalty, interest and dividend.

(c) The currency in which tax is to be deducted and paid over to the relevant tax authorities is the currency of transaction. Where the transaction is in foreign currency, the tax is to be withheld in the foreign currency and paid to the relevant tax authority, through the Central Bank of Nigeria (CBN). The CBN would then effect the necessary conversion, using the ruling rate of exchange and then credit the appropriate government account with the sum.

(d) The payment schedule must contain the following particulars:

i. Name of the taxpayers who suffered the deductions;
ii. Their addresses;
iii. The nature of their activities/services and period covered;
iv. Their tax file numbers [now Tax Identification Number (TIN)];
v. The total amount payable;
vi. The rate of tax applied;
vii. The amount of tax withheld;
viii. The balance paid to the taxpayer;
ix. The tax contract for which returns were being made;
x. The date of payment; and
xi. The cheque number and date.

EXAMINER'S REPORT

The question tests candidates' knowledge of the provisions of the law relating to Withholding Tax.

Many candidates attempted the question and performance was above average.

The commonest pitfall was the candidates' inability to state the rate applicable to international transactions.

Candidates are advised to study the law relating to Withholding Tax as contained in ICAN Study Text.

MARKING GUIDE

		MARKS	MARKS
(a)	Deducted at source	1	
	Advance payment of tax	1	
	Final tax liability	1	3
(b)	i. Rate	1	
	ii. Dividend	1	
	Interest	1	
	Royalty	1	4
(c)	Currency of transaction		3
(d)	Nature of the taxpayer		
	Addresses		
	Nature of activities		
	Tax file number		
	Total amount payable		
	The rate of tax		
	Amount of tax withheld		
	The balance paid to the taxpayer		
	The tax contract		
	Date of payment		
	Cheque number and date		
	(1 mark each subject to a maximum of 5 points)		5
			15

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – MAY 2017

PERFORMANCE MANAGEMENT

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

Kardex Industries Nigeria Limited is a subsidiary of a large manufacturing company based in China (Kardex International). The company manufactures washing machines, table gas cookers and refrigerators which are being sold by the subsidiary in Nigeria. Demand for the company's product is growing especially among the growing middle-class population until recently when the company started experiencing some hiccups as a result of the economic recession in the country and stiff competition.

The company is currently selling only two products in Nigeria (both are types of washing machine). These are:

- A basic product (Wash Up) with functions which are comparable with the existing local competitors' products and;
- A premium product (Perfect Wash) which has functions and features similar to Kardex's products in developed countries.

The competitive environment in Nigeria is changing rapidly. Apart from Kardex, two other companies are offering similar machines in the market. One of these has a factory in Nigeria and is producing machines similar to "Wash Up" to compete directly with Kardex. The government of Nigeria has supported this new entrant with tax holiday, as its product has been approved as a pioneer product. The other competitor is now considering building a manufacturing plant in Nigeria to produce more highly specialised washing machine similar to Kardex's Perfect Wash.

Kardex international's stated mission is to be the "leader in its industry". The Board of Kardex has set the following critical success factors (CSFs) for Kardex's Nigerian subsidiary:

- To be the market leader;
- To maximise profits and shareholders' wealth within acceptable risk; and
- To maintain the brand image of Kardex as top of the range product.

The Board is considering using the following key performance indicators (KPIs) for each product: total profit, average sales price per unit, contribution per unit, market share, margin of safety, return on capital employed and total quality costs.

You have just been employed by Kardex as its Performance Management Controller and the Board of Kardex International has requested that you provide calculations which will show the various indicators suggested above and then assess how the key performance indicators will address issues in the external environment in Nigeria. The data given in Appendix 1 below has been collated for your use.

Appendix 1

Nigerian subsidiary's information for the most recent financial year:

	Wash Up	Perfect Wash	
Variable costs	**₦ per unit**	**₦ per unit**	
Materials	9,000	12,000	
Labour	6,000	8,000	
Overheads	4,000	5,000	
Distribution costs	4,500	4,500	
Quality costs	2,000	3,000	
			Total
Fixed costs	**₦'m**	**₦'m**	**₦'m**
Administration costs	1,800	1,800	3,600
Distribution costs	1,600	1,600	3,200
Quality costs	600	600	1,200
Marketing costs	8,000	8,000	16,000
Other data	**₦'m**	**₦'m**	**₦'m**
Revenue	44,800	30,800	75,600
Capital employed	32,600	25,000	57,600
	Units	**Units**	**Units**
Total market size (millions)	9.33	1.33	10.66
Kardex's sales (millions)	1.12	0.44	1.56

Note:

The allocations of fixed costs are based on a recent activity-based costing exercise and are considered to be valid.

Required:

a. Provide calculations which show the key performance indicators (KPIs) suggested by the Board, for the performance assessment of Kardex Industries Nigeria Limited. (20 Marks)

b. Use PEST analysis to identify issues in the company's external environment and then comment on whether the suggested KPIs address these issues. (10 Marks)

(Total 30marks)

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

QUESTION 2

Sadet Nigeria Limited assembles three types of motorcycle in the same factory; the 50cc Prelude, the 100cc Roadmaster and the 150cc Roadstar. It sells the motorcycles throughout the West African Coast. In response to market pressure, Sadet has invested heavily in new manufacturing technology in recent years and, as a result, has significantly reduced the size of its workforce.

Historically, the company has allocated all overhead costs using total direct labour hours, but is now considering introducing activity-based costing (ABC). Sadet's Accountant has produced the following analysis.

Types of Motorcycles	Annual Output (Units)	Annual direct labour hours	Selling price (₦/ unit)	Raw Material cost (₦/ unit)
Prelude	5,000	500,000	25,000	4,000
Roadmaster	4,000	550,000	30,000	6,000
Roadstar	1,400	200,000	40,000	9,000

The three cost drivers that generate overheads are:

Deliveries to retailers - the number of deliveries of motorcycles to retail showrooms.

Set – ups - the number of times the assembly line process is re-set to accommodate the production run of a different type of motorcycle

Purchase orders - the number of purchase orders.

The annual cost driver volumes relating to each activity and each type of motorcycle are as follows:

	Number of deliveries to retailers	Number of set-ups	Number of purchase orders
Prelude	200	70	400
Roadmaster	160	80	300
Roadstar	140	50	100

The annual overhead costs relating to these activities are as follows:

	₦'000
Deliveries to retailers	24,000
Set –ups costs	60,000
Purchase orders	36,000

Direct labour is paid at ₦50 per hour. The company holds no inventories.

You are required to:

a. Calculate the total profit on each of Sadet's three types of product, using the following methods to absorb overheads:

   i. The existing method based upon labour hours.

   ii. Activity-based costing. (14 marks)

b. Write a report to the Directors of Sadet, as a Management Accountant, evaluating the labour hours and the activity- based costing methods in the circumstances of Sadet.

   Refer to your calculations in requirement (a) above, where appropriate.

(6 marks)

(Total 20 marks)

QUESTION 3

Tadex Nigeria Limited is an engineering company that specialises in building engines for grinding machines. One of the components for building these engines is sourced from Toka Nigeria Limited, a company in the same group with Tadex Nigeria Limited. Each component is being transferred to Tadex, taking account of Toka's opportunity cost of the component. The variable cost of Toka is ₦280 per component.

A prospective customer has approached Tadex to submit a quotation for a contract to build a new engine. This is a new customer to Tadex but directors of Tadex are keen on winning this contract as they believe that this may lead to more contracts in the future. As a result of this, they intend pricing the contract using relevant costs.

The following costs data is given in respect of the contract:

(i) The production director of Tadex is on an annual salary equivalent to ₦15,000 per 8 - hour day;

(ii) The materials needed for the contract are:

- 110 square metres of material A. This material is normally being used by Tadex and it has 200 square metres in stock. These were bought at a cost of ₦120 per square metre. They have resale value of ₦105 per square metre and replacement cost is ₦125 per square metre.

- 30 litres of material B. This material has to be purchased specially for this contract and the minimum order quantity from the supplier is 40 litres at a cost of ₦90 per litre. Tadex has no use for this material after the contract is executed. Sixty (60) components will be purchased from Toka at a purchase price of ₦500 per component.

(iii) A total of 240 direct labour hours will be required. The current wage rate for the grade of labour that will work on the contract is ₦110 per hour. Tadex currently has 75 direct labour hours of spare capacity for this grade and are being paid under collective wages agreement. The additional hours required will be sourced by either

- overtime at a cost of ₦140 per hour; or
- employment of temporary staff at a cost of ₦120 per hour.
  But this temporary staff, because they are not experienced, will require 10 hour supervision by existing supervisor who would be paid overtime at a rate of ₦180 per hour for this contract.

(iv) 25 machine hours will be required. The machine to be used is already leased at a weekly lease rental of ₦6,000. It has 40 hours per week capacity. The machine has sufficient available capacity to complete the contract. The variable cost of running the machine is ₦70 per hour.

(v) The company's fixed overhead absorption rate is ₦200 per direct labour hour.

You are required to:

a. Calculate the relevant cost of building the new engine and explain why you have included or excluded any costs in your calculations. (15 marks)

b. Discuss the factors that would be considered by Tokas to determine the opportunity cost of the component. (5 marks)

(Total 20marks)

QUESTION 4

Debens Nigeria Limited's Job costing system has two direct cost categories: direct materials and direct manufacturing labour. Manufacturing overhead (both variable and fixed) is allocated to products on the basis of standard direct manufacturing labour hours (SDMLH). At the beginning of 2016, Debens adopted the following standards for its manufacturing costs and sales:

S/N	Cost details	Input	Cost per output unit ₦
1	Direct Materials	3 kg at ₦500	1,500
2	Direct Manufacturing Labour	5 hours at ₦200	1,000
3	Manufacturing Overhead: Variable Fixed	 ₦120 per SDMLH ₦160 per SDMLH	 600 800
4	Unit Manufacturing cost		3,900
5	Standard Profit margin		1,300
6	Standard Selling Price		5,200

The denominator level for total manufacturing overhead per month in 2016 is 40,000 direct manufacturing labour hour. Debens flexible budget for January 2016 was based on this denominator level. The records for January indicate the following:

• Direct materials purchased	25,000kg at ₦520 per kg
• Direct materials used	23,100kg
• Direct manufacturing labour	40,100 hours at ₦190 per hour
• Total actual manufacturing overhead (Fixed and Variable)	₦12,000,000
• Actual Production/Sales	7,800 output units
• Actual Selling price	₦5,350

The proportion of the actual variable and fixed overhead costs is the same with in the standard.

Required:

a. Calculate the budgeted profit of the company for the month of January 2016? (2 Marks)

b. Calculate the following for the month of January 2016:
   i. Direct material variances.
   ii. Direct manufacturing labour variances
   iii. Variable manufacturing overhead variances.
   iv. Fixed manufacturing overhead variances.
   v. Sales variances. (10 marks)

c. Prepare a statement reconciling the actual profit with the budgeted profit. (8 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

A systems analyst uses different methods to gather information required for the system analysis phase of any project.

You are required to discuss these methods showing their advantages and disadvantages. **(Total 15 Marks)**

QUESTION 6

AL Limited is a manufacturing company based in Aba. One of its most successful products is Hadtone, a mortar colouring agent. Hadtone is made using a single processing machine which mixes the raw ingredients and dispenses the completed product into five-litre cartons.

A five-litre carton of Hadtone sells for ₦300 and estimated maximum annual demand at this price is 300,000 cartons. At this level of demand, AL can justify the operation of only one processing machine, which AL currently replaces every three years, although the processing machine has a productive life of 4 years.

In the first year of its life, the processing machine has a productive capacity in line with the maximum annual demand for the product, but each year thereafter this productive capacity falls at a rate of 15,000 units per annum. Annual maintenance costs in the first year of operating the processing machine are estimated at ₦300,000. Thereafter, the directors expect the annual maintenance costs to increase by ₦50,000 per annum regardless of the actual number of five-litre cartons produced. AL incurs variable costs, excluding depreciation and maintenance costs, of ₦200 in producing each five-litre carton. AL provides for depreciation on all its non-current assets using the straight-line method.

If AL were to dispose of the processing machine after one year, the directors estimate sale proceeds of ₦8,000,000, but these could fall by ₦3,000,000 per annum in each of the following two years. Assume the processing machine has three years life span.

Following a recent increase in the cost of a processing machine to ₦12,000,000, AL's Directors are reconsidering their current replacement policy with a view to maximising the present value of the company's cash-flows. It can be assumed that all revenues and costs are received or paid in cash at the end of the year to which they relate, with the exception of the initial price of the processing machine which is paid in full at the time of purchase.

Required:

a. Assuming that the processing machine is used to maximum capacity, and showing all your supporting calculations, advise AL's directors how often they should replace the processing machine. Assume cost of capital of 10%. (12 marks)

b. Itemise the major assumptions made in your calculations above. (3 marks)

(Total 15 marks)

QUESTION 7

Adebel Nigeria Limited manufactures motor cycles. The company is split into two divisions: the assembling division (division A) and the engine division (division E). Division E supplies engine to both Division A and to external customers. The two divisions run as autonomously as possible, subject to the group's policy that Division E must make internal sales first before selling outside the group; and that Division A must always buy its engine from Division E. However, this company policy, together with the transfer price which Division E charges Division A, is currently under review.

Details of the two divisions are given below:

Division A

Division A budget for the coming year shows that 45,000 engines will be needed. An external supplier could supply these to Division A for ₦80,000 each.

Division E

Division E has the capacity to produce a total of 70,000 engines per year. Details of Division E's budget, which has just been prepared for the forth coming year, are as follows:

Budgeted sales volume (units)	70,000
Selling price per engine for external sales of engine	₦85,000
Variable costs per unit for external sales of engine	₦77,000

The variable cost per unit for engines sold to Division A is ₦3,000 per unit less due to cost saving on distribution and packaging. Maximum external demand for the engines is 35,000 units per year.

Required:

a. Recommend the transfer price or prices at which these internal sales should take place. (5 marks)

b. Assuming that the group's current policy could be changed, advise, using suitable calculations, the number of engines which Division E should supply to Division A in order to maximise group profits. All relevant workings must be shown. (5 marks)

c. Discuss **TWO** main performance measurements that are appropriate for evaluating divisional performance of an autonomous division that operates as an investment centre. (5 marks)

(Total 15marks)

Formulae

Learning curve

$Y = ax^b$

where Y = cumulative average time per unit to produce x units

a = the time taken for the first unit of output

x = the cumulative number of units produced

b = the index of learning (log LR/log2)

LR = the learning rate as a decimal

Demand curve

P = a – bQ

$$b = \frac{change\ \ in\ price}{change\ \ in\ quantity}$$

MR = a – 2bQ

The linear regression equation of Y on X is given by:

$$Y = a + bX \text{ or } Y - \overline{Y} = b(x - \overline{X})$$

where:

$$b = \frac{Covariance\ \ (XY)}{Variance\ \ (X)} \quad = \frac{n\sum XY - (\sum X)(\sum Y)}{n\sum X^2 - (\sum X)^2}$$

$$a = \bar{Y} - b\bar{X}$$

$$\sum Y = na + b\sum X$$

$$\sum XY = a\sum X + b\sum X^2$$

Annuity Table

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

Where r = discount rate

n = number of periods

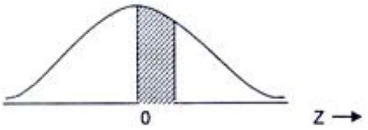
Periods

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

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

NORMAL DISTRIBUTION

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



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

SOLUTION 1

SECTION A:

QUESTION 1 KARDEX INDUSTRIES NIGERIA LIMITED

a. Calculation of the key performance indicators

(i)

Product	Wash Up ₦'M	Perfect Wash ₦'M	Total ₦'M
Revenue	44,800	30,800	75,600
Less costs:			
Total Variable costs	28,560	14,300	42,860
Total Fixed costs	12,000	12,000	24,000
	40,560	26,300	66,860
Total profit	4,240	4,500	8,740

(ii)

Product	Wash Up ₦'M	Perfect Wash ₦'M
Revenue (₦'M)	44,800	30,800
Sale in Units (Millions)	1.12	0.44
Sales price per unit (₦)	40,000	70,000

(iii)

Product	Wash Up ₦'M	Perfect Wash ₦'M
Sales per unit	40,000	70,000
Less variable cost per unit	25,500	32,500
Contribution per unit	14,500	37,500

(iv) $Market\ share = \frac{sales\ \ in\ units}{market\ \ size\ in\ units}$ x 100%

Product	Wash Up ₦'M	Perfect Wash ₦'M	Total ₦'M
Total market size (Millions)	9.33	1.33	10.66
Kardex's sales (Millions)	1.12	0.44	1.56
Market shares (%)	12%	33%	15%

(v) Margin of Safety = (Actual sales – Sales at BEP)

Product	Wash Up	Perfect Wash
Sales in Units (millions)	1.12	0.44
Break-even sales units (millions)	0.83	0.32
Margin of safety (million units)	0.29	0.12
Sales price per unit (₦)	40,000	70,000
Margin of safety (₦'M)	11,697	8,400

(vi) Return on Capital Employed (ROCE) = $\frac{Net\ Profit}{Capital\ \ Employed}\ x\ 100\%$

Product	Wash Up	Perfect Wash	Total
Total profit (₦'M)	4,240	4,500	8,740
Capital employed (₦'M)	32,600	25,000	57,600
Return on capital employed (%)	12	18	15

(vii) Total quality costs

Product	Wash Up ₦'M	Perfect Wash ₦'M	Total ₦'M
Total variable costs	2.240	1.320	3,560
Total fixed costs	600	600	1,200
Total quality costs	2,840	1,920	4,760

b. **PEST Analysis of Kardex Industries**

The issues on the external environment can be identified using PEST, which stands for political, economic, socio-cultural and technology.

The political environment is characterized by government actions which include the giving of tax holidays to a competitor to set up manufacturing operations in the country. This is not Kardex's mode of operation which is to manufacture outside Nigeria and only to undertake selling operations within the country. None of the KPIs directly addresses this issue which could lead to increased shareholders' wealth and increased available profit to develop the competitor's products or government action against Kardex by increasing import tariffs.

The economic environment is characterised by growth as the population of the middle-class is increasing although economic recession is creating some problem. There is no measure of this included in the KPIs. There is no measure of competitors' activity, although market share provided some measures of the relative strength of Kardex and its competitors. It is noticed that none of the KPIs measures current rates of growth in their area. Furthermore, the KPIs do not reflect the foreign exchange risk which Kardex could encounter in repatriating profits from the country.

The socio-cultural factors include demographic trends and changes in customers' taste. The increasing middle-class population mentioned will be a factor that is likely to drive the consumers' taste towards the more expensive "perfect wash" model. These would justify the large potential growth indicated in making Plan B. There are several measures which will bear on this area but all will require knowledge of trends, for example, the inflation of average price per unit and consequent improvement in profit and contribution indicators.

Technology can impact on Kardex in two ways: first, the development of new feature for the products themselves will require continued product development at Kardex as a whole, although it will be less relevant to the operation in Nigeria which may not have the market for cutting–edge technology yet. Therefore, it is appropriate that this area is not covered by the existing KPIs; and second, new technology in manufacturing could improve further the contribution per unit as costs are cut from the manufacturing process by, for example, increased automation in production. The use of contribution to measure this impact is indirect as it is also influenced by the selling price, so a measure of manufacturing cost per unit would better capture the change.

EXAMINER'S REPORT

The question tests candidates' understanding of Computation of key performance indicators (KPI) as well as PEST Analysis. About 80% of the candidates attempted the question.

However, about 30% of them understood the subject matter and that was responsible for the poor performance.

The commonest pitfalls were their inability to compute BEP, CSR and explain the meaning of PEST Analysis.

Candidates are encouraged to use their ICAN Study Text when preparing for future examinations.

MARKING GUIDE

SOLUTION 1			**MARKS**	**MARKS**
(a)		Key performance Indicators:		
	i.	Total profit	4¼	
	ii.	Average sales price per unit	2	
	iii.	Contribution per unit	2	
	Iv.	Market share	2¾	
	V.	Margin of safety	4	
	vi.	Return on capital employed	2¾	
	vii.	Total quality costs	2	
	viii.	Title	¼	20
(b)		Identification of PEST acronym:		
		P – Political	½	
		E – Economical	½	
		S - Socio-cultural	½	
		T – Technological	½	
		Explanations of the points @ 2 marks each	8	10
				30

SOLUTION 2

a. i. **Existing Method**

	Prelude	Roadmaster	Roadstar
	₦'000	₦'000	₦'000
Direct labour (₦350) (W1)	25,000	27,500	10,000
Materials (W2)	20,000	24,000	12,600
Overhead cost (at ₦96/hr)	48,000	52,800	19,200
	93,000	104,300	41,800
Output (units)	5,000	4,000	1,400
Cost per unit (W4) =	₦18,600	₦26,075	₦29,857
Selling price per unit	₦25,000	₦30,000	₦40,000
Profit per unit	₦6,400	₦3,925	₦10,143
Total units produced	5,000	4,000	1,400
Total profit per product	₦32,000,000	₦15,700,000	₦14,200,200
Total profit			₦61,900,200

ii. **Activity-Based Costing**

	Prelude	Roadmaster	Roadstar
	₦'000	₦'000	₦'000
Direct labour (W1)	25,000	27,500	10,000
Materials (W2)	20,000	24,000	12,600
Overhead:			
Deliveries (W5a)	9,600	7,680	6,720
Set up costs (W5a)	21,000	24,000	15,000
Purchase (W5a)	18,000	13,500	4,500
	93,600	96.680	48,820
Output	N93,600,000	₦96,680,00	₦48.820,00
	5,000	4,000	1,400
Cost per unit	₦18,720	₦24,170	₦34,871
Selling Price per unit	₦25,000	₦30,000	₦40,000
Profit per unit	₦6,280	₦5,830	₦5,129
Total profit per product	₦31,400,000	₦23,320,000	₦7,180,000
Total profit			₦61,900,600

WORKINGS

1. Labour cost

Prelude	= 500,000x50	=	₦25,000,000
Roadmaster	= 550,000x50	=	₦27,500,000
Roadstar	= 200,000x50	=	₦10,000,000

2. Material cost

Prelude	= 5,000x4,000	=	₦20,000,000
Roadmaster	= 4,000x6,000	=	₦24,000,000
Roadstar	= 1,400x9,000	=	₦12,600,000

3. Overhead per labour hour

Total overhead cost ₦(24,000,000 + 60,000,000+ 36,000,000) = ₦120,000,000

Total labour hours (500,000 +550,000 + 200,000) = 1,250,000 hours

Overhead per labour hour $= \frac{₦120,000,000}{1,250,000}$

= ₦96

4. Cost per unit

Prelude $\frac{Total\ cost}{Units\ produced} = \frac{93,000,000}{5,000} =$ ₦18,600

Roadmaster $\frac{Total\ cost}{Units\ produced} = \frac{104,300,000}{4,000} =$ ₦26,075

Roadstar $\frac{Total\ cost}{Units\ produced} = \frac{41,800,000}{1,400} =$ ₦29,857

5. Overheads

$\frac{Overhead\ cost\ of\ deliveries\ to\ retailers}{Total\ number\ of\ deliveries}$ $\frac{₦24,000,000}{500}$ = ₦48,000

$\frac{Overhead\ cost\ set\ ups}{Total\ number\ of\ set\ ups}$ $\frac{₦60,000,000}{200}$ = ₦300,000

$\frac{Overhead\ cost\ of\ purchase\ orders}{Total\ number\ of\ purchase\ orders}$ $\frac{₦36,000,000}{800}$ = ₦45,000

i. Deliveries overheads:

Prelude	= ₦48,000 x 200	=	₦9,600,000
Roadmaster	= ₦48,000 x 160	=	₦7,680,000
Roadstar	= ₦48,000 x 140	=	₦6,720,000

ii. Set up overheads:

Prelude	= ₦300,000 x 70	=	₦21,000,000
Roadmaster	= ₦300,000 x 80	=	₦24,000,000
Roadstar	= ₦300,000 x 50	=	₦15,000,000

iii. Purchase order overheads:

Prelude	= ₦45,000 x 400	=	₦18,000,000
Roadmaster	= ₦45,000 x 300	=	₦13,500,000
Roadstar	= ₦45,000 x 100	=	₦4,500,000

b. REPORT

To: Directors - Sadet
From: Management Accountant
Subject: Labour hours and Activity-Based Cost allocation
Date: 15-05-2016

Labour hours

The use of labour hours for allocation of overheads is only appropriate where there is a direct relationship between overheads and labour hours. This does not appear to be so for Sadet as painted in the scenario. The traditional method of cost allocation, such as the one based on labour hours was developed when manufacturing operations were simple and products went through similar operations. Also, this method was being widely used when overhead costs were only a small proportion of total costs while direct labour and material costs accounted for significant proportion of total costs. It seems that Sadet has invested so much in new technology and, as a result the labour size, has been reduced significantly. Direct labour costs now account for a relatively small proportion of total costs while overheads make up the highest single item. Allocation of overheads on the basis of labour costs would tend to allocate a greater proportion of overheads to the higher volume "Prelude" than lower volume Roadstar, ignoring the fact that lower volume product may require relatively more support services. Allocation of overheads on the basis of labour hours may therefore lead to inappropriate decision.

Activity-Based Costing.

Activity-based costing is an attempt to overcome the problem highlighted earlier by identifying the factors that drive the costs of an organization's major activity.

The idea behind activity-based costing is that activities such as ordering, materials handling, deliveries, set up etc, drive costs. Costs are therefore, assigned to a product on the basis of the product's consumption of such activities.

It is also argued by the proponents of activity-based costing that, it is activities that generate costs and not labour hours. The accuracy of any activity-based costing system will depend on the appropriateness of the activities as cost drivers. Each cost driver selected should be appropriate to the overheads to which it relates. There should be a direct and proportionate relationship between the relevant overhead costs and the cost driver selected. The labour hours overhead costs allocation system and activity-based costing result in different profit figures. The profit per unit of "Roadstar" significantly reduced from ₦10,143 to ₦5,129 while that of "Prelude" increased from ₦6,400 to ₦6,480 per unit.

The reason for this is that, although the "Roadstar" uses about 50% more labour hours per unit than the "Prelude", its low output volume of only 1,400 units (compared with 5,000 units of "Prelude") means that a proportionately lower amount of overheads is absorbed.

I hope this will assist in your further deliberations on the matters.

Thank you.

Signed
Management Accountant

EXAMINER'S REPORT

This question tests candidates understanding of activity-based costing as a method of overhead absorption.

About 60% of them attempted the question and the performance was fair as the commonest pitfall noticed was poor presentation.

Candidates are advised to make better use of ICAN Study Text and other high quality Study materials.

MARKING GUIDE

SOLUTION 2			**MARKS**	**MARKS**
(a)	Heading for each product	3 x $^1/_3$ =	1	
	Calculation of sales value	3 x $^1/_3$ =	1	
	Calculation of material costs	3 x $^1/_3$ =	1	
	Calculation of labour costs	3 x $^1/_3$ =	1	4
	Appointment of overhead under existing method (Labour)			
	Delivery to retailers	3 x $^1/_3$ =	1	
	Set-up costs	3 x $^1/_3$ =	1	
	Purchase orders	3 x $^1/_3$ =	1	
	Total overheads	3 x $^1/_3$ =	1	
	Profit	3 x $^1/_3$ =	1	5
	Appointment of overhead under activity based costing (ABC)			
	Deliveries to retailers	3 x $^1/_3$ =	1	
	Set-up costs	3 x $^1/_3$ =	1	
	Purchase orders	3 x $^1/_3$ =	1	
	Total overheads	3 x $^1/_3$ =	1	
	Profit	3 x $^1/_3$ =	1	
				5
(b)	Heading/layout of the report			
	4 points at ½ mark		2	
	Any 4 points in the report at 1 mark each		4	
				6
				20

SOLUTION 3

a. Relevant cost

	Note	₦
Production Director's salary	(i)	-
Material A	(ii)	13,750
Material B	(iii)	3,600
Components	(iv)	30,000
Direct labour	(v)	21,600
Machine hours	(vi)	1,750
Fixed overhead	(vii)	-
Total relevant cost		70,700

Notes: Explaining why a cost is included or excluded:

i. The Production Director is paid an annual salary and therefore there is no incremental cost to Tadex.

ii. Material A is in regular use by Tadex and consequently its relevant value is its replacement cost. The historical cost is irrelevant because it is a past cost and the resale value is not relevant since Tadex is not going to sell it as the material is in regular use and therefore must be replaced.

iii. Material B is to be purchased for the contract, therefore, its purchase cost is relevant. Although 30 liters are required for the work, the minimum order quantity is 40 liters and since Tadex has no other use for this material and there is no indication that the unused 10 liters can be sold, the full cost of purchasing the 40 liters is the relevant cost.

iv. The components are to be purchased from Tokas at a cost of ₦500 each. This is a relevant cost because it is future expenditure that will be incurred as a result of the work being undertaken.

v. Since 75 hours of spare capacity are available which have a zero relevant cost, the relevant cost relates only to the other 165 hours. Tadex has two choices:
- Either to use its existing staff and pay them overtime at ₦140 per hour which is a total cost of ₦23,100; or
- To engage temporary staff which attracts a cost of ₦19,800 plus supervision cost of ₦1,800 which is equal to ₦21,600.

The relevant cost is the cheaper of these alternatives which is to use the temporary staff.

vi. The machine is currently being leased and it has spare capacity so it will either stand idle or be used for this work. The lease cost will be incurred regardless, so the only relevant cost is the incremental running cost of ₦70 per hour.

vii. Fixed overhead costs are incurred whether the contract is accepted or not, so it is not a relevant cost.

(b) The factors that should be considered by Tokas to determine the opportunity cost of the components are its available capacity and the extent to which it has unsatisfied demands for its products.

If Tokas has spare capacity, then the components can be produced for Tadex using the capacity that is available. There is no opportunity cost so the relevant cost to the group would be the same as the relevant cost to Tokas which is the variable cost. If Tokas does not have sufficient spare capacity to produce all the components demanded by Tadex, then the extent that the internal sales are utilizing capacity that would have been used to produce more units for external customers there is an opportunity cost to the group equal to the contribution forgone by not making those external sales.

Once there is no further unsatisfied external demand, then the opportunity cost reverts to zero because there is no loss of contribution.

i. When a cost-based transfer pricing policy is used, it is usual for it to be on a cost-plus basis so that the "plus" provides an incentive to the supplier to make the internal sale. If it is on a cost basis, then there is no profit to the supplier, nor is there any incentive for them to be efficient because the cost (and therefore the inefficiency) is simply passed on the buyer. When a cost-plus transfer price is used, then the efficiency issue is made worse as illustrated by the following examples:

Assume that the transfer price is actual cost + 25%.
If the cost to the supplier is ₦200 the transfer price would be ₦250 (i.e. ₦200 + 25%) and thus the supplier would record a profit of ₦50 from the internal sale.

However, if the supplier were to become inefficient so that the cost of the item increases to ₦240, then the new transfer price would be ₦300 (i.e. ₦240 + 25%) with the result that the new supplier's profit would be ₦60.

This means that the supplier's profit increases as a result of the supplier's inefficiency, and therefore, the transfer pricing policy encourages such inefficiency to occur.

ii. If standard costs are used instead of actual costs, then the problem is solved provided the standard that is used is fair to both the supplier and the buyer.

Firstly, it is important that both the supplier and buyer agree on the standard cost for the item as being a fair standard. This may be difficult to achieve without the intervention of head office as it may be affected by the negotiating skills of the managers of the respective responsibility centres.

Secondly, there is the need to review the standard in the light of changing conditions that are beyond the control of the supplier. It would not be fair for the transfer price to be based on an out-of-date standard if the reason it has become out-of-date is outside the control of the supplier. This would require a renegotiation of the standard.

The use of the example given and assuming that the standard cost of the item is ₦200, means that initially the supplier was achieving the standard cost and there would be no change in the transfer price. However, if the supplier was to become inefficient, the transfer price would remain ₦250 and so, the supplier's profit reduces to ₦10. Conversely, if the supplier was to become more efficient and produced the item for ₦180, then his profit would increase to ₦70.

This would seem to solve the problem identified in (i) above as it encourages the supplier to be efficient.

EXAMINER'S REPORT

The question tests candidates understanding of relevant costing in project quotation.

Candidates' understanding of the concept and requirements of the question was average, as over 50% attempted it. The pass rate was about 40%.

The commonest pitfall was candidates poor understanding of factors that need to be taken into consideration in determining opportunity costs.

Candidates need to prepare better for future examination using ICAN Study Text and other relevant text.

MARKING GUIDE

		MARKS	MARKS
SOLUTION 3			
(a)	Calculation of relevant costs	3	
	Explanation why a cost is included or excluded	7	10
(b)	Discussion on factors to be considered before determining opportunity cost		4
(c)	Performance measurement problem where there is no external market	3	
	Explanation on how standard costs can solve the problem	3	6
			20

SOLUTION 4

Debens Nig Ltd. - Standard costing and Variance Analysis

a. Budgeted Profit = Budgeted sales - Unit Std Cost x budgeted Quantity.

₦5,200 x $\frac{40,000}{5}$

= ₦5,200 x 8,000 - ₦3,900 x 8,000

= ₦41,600,000 - ₦3,900 x 8000 = ₦10,400,000

b. Schedule of total manufacturing costs

Cost Element	**Actual Production**	**Unit Standard Cost(₦)**	**Total Cost ₦**
Direct material	7,800	1,500	11,700,000
Direct manufacturing Labour	7,800	1,000	7,800,000
Variable Manufacturing Overhead	7,800	600	4,680,000
Fixed Manufacturing Overhead	7,800	800	6,240,000
Total manufacturing Overhead			30,420,000

i. Direct material Variances:

Direct Material Price = (Actual Qty Purchased x Actual purchase price) less (Actual Quantity Purchased x Std Purchased price) = (25,000 x ₦520) – (25,000 x ₦500) = ₦500,000(U)

Direct Material Usage variance

= (Actual Quantity Used x Standard Price) - (Standard cost of actual production)

= (₦500 x 23,100) - (₦1,500 x 7,800) = (₦11,550,000 – ₦11,700,000) = ₦150,000 (F)

ii. Direct Manufacturing Labour Variances:

Direct Labour rate = (Actual rate x Actual Hours) - (Standard rate x actual Hours) = (₦190 x 40,100) – (40,100 x ₦200) = ₦7,619,000 – ₦8,020,000 = ₦401,000 (F)

Direct Labour efficiency:

= (Actual hours x Standard labour rate) – (Standard labour rate per unit x actual production) = (40100 x ₦200) - (₦1,000 x 7,800) = (₦8,020,000 - ₦7,800,000) = ₦220,000(U)

iii. Manufacturing Overhead variances:

Manufacturing Overhead rate variance = (Actual overhead rate x Actual labour Hours) – (Standard overhead rate x Actual Direct Labour Hours) = (₦12,000,000 – (₦280 x 40100) = (₦12,000,000 – ₦11,228,000) = ₦772,000(U).

Manufacturing overhead efficiency variance = Standard overhead rate x Actual Hours - Standard overhead rate per unit x actual production = (₦280 x 40100) - (₦ 1400 x 7800) = ₦11,228,000 – ₦10,920,000 = ₦308,000(U)

iv. This is made up of:
Variable manufacturing overhead efficiency variance =

(Standard Cost of Variable Manufacturing Overhead – Standard Cost of variable manufacturing overhead at Actual Production)

= {(40,100 x ₦120) – (₦600 x 7,800)}

= (₦4,812,000 – ₦4,680,000)

= ₦132,000(U)

- Fixed Manufacturing Overhead efficiency Variance =

(Standard cost of Fixed manufacturing overhead - Standard Cost of Fixed Manufacturing Overhead at actual production)
= (40,100 x ₦160) – (7,800 x ₦800) = ₦6,416,000 – ₦6,240,000 = ₦176,000(U)

v. Sales Price variance =
= (Actual selling Price x Actual Sales Quantity) - (Standard selling Price – Actual Quantity sold) = (₦5,350 x 7,800) - (₦5,200 x 7,800)
= ₦41,730,000 - ₦40,560,000 = ₦1,170,000(F)

Sales Volume Variance =

(Actual Sales Quantity x Standard selling price) – (Budgeted sales quantity x Standard selling Price) = {(₦5,200 x 7800) - (₦5,200 x 8000)} = (₦40,560,000 – ₦41,600,000)
= ₦1,040,000 (U)

Actual Volume Margin variance = $\frac{\text{Standard Profit Margin x Sales Volume variance}}{\text{Standard Selling Price}}$

= $\frac{1300}{1}$ x $\frac{₦1,040,000}{₦5,200}$ = ₦260,000 (U)

Alternative Solution

Calculation of variances

(i) Material variances
- Price variance
  = AQ purchased (SP –AP)
  = 25,000 kg (₦500-₦520) = ₦500,000 (A)

- Usage Variance
  = SP(SQ-AQ used)
  = ₦500 {(7800 x 3 kg) – 23,100 kg} = ₦150,000 (F)

(ii) Labour Variances

- Rate Variance

  = AH (SR –AR)

  = 40,100 hrs (₦200 – ₦190) = ₦401,000 (F)

- Efficiency Variance

  = SR (SH –AH)

  = ₦200 [(7,800 X 5 hrs) – 40,100] = ₦220,000 (A)

(iii) Variable overhead Variances

Note: The total actual manufacturing overhead is divided into variable and fixed as follows:

- Variable = $\frac{600}{600+800}$ x ₦$12m$ = ₦5,142,857

- Fixed = $\frac{600}{600+800}$ x ₦$12m$ = ₦6,857,143

- Expenditure variance

  = AH(SR – AR)

  = 40,100 hrs [₦120 –($\frac{₦5,142,857}{40,100}$)] = ₦330,857(A)

Efficiency Variance

= SR (SH – AH)

= ₦120 [(7,800 x 5 hrs) – 40,100] = ₦132,000 (A)

(iv) Fixed Overhead Variances

- Expenditure variance

  = Budgeted FOH –Actual FOH

  = (₦800 x 8000) – ₦6,857,143 = ₦457,143 (A)

- Volume variance

  = SR (SH –BH)

  = ₦160 [(7,800 x 5 hrs) - (8,000 x 5 hrs] = 160,000 (A)

(v) Sales Variances

- Price Variance

  = AQ sold (AP – SP)

  = 7,800 (₦5,350 – ₦5,200)

  = ₦1,170,000 (F)

- Sales Volume Variance
  = STD Profit (AQ –BQ)
  = ₦1,300 (7,800 – 8,000) = ₦260,000(A)

c.

(i) Schedule of Actual Profit for January 2016

Cost Element	**Actual Quantity/ Hours**	**Unit Selling Price/Unit Actual Cost(₦)**	**Total ₦**	**Total ₦**
Actual sales Revenue	7800 units	5,350		41,730,000
Less:				
Direct material	25000kgs	520	13,000,000	
Less: closing stock of raw materials at Standard cost	1900kg	500	(950,000)	12,050,000
Direct manufacturing Labour	40100hrs	190		₦7,619,000
Total Manufacturing Overhead	40100hrs			₦12,000,000
Total cost				₦31,669,000
Actual Profit				₦10.061,000

(ii)

	₦	₦	₦
Reconciliation of Budgeted Profit with Actual Profit			
Budgeted Profit =			10,400,000
Add: Sales Variances:			
Sales price variance	1,170,000		
Sales Volume Margin Variance	(260,000)		910,000
Standard Profit			11,310,000
Add/less Cost Variances	Add	Less	
Material Price variance		500,000	
Material usage Variance	150,000	-	
Labour Rate variance	401,000	-	
Labour Efficiency variance	-	220,000	
Manufacturing Overhead rate variance	-	772,000	
Manufacturing Overhead efficiency Variance	-	308,000	
Total variances	551,000(F)	1,800,000(U)	(1,249.000)
Actual Profit			10,061,000

NOTE:

Variable Manufacturing overhead efficiency variance - ₦132,000(U)
Fixed Manufacturing overhead efficiency variance - ₦176,000(U)
₦308,000(U)

EXAMINER'S REPORT

The question tests candidate's knowledge of Standard Costing, Variance Computation and reconciliation.

Candidates' understanding of the question was average even though over 80% attempted it, the pass rate was about 40%. Commonest pitfall noticed was their inability to reconcile budgeted profit with Actual Profit.

Candidates are advised to use ICAN Study Text and other relevant text material.

MARKING GUIDE

SOLUTION 4

			MARKS	MARKS
(a)		Computation of budged profit		2
(b)		Calculation of:		
	i.	Direct material variance	2	
	ii.	Director manufacturing labour variance	2	
	iii.	Manufacturing overhead variance	4	
	iv.	Sales variances	2	10
(c)	i.	Schedule of actual profit for January 2016	2	
	ii.	Reconciliation of Budgeted profit with Actual profit	6	8
				20

SOLUTION 5

The following table provides an overview of the basic methods for data collection as well as their advantages and disadvantages.

SN	Method	Advantages	Disadvantages
1	Observation is a systematic data collection approach. Researchers use all of their senses to examine people in natural settings or naturally occurring situations.	(i) Collect data where and when an event or activity is occurring (ii) Does not rely on people's willingness to provide information (iii) Directly see what people do rather than relying on what they say they do	(i) Susceptible to observer bias - (Hawthorne effect where people usually perform better when they know they are being observed). (ii) Does not increase understanding of why people behave the way they do
2	Interview – Verbal conversation between two people with the objective of collecting relevant information.	(i) Useful for gaining insight and context into a topic (ii) Allows respondents to describe what is important to them (iii) Useful for gathering quotes and stories	(i) Susceptible to interview bias (ii) Time consuming and expensive compared to other data collection methods (iii) May seem intrusive to the respondent
3	Focus Group is a small, but demographically diverse group of people whose reactions are studied.	Quick and relatively easy to set up Group dynamics can provide useful information that individual data collection does not provide Is useful in gaining insight into a topic that may be more difficult to gather information through other data collection methods	(i) Susceptible to facilitator bias (ii) Discussion can be dominated or sidetracked by a few individuals (iii)Data analysis is time consuming and needs to be well planned in advance (iv) Does not provide valid information at the individual level (v) The information is not representative of other groups
4	Survey and Questionnaire consisting of a series of questions and other prompts for the purpose of gathering information from respondents.	(i) Administration is comparatively inexpensive and easy even when gathering data from large numbers of people spread over wide geographic area (ii) Reduces chance of evaluator bias because the same questions are asked of all respondents	(i) Survey respondents may not complete the survey resulting in low response rates (ii) Items may not have the same meaning to all respondents (iii) Size and diversity of sample will be limited by people's ability to read

SN	Method	Advantages	Disadvantages
		(iii) Many people are familiar with surveys (iv) Some people feel more comfortable responding to a survey than participating in an interview (v) Tabulation of closed-ended responses is an easy and straightforward process	(iv) Given lack of contact with respondent, never know who really completed the survey (v) Unable to probe for additional details (vi) Good survey questions are difficult to write and they take considerable time to develop and own
5	Experimental Method: This involves the testing of a hypothesis about the relationship between an independent variable and dependant variable	(i) Experimentation normally involves the testing of a hypothesis about the relationship between an independent variable (cause)and a dependent variable (effect). (ii) Experiments are usually set up so that the scientist controls the introduction of possible independent variables.	(i) May suffer lower levels of reliable complex and be difficult to carry out. (ii) Sometimes the basis of the experiment may not reflect realities. (iii) Can only apply under given conditions and such conditions may not add up
6	Town Hall Meetings and Other large group events – used to gather large amount of data at one time, during the congregation of relevant respondents	(i) Can gather large amount of data at one time. (ii)Allows respondents to describe the issues that are important to them. (iii) Provides a venue where people can build on each others' knowledge	(i) Organizing the event takes time and resources (ii) Definitely need to have a draw to get people to attend in the form of incentives. (iii) Need to have access to people with good facilitation skills. (iv)Need to have "ducks in a row" to ensure attendance at event.
7	Case studies are indepth investigations of a single person, group, events or community.	(i)Fully depicts people's experience in program input, process, and results. (ii) Powerful way of portraying program to outsiders.	(i) Usually quite time consuming to collect information, organize and analyze it. (ii) Represents depth of information rather than breadth.
8	Document Review: Data collected from documents, journals and reports.	(i) Relatively inexpensive. (ii)Good source of information. (iii) Provide authenticated data.	(i) Information may be in-applicable. (ii) Could be time biased.

EXAMINER'S REPORT

This question demands candidates' understanding of the different methods of gathering information needs of systems analyst as well as their advantages and disadvantages.

Candidates understanding of the question was poor. However, over 60% attempted the question but the pass rate was about 15%.

The commonest pitfall was candidates' lack of adequate use of the ICAN Study Text where this topic was well dealt with. Candidates are advised to regularly and diligently use ICAN Study Text to ensure better performance in future examinations.

MARKING GUIDE

SOLUTION 5	MARKS	MARKS
Five discussion points at 1 mark each		5
One advantage for each of the five selected methods at 1 mark each		5
One disadvantage for each of the five selected methods at 1 mark each		5
		15

SOLUTION 6

(a)

i.

Year	1	2	3	4
Maximum capacity (units)	300,000	285,000	270,000	255,000
	₦'000	₦'000	₦'000	₦'000
Annual contribution at ₦100	30,000	28,500	27,000	25,500

ii. Where AEV = Annual Equivalent Value

Option 1: Replace every year

Year	0	1
	₦'000	₦'000
Outlay	(12,000)	
Contribution	-	30,000
Scrap value	-	8,000
Maintenance costs	-	(300)
NCF	(12,000)	37,700
PVF at 10%		
PV	1	0.909
	(12,000)	34,269

NPV = ₦22,269,000

AEV = ₦22,269,000/0.909 = ₦24,498,350

iii. **Option 2 – Replace every 2 years**

Year	0	1	2
	₦'000	₦'000	₦'000
Outlay	(12,000)		
Contribution	-	30,000	28,500
Scrap value	-	-	5,000
Maintenance costs	-	(300)	(350)
NCF	(12,000)	29,700	33,150
PVF at 10%	1	0.909	0.826
PV	(12,000)	26,997	27,382

NPV = ₦42,379,000

AEV = ₦42,379,000/1.736 = ₦24,411,866

(iii) Option 3 – Replace every 3 years

Year	0	1	2	3
	₦'000	₦'000	₦'000	₦'000
Outlay	(12,000)	-	-	
Contribution	-	30,000	28,500	27,000
Scrap value	-	-	5,000	2,000
Maintenance costs	-	(300)	(350)	(400)
NCF	(12,000)	29,700	33,150	28,600
PVF at 10%	1	0.909	0.826	0.751
PV	(12,000)	26,997	27,382	21,479

NPV = ₦59,728,000

AEV = ₦59,728,000/2.487 = ₦24,016,084

(v) **Conclusion:** The Directors should change their existing policy of replacing the processing machine every 3 years to replacing it every year, as that gives the greatest annual equivalent value.

(b) The following assumptions are made in the calculations:

- The existing machine will always be replaced with financially identical machine.
- Replacement will continue to infinity
- There is no inflation
- No taxation
- No competition
- No price change
- No technological change

EXAMINER'S REPORT

This question tests candidates' understanding of Net Present Value (NPV) calculation and related decision making at various times. Candidates exhibited below average understanding of the question even though over 20% of them attempted it. Performance pass rate was below 30%. Commonest pitfall was hinged on poor understanding of the requirements of the question. This can easily be resolved using the ICAN Study Text and other relevant text materials.

MARKING GUIDE

SOLUTION 6			**MARKS**	**MARKS**
(a)	i.	Computation of Contribution		
		10 ticks = 2 marks	2	
	ii.	Replaceable in Year one (Every year)		
		10 ticks = 2 marks	2	
	iii.	Replaceable in Year 2 (Every Two Years)		
		15 ticks = 3 marks	3	
	iv.	Replaceable in Year 3 (Every Three Years)		
		20 ticks = 4 marks	4	
	v.	Decision	<u>1</u>	
				12
(b)		Any three major assumptions at 1 mark each		<u>3</u>
				<u>15</u>

SOLUTION 7

(a) In order to work out the Transfer Price which should be set for the internal sales of 35,000 engines, the perspective of both divisions must be considered.

i. **From the group's perspective.**

For every engine sold externally, Division E generates a profit of ₦8,000 i.e(₦85,000 – ₦77,000) for the Group.

For every engine which Division A buys from outside the group, there is an incremental cost of ₦6,000 per unit {₦80,000 – (₦77,000 – ₦3,000}.

Therefore, from the Group's perspective, as many external sales should be made as possible before any internal sales are made. Consequently, the Group's current policy will need to be changed. This however, assumes that the quality of the engines bought from outside the Group is the same as the quality of the engine made by Division E.

Hence, Transfer Prices are ₦74,000 and ₦80,000.

ii. **From Division E's perspective.**

Division E's only buyer for these 35,000 engines is Division A, so the lowest price division E would be prepared to charge is the marginal cost of making these engines, which is ₦74,000 per engine. However, Division E would want to make higher profit on these engines too and would consequently expect a higher price than ₦74,000.

iii. **From Division A's perspective**

Division A knows that it can buy as many external engines as it needs from outside the group at a price of ₦80,000 per engine. Therefore, this will be the maximum price which it is prepared to pay.

iv. Overall Transfer Price Range

Therefore, the Transfer Price should be set between ₦74,000 and ₦80,000. From the perspective of the Group, the total group profit will be the same irrespective of where in this range the transfer price is set. However, it is important that divisional managers and staff remain motivated. Given the external sales price which Division A would have to pay ₦80,000 for each engine bought from outside the group, the transfer price should probably be at the higher end of the range.

(b)

Division E's total capacity is 70,000 units.

Given that it can make external sales of 35,000 units it can only supply Division A 35,000 units of 45,000 engines demanded. These 35,000 engines should be bought from Division E since, from the Group's perspective, the cost of supplying these internally is ₦6,000 per engine cheaper than buying externally. The remaining 16,000 engine required by Division A should then be bought in from the external suppliers at ₦80,000 per engine.

Profit on sales by Division E = 35,000 units at (₦85,000 – ₦77,000)	=	280,000,000
Loss on an external purchase of 10,000 at (₦74,000 – ₦8,000)	=	(60,000,000)
Group Profit	=	220,000,000

(c) The two main performance measurements that are appropriate for evaluating divisional performance of an autonomous division that operates as an investment centre are:

i. Return on Investment (ROI) – This is the profit of the division as a percentage of capital employed. The performance of the manager of an investment centre may be judged on the basis of ROI – whether the division has succeeded or not in achieving a target ROI for the financial year or whether ROI has improved since the previous year.

$$\text{ROI} = \frac{Profit}{Capital\ \ employed} \text{ or } \frac{Profit}{Investment\ \ cost}$$

ii. Residual Income (RI) – Residual Income is another way of measuring the performance of an investment centre. It is an alternative to ROI. RI is measured in either of the following ways:

Managerial evaluation:

	₦
Controllable profit	XX
Less national interest on average	
Controllable investment	XX
Controllable Residual income	XX

Or

Residual Income: Divisional evaluation:

	₦
Traceable profit	XX
Less national interest on average	

Traceable investment	XX
Divisional Residual income	XX

EXAMINER'S REPORT

This question test candidates' understanding of transfer pricing and measures of evaluating divisional performance. Over 82% of the candidates attempted the question, and performance was poor as less than 20% of them scored above the pass marks. Candidates' poor understanding of the requirement of the question was attributable to the poor performance. Candidates are therefore advised to use the ICAN Study Text and other relevant text in order to improve their performance in future examinations.

MARKING GUIDE

SOLUTION 7			**MARKS**	**MARKS**
(a)				
	i.	Division E's external sales generate ₦8,000	1	
	ii.	Division A's external purchases cost ₦6,000	1	
	iii.	Maximum TP from division E's perspective	1	
	iv.	Maximum TP from division A's perspective	1	
	v.	Range of TP discussion	1	5
(b)				
	i.	Division A should buy 10,000 units from outside	1	
	ii.	Sale/computation of max. profit	4	5
(c)		Two main performance measures in autonomous divisions		5
				15

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – MAY 2017

AUDIT AND ASSURANCE

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

The following is the statement of Profit or Loss and other comprehensive Income of ABRICON NIGERIA LIMITED for the year ended December 31, 2016

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

	2016	2015
	₦	₦
Turnover	51,911,612	45,283,683
Less: Cost of Sales	(36,844,571)	(35,850,619)
	15,067,041	**9,433,064**
Loss on sale of Motor Vehicle	(13,034)	-
GROSS PROFIT	**15,054,007**	**9,433,064**
LESS: ADMIN EXPENSES		
Staff Salaries & Allowances	3,255,785	1,605,977
Repairs & Maintenance	762,755	496,580
Transport & Travelling	320,810	180,840
Printing, Postage & Stationery	1,200	62,000
Telephone Expenses	306,916	33,340
Office Rent	238,000	140,000
Motor Running Expenses	421,910	337,430
Electricity	68,355	39,400
Advertising	35,750	50,000
Medical Expenses	55,000	24,000
Subscriptions & Donations	513,045	71,324
Insurance	21,500	27,500
Legal & Professional Fee	-	10,000
Entertainment	17,655	10,960
Sundry Expenses	363,800	642,640

	2016	2015
	₦	₦
Audit Fee	100,000	50,000
Bank Charges & Interest	1,656,484	900,000
Depreciation	781,400	758,400
Prov. for Bad & Doubtful Debts	149,084	(43,818)
	9,069,449	**5,396,573**
Profit Before Taxation	**5,984,558**	**4,036,491**
Taxation	(897,684)	(1,009,123)
PAT transferred to Gen. Reserves	**5,086,874**	**3,027,368**

You are required to:

a. Perform analytical tests on the figures given. (16 Marks)

b. Identify unusual features. (8 Marks)

c. Provide possible explanations why some apparently unusual items were not selected in (b) above. (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

The Auditor is required by ISA 500 to design and perform appropriate audit procedures for obtaining sufficient and appropriate audit evidence.

You are required to:

a. Identify **FIVE** factors that an Auditor will consider in determining what constitutes sufficient audit evidence. (5 Marks)

b. Explain **FIVE** principles that would assist the Auditor in assessing the reliability of audit evidence. (5 Marks)

c. Explain **FOUR** principles that would assist the Auditor in assessing the relevance of audit evidence. (10 Marks)

(Total 20 Marks)

QUESTION 3

There are a variety of circumstances that could give rise to the threats of self-interest, advocacy, familiarity and intimidation against the five fundamental principles of integrity, objectivity, personal competence and due care, confidentiality, and professional behaviour as enunciated in the Code of Ethics. There are however safeguards created to help the Professional Accountant in such circumstances.

You are required to:

a. List **FIVE** safeguards created by the profession and legislation. (5 Marks)

b. Identify and explain **FIVE** safeguards that could be created by firms of Chartered Accountants. (10 Marks)

c. List **FIVE** possible safeguards that an individual Chartered Accountant could apply. (5 Marks)

(Total 20 Marks)

QUESTION 4

For many businesses, inventory is one of the areas requiring most attention from the auditor.

You are required to:

a. State **FIVE** reasons supportive of the importance of closing inventory to an Auditor. (5 Marks)

b. Prepare a list of **FIVE** audit procedures relevant to ascertaining the cost of work-in-progress and finished goods. (5 Marks)

c. State **FIVE** reasons why a physical count of inventory is important. (5 Marks)

d. List **FIVE** reasons why the Auditor must be present at physical inventory count

(5 Marks)

(Total 20 Marks)

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

QUESTION 5

You are the Auditor of Bistro Bottling Limited (BBL), a major manufacturer and distributor of fruit juice drinks based in Lagos. A review of the previous year's audit working papers revealed some weaknesses in internal controls with regard to safeguarding the company's non-current assets.

The company uses a combination of both owned and leased motor vehicles for operational activities including deliveries to customers. It has recently sold some old vehicles and bought new ones in a bid to lower motor vehicle running expenses.

During the planning of the audit, you have decided that motor vehicles will be a key area because of the likelihood of weaknesses in the company's system of internal control over non-current assets.

Required:

a. Explain with suitable illustration the meaning of Internal Control. (4 Marks)

b. List **FIVE** examples of internal controls. (5 Marks)

c. Identify **TWO** sources of audit evidence you will obtain for each of the following: completeness, ownership and valuation, to provide reasonable assurance with regard to the company's assets and liabilities. (6 Marks)

(Total 15 Marks)

QUESTION 6

ISA 230 requires the Auditor to prepare documentation on a timely basis, sufficient to enable an experienced auditor, with no previous connection with the audit to understand significant matters arising during the audit and the conclusions reached thereon.

You are required to:

a. Explain **THREE** reasons for preparing audit working papers. (3 Marks)

b. State **FIVE** other purposes of audit documentation. (5 Marks)

c. List **FIVE** items of information that might be included in the Permanent Audit File. (5 Marks)

d. Explain what differentiates the Permanent Audit File from the Current Audit File. (2 Marks)

(Total 15 Marks)

QUESTION 7

One essential feature of analytical procedures in auditing is 'comparison'. The auditor will calculate key relationships between figures (non-financial figures as well as financial figures) and then make comparisons.

You are required to:

a. Identify **FOUR** areas of comparison when using analytical procedures and explain their purpose. You could tabulate your answers. (8 Marks)

b. List **FOUR** precautionary steps the Auditor is required to take before using analytical procedures in substantive testing. (4 Marks)

c. Describe **THREE** limitations of ratio analysis in its use in substantive testing. (3 Marks)

(Total 15 Marks)

SOLUTION TO QUESTION 1

a.

ABRICON NIGERIA LIMITED

Analytical procedures on the figures of the Statement of Profit or Loss and other Comprehensive Income

	2016	2015	DIFFERENCE	CHANGE
	₦	₦	₦	%
Turnover	51,911,612	45,283,683	6,627,929	14.64
Less: Cost of Sales	(36,844,571)	(35,850,619)	(993,952)	2.77
	15,067,041	***9,433,064***		
Loss on sale of M/V	(13,034)	-		
GROSS PROFIT	**15,054,007**	**9,433,064**		**59.59**
LESS: ADMIN EXPENSES				
Staff Salaries & Allowances	3,255,785	1,605,977	1,649,808	102.73
Repairs & Maintenance	762,755	496,580	266,175	53.60
Transport & Travelling	320,810	180,840	139,970	77.40
Printing, Postage & Stationery	1,200	62,000	(60,800)	(98.06)
Telephone Expenses	306,916	33,340	273,576	820.56
Office Rent	238,000	140,000	98,000	70.00
Motor Running Expenses	421,910	337,430	84,480	25.04
Electricity	68,355	39,400	28,955	73.49
Advertising	35,750	50,000	(14,250)	(28.50)
Medical Expenses	55,000	24,000	31,000	129.17
Subscriptions & Donations	513,045	71,324	441,721	619.32
Insurance	21,500	27,500	(6,000)	(21.82)
Legal & Professional Fee	-	10,000	(10,000)	(100.00)
Entertainment	17,655	10,960	6,695	61.09
Audit Fee	100,000	50,000	50,000	100.00
Bank Charges & Interests			756,484	

	1,656,484	900,000		84.05
Depreciation	781,400	758,400	23,000	3.03
Prov. for Doubtful Debts	149,084	(43,818)	192,902	(440.23)
	9,069,448	**5,396,573**		
Profit Before Taxation	***5,984,559***	***4,036,491***	1,948,068	48.26
Taxation	897,684	1,009,123	(111,439)	(11.04)
PAT transferred to Gen. Reserves	**5,086,875**	**3,027,368**		

(b) Using the growth in gross profit of 59 percent as benchmark, the following exhibit unusual features:

i. Staff Salaries & Allowances
ii. Transport & Travelling
iii. Printing, Postage & Stationery
iv. Telephone Expenses
v. Office Rent
vi. Electricity
vii. Medical Expenses
viii. Subscriptions & Donations
ix. Bank Charges & Interests
x. Legal and Professional fees

(c) Possible explanations why some apparently unusual items were not selected in (b) above include the following:

i. Audit Fee is higher than the gross profit percentage and it was not selected because the auditor should have explanation for it.
ii. Provision for Doubtful Debts was not selected because the auditor will review the debtors' lists during the audit and re-compute the provision figure.
iii. Depreciation of Non-Current Assets was not selected because the auditor will still do a comprehensive work on the Schedule of Non-Current Assets and will thereafter check the calculation of the depreciation figure.

EXAMINER'S REPORT

The question, which is in three parts, tests candidates on analytical procedures. About 97% of the candidates attempted the question. The candidates displayed poor understanding of the question in parts (a) and (c) but performance in part (b) was just fair.

Performance was consequently poor in the question. The commonest pitfalls were poor interpretation of requirements of the question and poor application of their knowledge to practical situation.

Candidates are advised to study well and be able to duly apply their knowledge.

MARKING GUIDE

SOLUTION 1		MARKS
(a)	Analytical tests of figures given	
	40 entries under difference and % change x 0.4marks each	16
(b)	Unusual figures identified	
	8 points x 1 mark each	8
(c)	Explaining why some unusual items are selected in (b) above	
	3 points x 2 marks each	6
		30

SOLUTION TO QUESTION 2

(a) **SUFFICIENCY OF AUDIT EVIDENCE**

Deciding on whether existing audit evidence is sufficient is a matter of judgement by the auditor. The sufficiency of audit evidence required will depend largely on the following:

i. The quality of that evidence. The quality will depend on the source of the evidence and its reliability.

ii. The gravity of the risk that the financial statements might not give a true and fair view: when this risk is high, more audit evidence will be required.

iii. The materiality of the item.

iv. The strength of the internal controls in the client's accounting systems.

v. The sampling method that the auditor uses to obtain the audit evidence: the chosen method will affect the size of the audit sample that the auditor requires.

(b) **RELIABILITY OF AUDIT EVIDENCE**

There are a number of general principles set out in *ISA 500* to assist the auditor in assessing the reliability of audit evidence. These can be summarised as follows:

i. Audit evidence is more reliable when it is obtained from independent sources outside the entity under audit. For example, letter of confirmation of bank balance obtained from the bank by the auditor.

ii. Internally generated audit evidence is more reliable when the related controls are effective.

iii. Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference. For example, observation of the operation of a control by the auditor is more reliable than inquiry about the operation of that control, such as attendance at inventory counts.

iv. Audit evidence is more reliable when it exists in documentary form. This could be paper, electronic or other medium. For example, a written record of a meeting is more reliable than a subsequent oral representation of the matters discussed.

v. Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies, or documents that have been filmed, or otherwise transformed into electronic form. This is because the reliability of those other forms may depend on the controls over their preparation and maintenance.

(c) RELEVANCE OF AUDIT EVIDENCE

There are a number of general principles set out in *ISA 500* to assist the auditor in assessing the relevance of audit evidence. These can be summarised as follows:

i. Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure, and, where appropriate, the assertion under consideration. For example, relevance may be affected by the direction of testing, say when testing for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure. On the other hand, when testing for understatement, testing the recorded accounts payable would not be relevant, but rather testing subsequent disbursements, unpaid invoices, suppliers' statements and unmatched receiving reports may be relevant.

ii. A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. For example, inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cut-off.

iii. Tests of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. Relevant audit evidence would include identifying conditions that indicate performance of a control, and deviation conditions. The presence or absence of those conditions can then be tested by the auditor.

iv. Substantive procedures are designed to detect material misstatements at the assertion level. Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

EXAMINER'S REPORT

The question is in parts (a) to (c). It tests candidates understanding of audit evidence.

About 60% of the candidates attempted the question. The candidates generally showed a fair understanding of the question and their performance was average.

The commonest pitfall was lack of proper differentiation between sufficiency, reliability and relevance of audit evidence.

Candidates should study for proper understanding.

MARKING GUIDE

SOLUTION 2		**MARKS**
(a)	Five factors the auditors will consider in determining what constitutes sufficient audit evidence 5 points x 1 mark each	5
(b)	Five principles that will assist the auditor in assessing the reliability of audit evidence 5 points x 1 mark each	5
(c)	Four principles that would assist the auditor in assessing the relevance of audit evidence 4 points x 2.5 marks each	**10**
		20

SOLUTION TO QUESTION 3

(a) **Safeguards created by the profession and the legislation include:**

i. Educational, training and experience requirements for entry into the profession.

ii. Continuing professional development requirements.

iii. Corporate governance regulations.

iv. Professional standards (such as ISAs / NSAs).

v. Professional or regulatory monitoring and disciplinary procedures (such as the ICAN's disciplinary procedures).

vi. External review by a legally empowered third party (such as a regulator appointed by the government) of the reports or information produced by a member.

vii. Enactments governing the qualifications and working requirements of the auditor, where appropriate, like the Companies and Allied Matters Act CAP C20 LFN 2004.

(b) Safeguards created by firms of chartered accountants include:

i. The employer's own systems of monitoring and ethics and induction programmes (such as an internal training or mentoring programme).

ii. Recruitment procedures, ensuring that only high-calibre, competent staff are recruited.

iii. Appropriate disciplinary processes to deal with cases of infractions and non-compliance with the firm's procedures and policies.

iv. Strong internal controls being applied by the firm.

v. Leadership that stresses the importance of ethical behaviour .

vi. Policies and procedures to implement and monitor the quality of employee performance.

vii. Policies and procedures to implement and monitor the quality of engagements.

viii. Documented policies regarding the identification of threats to compliance with the fundamental principles, the evaluation of those threats and the implementation of appropriate safeguards.

ix. Communication of such policies and procedures and training on them.

x. The use of different partners and engagement teams for the provision of non-assurance services to assurance clients.

xi. Use of different partners and engagement teams for the provision of assurance services to competing clients.

(c) Safeguards created by the individual chartered accountant include:

i. Complying with continuing professional development requirements.

ii. Keeping records of contentious issues and approach to decision-making.

iii. Having a broader perspective on how other organisations operate by forming business relationships with other professionals

iv. Using an independent mentor.

v. Keeping in contact with legal advisors and professional bodies.

vi. Taking up professional indemnity insurance Policy

EXAMINER'S REPORT

The question, in three parts, tests candidates on safeguards which are created to assist the professional accountant in the face of threats of self-interest, advocacy, familiarity and intimidation. About 75% of the candidates attempted the question.

Candidates exhibited low understanding notwithstanding the relevance attached to this part of the syllabus. Performance was generally average.

The candidate's major undoing was writing out of context.

Candidates are advised to study well and relate their knowledge to the requirements of the question.

MARKING GUIDE

SOLUTION 3		**MARKS**
(a)	Safeguards created by the profession and legislation 5 points x 1 mark each	5
(b)	Safeguards created by the firm of Chartered Accountants 5 points x 2marks each	10
(c)	Safeguards the individual Chartered Accountants could apply 5 points x 1 mark each	5
		20

SOLUTION TO QUESTION 4

(a) The reasons for the importance of closing inventory for the auditor include the following:

i. Inventory is often a material item in the financial statements with its attendant effect on operating results of a business entity.

ii. Inventory may be a high risk area, involving a high degree of judgement in areas such as valuation. For example, judgement may be needed to estimate the stage of completion of work in progress.

iii. Inventory may suffer deterioration, loss or theft that may not be recognised in the client's financial statements.

iv. Inventory may be highly technical in nature. Where inventory is complex, the auditor may need to consider whether to rely on the work of an expert.

v. Establishing a closing inventory figure may be a lengthy and complex process for the client, with a high risk of error.

vi. Closing inventory is often not part of the double entry system, so directional testing (tests on other areas and other balances) may not reveal misstatements in inventory.

(b) Cost of work –in-progress and finished goods

For work-in-progress and items of finished (manufactured) goods, the auditor needs to check each of the elements in the cost: direct materials, direct labour and production overheads.

He should therefore carry out the following tests:

i. Obtain schedules showing the make-up of the cost figures for each item of work-in-progress and finished goods.

ii. Check the accuracy of the calculations.

iii. **Materials:**
- Check that the correct quantity of materials has been used in the valuation.

- Confirm the approach adopted by the company to ascertain the cost of materials used or sold (e.g. FIFO, weighted average cost)
- Check the costs of inventory with prices in purchase invoices or suppliers price lists.

iv. **Labour**: Check pay rates for direct labour cost against payroll/personnel records for the employees who produced the work-in-progress or finished goods items. Check the hours worked (and used to calculate labour costs in the inventory) with the time records for the employees concerned.

v. **Production overheads**: Confirm that only production overheads (as opposed to selling and administration overheads) are included in the valuation. Confirm that overhead absorption rates are based on normal levels of output.

vi. **Work-in-progress**: In addition to the above tests, the auditor may also need to check the stage of completion of the work-in-progress, in respect of both materials and conversion costs (labour and overheads).

(c) The reasons for physical counts of inventory include the following:

i. Physical counts provide evidence of the actual existence of the inventory. This evidence is important to the company (for preparing the financial statements) as well as for the auditor (for checking the reliability of those statements).

ii. Physical counts can be used by the entity to check the accuracy of its inventory records, where it maintains continuous inventory records.

iii. Where the entity does not have continuous inventory records, a physical count of inventory is probably the only way of establishing the quantity of inventory at the year-end.

iv. Discrepancies between the physical count of inventory and the entity's inventory records may indicate weaknesses in physical controls over inventory, and losses due to theft or for losses from other causes.

v. A physical count of inventory can also be used to check the physical condition of inventory, and to confirm whether there has been any deterioration in condition.

vi. Physical count may be easy to arrange, particularly where most items of inventory are held in a limited number of physical locations.

vii. Physical count enables easier ascertainment of inventory belonging to third parties.

(d) Reasons why auditors must be present at physical inventory count include:

i. Evaluate management's instructions and procedures for recovering and controlling the results of the count.

ii. Observe the performance of management's count procedures.

iii. Inspect the inventory to confirm existence

iv. Perform test count

v. Perform audit procedures over the final inventory records to determine whether they accurately reflect the results of the count.

vi. Confirm whether or not inventory not owned by the entity is properly identified and labelled.

EXAMINER'S REPORT

The question is in four parts. It relates to the auditor's work as regards inventory.

About 70% of the candidates attempted the question. The understanding exhibited by the candidates was low for parts (a) to (c), but fair in part (d). This obviously translated to the average marks earned by the candidates.

The commonest pitfalls were misinterpretation of the question and avoidable mix-up of answers between different parts.

Candidates are advised to ensure that they know the specific needs of a question before attempting them.

MARKING GUIDE

SOLUTION 4		MARKS
(a)	Five reasons supporting the importance of closing inventory to the auditor 5 points x 1 mark each	5
(b)	Five audit procedures relevant to ascertaining the cost of work-in-progress and manufactured finished goods 5 points x 1 mark each	5
(c)	Reasons why a physical count of inventory is important 5 points x 1 mark each	5
(d)	Five reasons why the auditor must be present at physical inventory count 5 points x 1 mark each	5
		20

SOLUTION TO QUESTION 5

(a) Internal Control - Is the process designed and implemented by the company's management or those charged with governance to provide reasonable assurance with regard to:

- effectiveness and efficiency of operations
- reliability of financial reporting
- compliance with laws and regulations

The following points should be noted from this definition:

i) It is the responsibility of management or those charged with governance to design and put in place a suitable system of internal control.

ii) Internal control is designed to deal with financial risks, operational risks and compliance risks.

iii) Since internal control is established by management or those charged with governance, the auditor has to accept what controls are in place. However, he can assess and evaluate the controls, and will plan his audit on the basis of his assessment.

The five elements of Internal Control System are

- The control environment
- The entity's assessment process
- The information system
- Control activities (internal controls)
- Monitoring of controls

(b) Examples of Internal controls include:

- Segregation of duties
- Organisational controls
- Physical controls
- Personnel
- Accounting / arithmetical control
- Performance reviews
- Information processing
    - Application controls
    - General IT controls

(c) Sources of Audit evidence that would be obtained for

(i) **Completeness** – All assets, liabilities and equity have been recorded with disclosures. Example of the sources are: test of controls, substantive procedures, receivable and payable circularisations, and confirmation letters.

(ii) **Ownership** – Full control and right to assets, liabilities and obligations Examples of sources are: non-current assets register, insurance policies, physical inspection, solicitors' certificates, suppliers invoices, title documents.

(iii) **Valuation** – Accuracy and allocation of assets, liabilities are correctly included in the financial statements. Examples of sources of evidence are test of controls, substantive procedures, suppliers' invoices, sales invoices, bank statements, Interviewing of management staff and employees.

EXAMINER'S REPORT

The question is in three parts. Parts (a) and (b) test candidates on Internal Control while part (c) is on audit evidence. About 85% of the candidates attempted the question.

The candidates exhibited good understanding in part (a), but poor understanding in (b) and (c). The performance generally was average.

The commonest pitfall was wrong interpretation of the question and lack of use of the Institute's Study Text.

It is recommended that candidates should cover the syllabus adequately and make use of the Institute's Study Text.

MARKING GUIDE

SOLUTION 5		MARKS	MARKS
(a)	Explanation of "Internal Control"	3	
	Illustration	1	4
(b)	Five examples of Internal Controls		
	5 points x 1 mark each		5
(c)	Sources of audit evidence for		
	Completeness:		
	2 points	2	
	Ownership		
	2 points	2	
	Valuation		
	2 points	2	6
			15

SOLUTION TO QUESTION 6

(a) Preparing sufficient and appropriate audit documentation on a timely basis helps to:

i. enhance the quality of the audit

ii. facilitate the effective review and evaluation of the audit evidence obtained and conclusions reached, before the audit report is finalised.

iii. assure that documentation prepared at the time the work is performed is likely to be more accurate than documentation prepared later.

(b) Other purposes of audit documentation include the following:

i. Assisting the audit team to plan and perform the audit.

ii. Assisting supervisors in directing and supervising audit work.

iii. Ensuring members of the audit team are accountable for their work.

iv. Keeping a record of matters of continuing significance to future audits.

v. Enabling an experienced auditor, with no previous connection with that audit, to conduct quality control reviews or other inspections i.e. by understanding the work that has been performed and the conclusions that have been reached.

(c) The permanent audit file records information that are likely to be of significance to every annual audit of that client. Examples of such information may include:

i. the legal constitution of the company or entity

ii. other important legal documents such as loan agreements, major contracts/agreements

iii. a summary of the history, development and ownership of the business or organisation

iv. a summary of accounting systems and procedures

v. copies of previous years' financial statements, together with key ratios and trends.

vi. Letter of appointment as auditors

vii. Important minutes of board meetings

viii. Information about directors and advisers

ix. Copy of the engagement letter and subsequent amendments

x. Result of the assessment of the entity's internal control system

(d) Differences Between The Permanent Audit File And The Current Audit File

While the Permanent Audit File records information that is likely to be of significance and continuing importance to every annual audit of that client, the Current Audit File contains information of relevance to the current year's audit.

The Current Audit File is prepared annually while the Permanent Audit File is updated only when there are changes in the information content.

EXAMINER'S REPORT

The question, in four parts, tests candidates on audit documentation.

About 90% of the candidates attempted the question. Understanding was poor in parts (a) and (b), but good in parts (c) and (d). Performance was good in parts (c) and (d), but poor in (a) and (b).

The candidates undoing was poor exhibition of their learning faculty in the examinations and lack of use of the Institute's Study Text.

Candidates are advised to study well for the examination and utilise the Institute's Study Text.

MARKING GUIDE

SOLUTION 6		**MARKS**
(a)	Three main reasons for preparing audit working papers 3 points x 1 mark each	3
(b)	Other purposes of audit documentation 5 points x 1 mark each	5
(c)	Items of information in the permanent audit file Any 5 items x 1 mark each	5
(d)	Differences between the permanent audit file and current audit file 2 points x 1 mark each	2
		15

SOLUTION TO QUESTION 7

(a) Areas of comparison when using analytical review procedures include:

COMPARISON WITH	PURPOSE OF COMPARISON
Prior accounting periods	To establish patterns and trends, and to look for unusual fluctuations in amounts in the current financial year that seem inconsistent with what happened previously.
Expected results	Actual results can be compared with the budgeted results or with forecasts, or with results that the auditor was expecting.
Industry average results	Comparable information may be obtained for other entities in the industry or about individual entities in the same industry. Information may be obtainable for the industry as a whole from an industry body or a financial information service. Information about individual companies in the same industry may be obtainable as published financial statements.
Comparable parts of the same entity	The auditor may be able to compare the results of different branches or divisions within the same entity, where there are similar branches or divisions within the entity.

(b) Precautionary steps the auditor is required to take before using analytical review procedures in substantive testing:

i. Determine the suitability of particular substantive analytical review procedures for given assertions – i.e. how effective they will be in detecting a particular type of material misstatement.

ii. Develop an expectation of recorded amounts or ratios and evaluate whether that expectation is sufficiently precise to identify a misstatement.

iii. Evaluate the reliability of the data from which the expectation has been developed.

iv. Determine what level of difference from expected amounts is acceptable without further investigation.

(c) Limitations of ratio analysis in its use in substantive testing

i. The auditor needs to understand the client's business, so that he is able to understand the potential significance of ratios, or reasons for differences (for example, differences between one year and the next).

ii. The usefulness of ratio analysis depends on the quality of the underlying financial information. It is usual for the auditor to calculate financial ratios from the client's management accounts, which are more detailed than financial statements and can provide a source of more and better information.

iii. For comparison purposes, the ratio analysis must be calculated on a consistent basis.

iv. The figures used to calculate a ratio must be logically related.

EXAMINER'S REPORT

The question is in three parts. It tests candidates on analytical procedures and its use in substantive testing.

About 15% of the candidates attempted the question and the understanding exhibited was poor, therefore performance was also poor.

The candidates exhibited a shallow knowledge ostensibly occasioned by their non-coverage of this area of the syllabus.

Candidates are advised to adequately cover the syllabus.

MARKING GUIDE

SOLUTION 7		**MARKS**
(a)	Four areas of comparison when using analytical review procedures and their respective purposes 4 points x 2 marks each	8
(b)	Precautionary steps the auditor is required to take before using analytical review procedures in substantive testing 4 points x 1 mark each	4
(c)	Three limitations of ratio analysis in substantive testing 3 points x 1 mark each	3
		15

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – MAY 2017

PUBLIC SECTOR ACCOUNTING & FINANCE

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

The following balances were extracted from the books of KALOBA State Government of OTAN as at December 31, 2015:

	Dr ₦'Million	Cr ₦'Million
Cash Account	60,000	
Consolidated Revenue Fund as at January 1, 2015		120,000
Allocation from Federation Account		300,000
Other Revenue		40,000
Personnel Costs	150,000	
Ordinary Shares of ₦1 each in AKRAN Plc	150,000	
Deposits		60,000
Advances	80,000	
Loans from Federal Government		60,000
Loans to Local Government	80,000	
Fixed Deposit – LOBO Bank Plc	60,000	
Total	**580,000**	**580,000**

Additional information:

(i) ₦40 billion should be transferred to Development Fund for Capital projects to be embarked upon in the 1st quarter of 2016.

(ii) Other charges approved by the Fund Management Committee and paid during the year but which were omitted from the books amounted to ₦50 billion.

(iii) Total grants of ₦100 billion collected from Federal Government for capital project to be embarked upon in the 1st quarter of 2016 was not recorded anywhere in the books.

Required:

Prepare the following statements for submission to the Auditor-General for the State

a. i. Consolidated Revenue Fund Account for the period ended December 31, 2015. (8 Marks)

ii. Development Fund Account for the period ended December 31, 2015 . (3 Marks)

iii. Statement of Assets and Liabilities as at December 31, 2015. (9 Marks)

b. State the components of General Purpose Financial Statements (GPFS) of a typical Federal or State Government. (4 Marks)

c. State **FOUR** principal users of government financial reports and their needs. (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

The Zero-based budgeting system is a budgeting system that requires every item of expenditure to be justified as if the particular activity or programme is taking off for the first time.

Required:

a. State the stages involved in Zero-based budgeting system. (5 Marks)

b. Explain **THREE** benefits associated with the Zero-based budgeting system. (6 Marks)

c. Explain **THREE** drawbacks of the Zero-based budgeting system. (6 Marks)

d. State **THREE** key users of the Zero-based budgeting system. (3 Marks)

(Total 20 Marks)

QUESTION 3

Engineer Paul Maihala assumed duty as the Managing Director/CEO of FCT Abuja Water Authority (FAWA) – a company fully owned by the Federal Government of Nigeria. FAWA is responsible for the supply of water to the Federal Capital. Engr. Maihala, before resuming at FAWA in October 2015, was the Director (General Services) at the Federal Ministry of Works and Housing. Upon resumption, he was determined to put an end to the shortage of water supply in the Federal Capital in fulfilment of the mandate given to him on his appointment.

At a meeting with his directors, the new Managing Director/CEO asked for a list of challenges facing the Authority and suggestions on how to solve them. Top on the list of challenges were the issues of unreliable public power supply and the excessive cost of running generators due to the high cost of diesel. There was also the case of shortage of raw materials such as chlorine (Sodium Hypo chloride) and other essential chemicals used for water treatment.

The Director, (Maintenance) decried the incessant cases of non-availability of essential chemicals and materials. He also said that there were cases of low quality and unusable chemicals supplied to the store.

The Managing Director directed that adequate stock of diesel and essential chemicals must be kept at all times and that he would not tolerate any case of stock-out, diversion or theft of diesel, chemicals and other store items.

The Director, (General Services), stated that the major challenge he faced was that the Authority's store was porous and that the controls in the store were inadequate. He blamed the Finance and Accounts department for inadequate records keeping leading to frequent stock-outs and non-documentation of stores discrepancies. He said that "he would have preferred a situation where the accounts department would leave his stores alone".

The Director, Finance and Accounts said in his presentation, that he had no control over the store as the storekeeper reports to the Director, General Services. He said he was only responsible for the store accounting function and that the officer-in-charge of stores accounting had his office in the Accounts section. He further said that the storekeeper was not co-operating with the accounts staff and saw them as unnecessary disturbance as they often presented themselves as "policemen". The argument between the two directors was heated up to the extent that the meeting had to be adjourned.

Required:

a. According to Government Financial Regulation (2009 Edition), explain the term "STORES" (2 Marks)

b. In line with the Treasury's objective of ensuring an effective system of internal control in the management of stores, what are the responsibilities of the Accounting Officer? (4 Marks)

c. State **SIX** actions the Accounting Officer could take to prevent cases of:

   i. Stock-outs (6 Marks)

   ii. Diversion or theft of diesel or other store items. (6 Marks)

d. State **TWO** measures necessary to ensure that chemicals and other store materials meet the required standards. (2 Marks)

(Total 20 Marks)

QUESTION 4

Treasury Single Account (TSA) is one of the financial policies being implemented by the Federal Government of Nigeria to consolidate all inflows from all Ministries, Departments and Agencies (MDAs) in the country by way of deposit into Commercial Banks traceable into a single account at the Central Bank of Nigeria.

You are required to identify:

a. **FIVE** benefits associated with the financial policy. (5 Marks)

b. **FIVE** challenges inherent in operating the financial policy. (5 Marks)

c. **FIVE** roles and responsibilities of Ministries, Departments and Agencies (MDAs) under the TSA scheme in Nigeria. (5 Marks)

d. **FIVE** roles and responsibilities of State Accountant-Generals under the TSA scheme in Nigeria (5 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 accumulation of external debt is a common phenomenon in developing countries at the stage of development where external resources are needed to bridge budgetary gap.

Required:

a. Explain what is meant by ***External Debt.*** (3 Marks)

b. Discuss the causes and likely adverse consequences of the rising level of Nigeria's total external debt stock. (12 Marks)

(Total 15 Marks)

QUESTION 6

State and explain **FIVE** macroeconomic objectives of the Federal Government of Nigeria.

(Total 15 Marks)

QUESTION7

A number of factors have been identified as inevitably leading to rapid growth in government spending in many countries over time.

Required:
Identify and explain **FIVE** of these factors as they apply to Nigeria.

(Total 15 Marks)

SUGGESTED SOLUTIONS

SOLUTION 1

a. i. **KALOBA State Government of OTAN**

Consolidated Revenue Account for the Period Ended December 31, 2015

	₦'Million	₦'Million
Opening Balance		120,000
Revenue		
Allocation from Federation Account	300,000	
Other Revenue	40,000	340,000
Total Revenue		**460,000**
Expenditure		
Personnel Costs	150,000	
Other Charges	50,000	
Total Recurrent Expenditure	200,000	
Transfer to Capital Development Fund	40,000	
Total Expenditure		**(240,000)**
Closing Balance		**220,000**

a.ii. **KALOBA State Government of OTAN**

Development Fund Account for the Period Ended December 31, 2015

	₦'Million	₦'Million
Revenue		
Grants from Federal Government	100,000	
Transfer from Consolidated Revenue Fund	40,000	
Total Revenue		**140,000**
Expenditure		**0**
Closing Balance		**140,000**

a.iii. **KALOBA State Government of OTAN**

Statements of Assets and Liabilities as at December 31, 2015

	₦'Million	₦'Million
ASSETS		
Liquid Assets:		
Cash Account (W I)		110,000
Investments and Other Cash Assets:		
Ordinary Shares of ₦1 each in AKPAN Plc	150,000	
Fixed Deposit- LOBO Bank Plc	60,000	
Advances	80,000	
Loans to Local Governments	80,000	
Total Investments and Other Cash Assets		**370,000**
Total Assets		**480,000**
LIABILITIES		
Fund Balances:		
Consolidated Revenue Fund Balance	220,000	
Development Fund Balance	140,000	
Total Fund Balances		**360,000**
External and Internal Loans:		
Loans from Federal Government	60,000	
Total External and Internal Loans		**60,000**
Other Liabilities:		
Deposits	60,000	
Total Other Liabilities		**60,000**
Total Liabilities		**480,000**

(W I) Cash Balance

= ₦60 Billion + ₦100 Billion – ₦50 Billion

= **₦110 Billion**

b. **Components of General Purpose Financial Statements (GPFS)**

Presently, entities in Nigeria prepare the following GPFS:

i. Cash Flow Statement;
ii. Statement of Consolidated Revenue Fund;
iii. Statement of Capital Development Fund;
iv. Statement of Assets and Liabilities
v. Notes to the Accounts;
vi. Performance Reports i.e. Comparison of budget and actual amounts;
vii. Statistical Reports;
viii. Accounting Policies; and
ix. Responsibility Statement.

c. **Users and their needs**

There are two groups of users of Government financial reporting. These are "Internal"and External" users whose peculiarities and areas of interest are briefly discussed, as follows:

Internal Users: This group of users includes;

i) **The Labour Union** in the public service which is interested in negotiating for improved conditions of employment and security of tenure for their members.

ii) **Members of the Executive Arm of Government** such as the President, Ministers, Governors, Commissioners and Chairmen of Local Governments. Their areas of interest are to ensure probity and accountability through efficient and effective record keeping and performance evaluation and control which are achieved through useful accounting information.

External users include:

i) **Members of the Legislature** at National, State and Local Government levels. Information in the accounts of Governments is the major medium through which politicians render stewardship to their constituencies and appraise them of the endeavours of governance.

ii) **Members of the Public**: It assists the people to appreciate or otherwise the efforts of Governments.

iii) **Researchers and Financial Journalists**: Researchers are expected to develop new and better ideas of governance. Financial journalists cherish accounting information to advise existing and potential investors.

iv) **Financial Institutions**: These include the Commercial Banks, World Bank and International Monetary Fund (IMF). Accounting information assists them to evaluate the credit rating of a borrowing nation.

v) **Governments:** Apart from the ones reporting, governments collaborate on ideas of investment and research. They also require accounting information on the well-being or otherwise of each other. They require accounting information to ascertain the financial viability of the public sector organisations and the efficiency and effectiveness of management. They would want to know whether the accounting information enhances the quality, consistency, and transparency of public sector financial reporting.

vi) **Suppliers and Contractors:** It assists these groups to ascertain the ability of a government to pay for goods and services delivered as at when due.

EXAMINER'S REPORT

The question tests candidates' ability to prepare the accounts of Consolidated Revenue Fund, Development Fund and Statement of Assets and Liabilities. In addition, the question also requires candidates to state the components of General Purpose Financial Statements (GPFS) and users of government financial reports.

All candidates attempted the question and performance was average. The major pitfall of the candidates was their inability to state the users of financial information and their needs.

Candidates are advised to make good use of ICAN Study Text for future examinations by stud.

MARKING GUIDE

		Marks	**Marks**
a (i)	Heading (2 ticks @ ½ mark each)	1	
	Opening Balance	½	
	Calculation of Total Revenue (5 ticks @ ½ mark each)	2 ½	
	Calculation of Total Expenditure (6 ticks @ ½ mark each)	3	
	Calculation of Closing Balance (2 ticks @ ½ each)	1	8
(ii)	Heading	½	
	Calculation of Total Revenue (3 ticks @ ½ mark each)	1 ½	
	Calculation of Closing Balance (2 ticks @ ½ mark each)	1	3
(iii)	Heading	½	
	Calculation of Total Assets (7 ticks @ ½ mark each)	3 ½	
	Calculation of Total Liabilities (8 ticks @ ½ mark each)	4	
	Workings for Cash Closing Balance	1	9
b.	Any Four Components at 1 mark each		4
c.	Any four users @ ½ mark each	2	
	Any four needs of the Users @ 1 mark each	4	6
	Total		**30**

SOLUTION 2

a. The stages involved in Zero-based budgeting system are as follows:
   i. Identification of **Decision units/tasks** and formulating operational plans;
   ii. Analysing/evaluating the whole budget into **Decision packages** based on the **Decision units/tasks** to which costs are assigned;
   iii. Ranking in priority the **Decision packages** covering the activities, both new and existing, in a competitive manner;
   iv. Determination of the **cut-off** point, to choose the packages which can be included and those to be rejected, and
   v. Prioritisation/selection of the packages, to highlight the ones which fit in with the available resources.

b. Benefits associated with Zero-based budgeting system include the following:
   i. It acts as a tool for change from which benefits are likely to accrue/Improve coordination and communication within departments;
   ii. It allows for optimal allocation of resources;
   iii. It provides better yardstick for the measurement of performance;
   iv. It focuses attention on the future rather than on the past i.e. old and new projects are appraised on the same basis/accuracy as against traditional method;
   v. Important projects can continue to receive funds, owing to their viability/reduction in redundant activities;
   vi. It is good for profit-oriented projects/social oriented projects; and
   vii. The budgets of the Ministries, Departments and Agencies (MDAs) are closely linked with government overall agenda

c. Drawbacks associated with Zero-based budgeting (ZBB) system include the following:
   i. It may cause a major shift in resource allocation;
   ii. It is not considered useful for recurrent expenditure;
   iii. Departments like Research and Development may encounter cash-crunch or may be denied desired resources;
   iv. Sometimes ZBB sounds too radical and so consensus is difficult to obtain;
   v. Justifying every expense may not be feasible or practicable;
   vi. Preparation time and the cost of preparing the budget tend to increase; and
   vii. It involves the task of analysing and ranking of data and information which a number of civil servants find difficult to manage .

d. Key users of Zero-based budgeting system in public sector are:
   i. The Legislative Arm e.g. National Assembly, State Assemblies;
   ii. The Executive Arm, e.g. President, Governors; and
   iii. The various Ministries, Departments and Agencies (MDAs)and Parastatals

EXAMINER'S REPORT

The question tests candidates' knowledge of the Zero-based budgeting system, its stages, benefits, drawback and users.

Majority of the candidates attempted the question and the performance was average. The major pitfall was their inability to state the stages, drawbacks and the users of Zero-based budgeting system.

Candidates are advised to use the ICAN Study Text and other materials for future examinations.

MARKING GUIDE

		Marks
A	Stating of five Stages at 1 mark each	5
B	Stating of any Three benefits at 2 marks each	6
C	Stating of any Three Drawbacks at 2 marks each	6
D	Stating of any Three Key Users at 1 mark each	3
	Total	**20**

SOLUTION 3

a. According to Financial Regulation (2009 Edition), the term 'Stores' include all movable property purchased from public funds or otherwise acquired by government.

b. The Accounting Officer is responsible for:

i) The general supervision and control of stores and stores accounts of his Ministry/Extra-Ministerial office and other arms of government.

ii) The introduction and implementation of Stores accounting procedure that covers the receipt, custody, issue and disposal of store items

iii) The maintenance of Stores Guide, setting out detailed approve system and procedures and store instructions.

iv) The appointment of Officers to inspect all stores within his Ministry/ Extra-Ministerial department; and

v) Surcharging any Officer responsible for loss of stores.

c. i. The Accounting Officer should introduce the following to prevent Stock-out:

- Introduce and maintain Lead Time for all the store items. This is the time between the time an order is made and the time the item is received;
- Introduce Re-order Levels and Quantities for all the Store items;
- Introduce Maximum and Minimum Levels for all the Store Items.;
- In the case of unallocated Stores, the maximum limit of the value of the stores that may be held in stock at any point in time shall not be exceeded without the authority of the Minister of Finance;
- Ensure that periodic physical stocktaking is carried out;
- Unserviceable and obsolete stores should be posted in separate ledgers;
- Ensure that stores are well arranged and labelled;
- Avoid irregular issue or waste of stock items;
- Introduction and maintenance of Buffer stock;
- Ensure that high quality products are delivered by suppliers to avoid low quality products; and
- Ensure that there are more than one supplier for individual store items.

ii. The Accounting Officer should ensure that:
   - The inspection of all stores within the Ministries/Extra-Ministerial offices and other arms of government, whether at headquarters or outstations shall be carried out at least twice yearly;
   - Checking of every item of stock at least once a year by stock verifiers;
   - Inspection by Internal Auditors are carried out as part of their regular routine function;
   - Board of Surveys are held annually and at such other times as may be necessary;
   - Stores officers and/or stock verifiers shall not participate in the procurement of stores. They are also not to participate in the selection of a contractor or sit on the Tenders Board. Their duties are mainly to ensure that the goods ordered are received according to specifications and recorded in the stores ledgers as appropriate;
   - All necessary Stock Records e.g. Bin Cards, Store Requisition Forms, Store Issue Vouchers, Store Receipt Vouchers etc are being maintained accordingly;
   - In case of Loss of Stores, proper procedures are being followed in accordance with Financial Regulations (2009 Edition);
   - All stores premises must have adequate fire fighting appliances provided and maintained in a serviceable condition;
   - Security Guards should be employed to look after all government stores; and
   - Frequent and periodic Stocktaking/Inventory should be carried out.

d The measures necessary to ensure that chemical and other store materials meet the required standards are :

i. Set up an Internal Quality Control Unit in the office;
ii. Benchmark products, services, and practices against those of the strongest competitors;
iii. Supplier partnering; which means that the Office work directly with their stores suppliers to improve quality at the supplier's location;
iv. Quality awards: As quality control grows in popularity, companies strive to prove to customers that quality is their most important concern. One way they do this is to compete for the plethora of quality awards that are now available;
v. Due process must be followed in engaging suppliers; and
vi. Checking for the expiry dates.

EXAMINER'S REPORT

The question tests candidates' understanding of the concept of 'Stores', its required effective internal control system in the management of stores, action to be taken by the Accounting Officer to prevent stock-out and theft by the as contained in the Government Financial Regulation (2009 Edition).

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

Candidates' major pitfall was their lack of in-depth knowledge in this area of the syllabus.

Candidates are advised to always cover the syllabus while preparing for the examination.

MARKING GUIDE

		Marks
a.	Explanation/Definition of Stores	2
b.	Stating of any Two responsibilities @ 2 marks each	4
c. i.	Stating of any six actions to prevent Stock out @ 1 mark each	6
ii.	Stating of any six actions to prevent Theft/Diversion @ 1 mark each	6
D	Stating of any Two measures @ 1 mark each	2
	Total	**20**

SOLUTION 4

a. Benefits associated with Treasury Single Account (TSA) include the following:

   i. Provision of complete and timely information on government cash resources;
   ii. Improvement of operational control on budget execution or support government budget execution;
   iii. Enablement of efficient cash management;
   iv. Reduction of bank charges and transaction costs maintained by MDAs;
   v. Facilitation of efficient payment mechanisms;
   vi. Improvement of bank reconciliation and quality of fiscal data;
   vii. Improvement of liquidity of government;
   viii. Issuance of Warrants and Authority to Incur Expenditure (AIEs) are based on cash plan;
   ix. Drastic fall on the Ways and Means (Overdraft) requirement from CBN;
   x. Prevention and detection of potential and actual fraud
   xi. Improvement of transparency and accountability of all FGN receipts.

b. Challenges inherent in operating the Treasury Single Account (TSA) include:

   i. Fees charged by service provider deducted at source not provided for in the Budget;
   ii. Lack of unified service agreement among Stakeholders;
   iii. Some MDAs still maintain hidden Commercial Bank Accounts;
   iv. Poor internet connectivity;
   v. Infrastructure, incentives and logistics (i.e. unnecessary delay in fund transactions);
   vi. Resistance by some MDAs;
   vii. Capacity gap of users;
   viii. Inadequate sensitization;
   ix. Diversion of tax revenue and other government funds into personal accounts;
   x. Different IT platforms- REMITA, GIFMIS, NIBBS;
   xi. Over-extension of CBN's existing capacity in view of new roles;
   xii. Unethical practices by banks; and
   xiii. Internet hacking or cyber crime.

c. Roles and responsibilities of Ministries, Departments and Agencies (MDAs) under the Treasury Single Account (TSA) include:

i. Ensure that the revenue targets are met;
ii. Provide the payers with details of payment including amount and nature of payment;
iii. Guide payers on e-collection processes including how to pay at the bank or through other channels of the CBN Payment Gateway;
iv. Ensure that appropriate services are rendered upon confirmation of payment where applicable;
v. Monitor the payers and collecting banks to ensure that payments are actually made;
vi. Undertake regular reconciliation of all collections;
vii. Render revenue returns to the Office of the Accountant-General of Federation on monthly basis;
viii. Ensure that proper books of Revenue Accounts are maintained;
ix. Ensure prompt issuance of receipts for remittances paid through the e-collection;
x. Ensure that Internally Generated Revenue is not diverted; and
xi. Ensure that sharp practices emanating from collusion among dishonest revenue officers are discouraged and stopped forthwith.

d. Roles and Responsibilities of State Accountant-Generals under the Treasury Single Account (TSA) are:

i. Ensuring effective implementation of e-collection reform;
ii. Proper monitoring of the e-collection gateway;
iii. Prompt reconciliation of all collections;
iv. Providing MDAs with periodic report of collection;
v. Supporting MDAs, banks and payers on the operation of e-collection;
vi. Regular monitoring of all collections to ensure prompt remittance and accounting for collection;
vii. Continuous update of e-collection guidelines and processes;
viii. Abiding by the provisions of the MoU with Stakeholders; and
ix. Revenue monitoring visits to all MDAs, Government Companies and Parastatals.

EXAMINER'S REPORT

The question tests candidates' knowledge of the operation of Treasury Single Account (TSA). It requires candidates to identify its benefits, challenges, the roles of the MDAs and State Accountant-General under the scheme.

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

Candidates' major pitfall was their poor knowledge of the TSA operation in Nigeria.

Candidates are advised to be aware of government financial policies and make good of ICAN Study Text when preparing for future examinations

MARKING GUIDE

		Marks
a	Stating of any Five benefits @ 1 mark each	5
b	Stating of any Five challenges @ 1 mark each	5
c	Stating of any Five roles and responsibilities @ 1 mark eacl	5
d	Stating of any Five roles and responsibilities @ 1 mark eac	<u>5</u>
	Total	**<u>20</u>**

SOLUTION 5

a. External Debt.

This refers to debt that a country owes to foreign individuals, governments and international organizations. From the experience of Nigeria, there are four types of external debt; trade debt, balance of payments support loan, project-tied loans and loans for socio-economic needs. Sources of Nigeria's external debt include the Paris Club of Official Creditors, London Club of Commercial Creditors, Multilateral Creditors such as the World Bank, International Monetary Fund (IMF), African Development Bank (AFDB) and others.

b. The causes of the rising level of Nigeria's total external debt stock includes:

i. **Fluctuations in government revenue:** Nigeria operates a mono cultural economy depending substantially on crude oil export for foreign exchange income. Poor performance of the product in the international market always reduces income considerably and affects budget implementation adversely. Any country that finds itself in such a situation will have no option than to borrow from outside the economy to bridge budgetary gap.

ii. **Deficit financing:** The persistent practice of deficit financing adopted by national and sub-national governments in Nigeria may also be a factor for steady increase in the level of external debt stock from which deficits are usually being financed.

iii. **Balance of payments disequilibrium:** Excessive reliance on foreign resources to maintain domestic production processes and on foreign goods and services beyond the nation's foreign exchange earning capacity also creates the need for the government to borrow.

iv. **Rapidly increasing population:** Nigeria has one of the fastest growing population in the world. The need arises for government borrowing to expand public enterprises and public utilities to cater for the welfare of the people.

v. **Implementation of development programmes:** To promote economic development usually requires the provision of new and upgrading of existing social and economic infrastructural facilities like roads, railways, electricity, schools and hospitals. Financing of domestic projects, which could not pay their way as well as instability of the exchange rate, also increased external debt stock, hence the resort to government borrowing.

vi. **Natural disaster and sectarian violence:** Government has the responsibility to provide relief to the victims of flood and fire disasters and sectarian violence such as Boko Harram terrorist attacks. Government borrowing will be justified because such occurrences are never expected or budgeted for.

Likely adverse consequences of rapidly increasing external debt stock include:

i. **Burden on future generation:** It imposes future obligation on taxpayers when borrowed funds are diverted to prestigious or white elephant projects that have no direct relevance to economic growth and development.

ii. **Depletion in foreign exchange:** Funding excessive interest rate on public debt in hard currency deprives the nation of foreign exchange needed to procure critical inputs, especially in a country like Nigerian that is highly import dependent with respect to inputs required in the industrial sector. This leads to declining industrial capacity utilization and loss of industrial jobs.

iii. **Effects on living standards:** Borrowing goes along with unbearable conditionalities. For example, the conditions attached to the IMF balance of payments support loan, usually include trade liberalization, withdrawal of subsidies on essential products, expenditure reduction, non-increase of salary of public servants and other stiff conditions that carry repercussion on living standards of the people

iv. **Effect on amortization:** Debt-servicing problem is aggravated when short or medium term loan is committed to long-term projects with amortization becoming due before projects are completed.

v. **Provision of amenities:** Rising external debt stock imposes a burden on the future generation which will be required to pay taxes for the purpose of servicing debt rather than the provision of amenities for the benefit of taxpayers.

vi. **Debt trap:** Where there is wrong deployment of borrowed funds into projects of low returns or non-self liquidating, it may be difficult for the country to extricate itself from the burden of debt.

EXAMINER'S REPORT

The question tests candidates' understanding of the concept of external debt, its causes and effects on the rising level of external debt stock in Nigeria.

Majority of the candidates attempted the question while the pass rate was average. Those who scored poorly did not have full grasp of the requirements of the question. In particular, they failed to provide copious explanation of the consequences of the country's debt profile on the level of external debt stock

Candidates are advised to make good use of ICAN Study Text as it contains vital information on the topic. They should also read widely and intensively for effective coverage of the syllabus.

MARKING GUIDE

		MARKS	MARKS
a.	Definition ofExternal debt	1	
	Stating of any type of external debt @ 1 mark each	1	
	Stating of any sources of external debt @ 1 mark each	1	3
b.	**Causes of the rising External Debt stock.**		
	Identificationof any three@ 1 mark each	3	
	Explanationof any three causes identified @ 1 mark each	3	6
	Adverse consequences:		
	Stating of any three identification of any Adverse consequence @ 1 mark each	3	
	Explanation of any three adverse consequence identified	3	6
	Total		**15**

SOLUTION 6

Like every modern developing economy, the main macroeconomic objectives of the Federal Government of Nigeria are:

i. **Full Employment:** The government pursues the goal of full employment in order to generate substantial new employment opportunities. That is a higher level of employment of productive resources, especially to ensure that not less than 95 percent of the economy's labour force is engaged in production activity. A higher level of employment is associated with higher real national income and a higher average standard of living.

ii. **Price Stability:** This is to curb inflation, deflation or price fluctuations in the economy. Either inflation or deflation is inimical to economic growth and development. For example, a sustained widespread rapid increase in the prices of goods and services will lower standards of living of fixed income earners, while fluctuations in prices will discourage investment, lower employment and output levels as well as reduce average standard of living.

iii. **Economic Growth/Development:** This refers to expansion of the productive capacity of the economy for greater output of welfare–enhancing goods and services. This is measured as a sustained increase in real national income and *per capita* real income.

iv. **External Balance/Balance of Payment Equilibrium:** Government also promotes balance of payments equilibrium which implies less reliance on foreign goods and services, avoidance of debt and its burden and increase in capital inflow in the forms of *foreign direct investments (FDIs) and portfolio investment.*

v. **Equitable distribution of income and wealth:** To reduce the gap between the rich and the poor, government uses progressive taxes, direct transfer payments, and subsidies to redistribute income and wealth.

vi. **Poverty Reduction:** This is to substantially reduce the number of people wallowing in abject poverty and squalor in the country, the government usually adopt a mix of economic policies and specific poverty–alleviation strategies designed to create economic empowerment opportunities for the poor masses. This is to enable them have access to the goods and services they desire for higher standard of living.

EXAMINER'S REPORT

The focus of the question is on the macroeconomic objectives of the Federal Government of Nigeria, a key player in the country's economic environment.
Majority of the candidates attempted the question and the pass rate was above average.

Majority of the candidates were able to identify the relevant points while many of them could not provide copious explanation of the points raised.

Candidates are advised to pay more attention to the materials on this aspect of the syllabus in the ICAN Study Text for more insight.

MARKING GUIDE

	Marks	Marks
Identification of any five Macroeconomic objectives @ 1 mark each.	5	
Explanation of any five Macroeconomic objectives @ 2 marks each	10	15
Total		**15**

SOLUTION 7

A number of factors have been responsible for the phenomena increase in the size of government spending especially in Nigeria and the reasons for this can be listed as follows:

a. **Population growth:** As population increases, the government requires higher provision of social amenities; hence, government spending tends to increase more and more. This is the case of Nigeria where population grows rapidly which calls for the increase in government spending on social amenities like pipe-borne water, electricity etc. in the country

b. **Economic development goal**: Nigerian government has the desire to achieve rapid economic development for the country. The channel through which this goal can be achieved is to increase government spending which will stimulate higher level of productivity in all sectors of the economy.

c. **Defence and security**: There is the need on the part of the government to increase its spending on equipment required by the armed forces in order to provide strong defence and security for the entire citizenry against internal or external aggression.

d. **Increase in the general price level**: The general prices of goods and services have risen persistently and cost government more to provide the same amenities than before. This implies that the level of inflation is moving up in the country and is responsible for increase in government spending in recent times.

e. **Urbanization:** The shift of the population from the rural to urban areas is also responsible for increase in government spending in Nigeria. For instance, the movement of federal capital from Lagos to Abuja has raised government spending on construction and other projects on annual basis from inception till date.

f. **Costly political arrangement:** Since Nigeria is practicing democracy, the government spends more on yearly basis in maintaining democratic institutions. Huge amounts are allocated to electoral agencies during election into local, state and federal offices, many of which are duplicated

g. **National crisis or war:** National crisis or war always calls for a lot of funds to be allocated to the provision of arms and ammunition. For instance, the case of militancy in the Niger Delta and Boko Haram insurgency forced the Nigerian government to increase its funding of the purchase of sophisticated weapons to fight these insurgencies.

h. **Industrialization or financing developmental projects:** Nigerian government is also embarking on developmental projects and technological acquisition, which require large government spending.

EXAMINER'S REPORT

The question requires candidates' understanding of factors responsible for the rapid growth of government spending in Nigeria.
A good number of the candidates attempted the questionand the performance was below average.

Many of the candidates misinterpreted the question by focusing on the different types of development projects undertaken by the Federal Government of Nigeria. In general, majority of the candidates demonstrated inadequate and shallow knowledge of this aspect of the syllabus.

Candidates are advised to spend time to identify the requirements of any question and should make use of ICAN Study Text and standard texts on Public Finance for better understanding of this aspect of the syllabus,

MARKING GUIDE

		Marks
i.	Identification of any five factors @ 1 mark each	5
ii.	Explanation of any five factors identify @ 2 marks each	<u>10</u>
	Total	**<u>15</u>**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – MAY 2017

MANAGEMENT, GOVERNANCE AND ETHICS

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

Gbenga Alimi wants to establish a fast food restaurant in Koko, a state in Naijaland. A well-known global fast food outfit in Naijaland has agreed to give him a franchise to enable him operate the business in the state. However, the Franchisor has requested the young man to present a good business plan to determine the viability of the business in the state. Your consulting firm has been engaged by the young man to:

Required:

a. Outline the contents of a business plan that would address the viability of the proposed franchise fast food restaurant. (20 Marks)

b. With the aid of the appropriate graphical representation, you are required to educate Gbenga Alimi on the four stages involved in the classical product life cycle. (6 Marks)

c. Within the context of an organisation, distinguish between the following pairs:
   i. Narrow and wide stakeholders
   ii. Active and passive stakeholders (4 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

a. Johnson and Scholes suggested that there is a cultural web within an organisation.

   Required

   Discuss the idea of cultural web and its interrelated elements in a way that would assist a new employee to understand this concept in a business organisation. (15 Marks)

b. As a professional accountant, explain any **TWO** ethical principles or requirements you would consider in deciding whether or not to keep a promise to maintain confidentiality with regards to information acquired from a client in the ordinary course of business.

(5 Marks)

(Total 20 Marks)

QUESTION 3

Mallam Danladi is a civil servant who has won a sum of one hundred million Naira in a lottery. Being a very conservative person who is averse to risks, Mallam Danladi is contemplating putting the money in a fixed deposit account at an interest rate of 14% per annum or into treasury bills at an interest rate of 18.5%per annum. These two options are considered to be virtually risk free. Mr. Madoff, a risk consultant, advised him to invest in the production of shea butter, coconut oil and black soap, with a promise of 52% profit per annum. In an attempt to convince Mallam Danladi to invest in the production of these items, Mr Madoff, tried to educate Mallam Danlandi on the nature of risks and how to effectively monitor and control them in ways that will ensure that business remains highly profitable.

Required:

a. Explain briefly the nature of risk in business to Mallam Danladi. (2½ Marks)

b. Discuss **FOUR** distinct means of controlling business risk. (10 Marks)

c. Explain briefly the purpose of monitoring risks in business. (3 Marks)

d. Discuss **THREE** ways of monitoring risks in business. (4½ Marks)

(Total 20 Marks)

QUESTION 4

a. With the aid of an appropriate diagram, explain how organisations and management structures might change as business grows using Greiner's growth model.

(10 Marks)

b. Explain briefly the concept of board diversity giving **THREE** examples of categories of diversity. (5 Marks)

c. Explain **THREE** benefits of the diversity of the board of a large company

(3 Marks)

d. Discuss **TWO** limitations of board diversity (2 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

a. Using ISO 31000 framework, show what an organisation might do to address risk management challenges. (9 marks)

b. Explain **THREE** main elements of risk management contained in ISO 31000 framework. (6 Marks)

(Total 15 Marks)

QUESTION 6

a. Agency problems and conflicts are common in all organisations.

Required:
Explain the concept of agency problems and discuss **FIVE** types of agency conflicts that might exist in an organisation. (8 Marks)

b. Tucker's Five Question Model can be employed in training new professional accountants in ethics.

Required:
Explain the issues covered by the Tucker's Five Question Model. (7 Marks)

(Total 15 Marks)

QUESTION 7

Nolan Committee on standards in public life was set up to report on standards of behaviour amongst politicians, civil servants and public bodies. Provide an analysis of Nolan's' **SEVEN** Principles of Public Life. (15 Marks)

(Total 15 Marks)

SUGGESTED SOLUTIONS

SOLUTION 1

(a) Components of a business plan

i. **Title page**

The title page is to attract readers to the report and assist them in finding the plan/report at a later date. It would typically include:

- Title (and any sub-titles) – this should define the plan/report and ensure it is easily distinguishable from others
- Author
- Organisation's name
- Reference numbers (if any)
- Degree of confidentiality
- Date

You might also include some kind of unobtrusive artwork (such as the logo of the relevant organisation) that relates to the plan/report subject.

ii. **Table of contents**

A table of contents is a list of all the sections that are included in the plan/report (in the same order in which they appear) plus relevant page numbers.

iii. **Introduction**

The introduction prepares readers for the plan/report itself. It provides information on such questions as why the plan/report has been written and the questions it answers.

The introduction should:

- Make the subject of the plan/report clear;
- Clearly state its purpose; and
- Briefly explain the methods used to get the information provided.

iv. **Executive summary**

An executive summary is important because, for senior officers with little time, it is one section they will surely read. It should be succinctly, clearly and well written.

The executive summary should include:

- What the plan/report is about;
- The relevant problems;
- The conclusions arrived at; and
- Recommendations.

The primary idea of writing an executive summary is to give the overall picture without including too much detail. A useful by-product of writing an executive summary is that it provides an opportunity to check that the plan/report itself is logical and convincing.

v. **Body of the plan/report**

The body of the plan/report should be split into sections with logical headings and sub-headings. These should reflect the groupings and sub-groupings created during the planning and structuring phase.

The headings are essentially 'signposts' that allow readers to navigate to the relevant details in a logical fashion so as to further investigate something they have read in the executive summary. Typical components would include:

- Business description, which briefly explains:
  - Overall mission and objectives;
  - History and ownership;
  - Products and services; and
  - Operating/production plan.

- Business environment analysis (for example – PEST Analysis and SWOT Analysis) that specifies the industry's background.

vi. **Market analysis**

Market analysis should articulate:

- Size, segmentation and growth/decline of market; and
- Marketing plan.

vii. **Management summary**

Management summary should highlight:

- Who the key management personnel are and their backgrounds; and
- Organisation chart (summary only – more detail may be provided as an appendix).

viii. **Financial plan**

Financial plan must include a summary of financial information. This should include income statement, statement of financial position and cash flow statement/ risk factors.

ix. **Conclusions and recommendations**

The conclusions and recommendations must follow logically from the rest of the plan/report. When writing the conclusion and recommendations section, the following should be considered:

- The conclusion and recommendations should follow logically from the rest of the plan/report, i.e.
    - Draw out the main point(s) of the plan/report and present a considered judgement on them;
    - Draw conclusions that are justified by the evidence and facts contained in the body of the plan/report;
    - Make recommendations based only on your discussions and conclusion; and
    - Does not introduce a new line of argument or material.
- Check the conclusions and recommendations against the original objective of the plan/report.
- Make sure you have answered all key questions.
- Finish with the final impression you want to make.

x. **Appendices/Bibliography**

The appendices should include detailed information that a reader can essentially do without in order to make sense of the main body of the report. For example: calculations, examples, questionnaires and CVs. They are essentially the bottom level of the logical pyramids you constructed during the structuring phase.

In summary, appendices:

- Should be included only if absolutely necessary.
- Are non-essential for understanding the main arguments.
- Should be referred to somewhere in the body of the text, i.e., there must be a link.
- Are presented as the final item in the table of contents.

An alternative approach is to exclude appendices but invite the reader to contact the author should they wish to see a copy of the details. However, as a minimum, most business plans would include the following two appendices:

- Detailed financial information – more details than in the financial plan in the main body.
- CVs of key management – certainly those of board members, but can also include those of other key management personnel

b. The 'classical' product lifecycle

A 'life cycle' is the period from birth or creation of an item to the end of its life. Products, companies and industries all have life cycles. A product life cycle begins with its initial development and ends at the time it is eventually withdrawn from the market.

A life cycle is said to go through several stages. The 'classical' life cycle for a product, or even an entire industry, goes through four stages or phases:

i. Introduction;
ii. Growth;
iii. Maturity; and
iv. Decline.

Introduction phase. During this stage of a product life cycle, there is some sales demand but total sales are low. Firms that make and sell the product incur investment costs and start-up costs. Running costs are usually high. The product is not yet profitable.

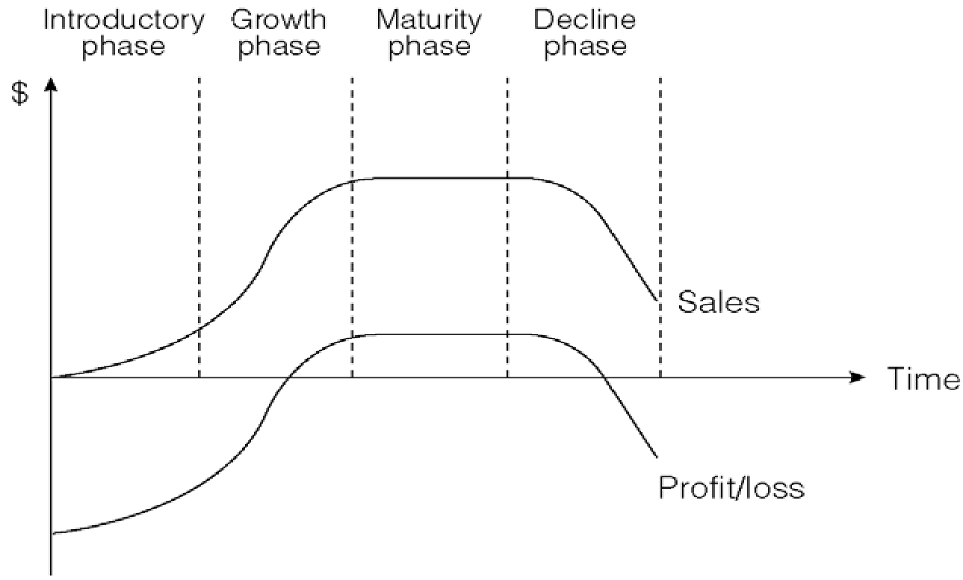
Growth phase. During the growth phase, total sales demand in the market grows at a faster rate. New entrants are attracted into the market by the prospect of high sales and profits. At an early stage during the growth phase, companies in the market begin to earn profits.

Maturity phase. During the maturity phase, total annual sales remain fairly stable. Prices and profits stabilise. The opportunity for more growth no longer exists, although the life of the product might be extended, through product updates.

More companies might seek to improve profits by differentiating their products more from those of competitors, and selling to a 'niche' market segment.

Decline phase. Eventually, total annual sales in the market will start to fall. As sales fall, so do profits too. Companies gradually leave the market. At some point in time, it is no longer possible to produce and sell the product at a profit, and the product is therefore discontinued.

A 'classical' product life cycle is shown in the following diagram.



Not all products have a classical life cycle. Unsuccessful products never become profitable. A business entity might be able to 'revitalise' and redesign a product, so that when it enters a decline phase, its sales increases again, and it consequently goes into another period of growth and maturity.

The length of a product life cycle can be long or short. A broad type of product, such as a motor car, has a longer life cycle than particular types of the product, such as a Volkswagen Beetle or a Ford Escort.

At each phase of a product's life cycle:

i. selling prices will be altered;
ii. costs may differ;
iii. the amount invested (capital investment) may vary; and
iv. spending on advertising and other marketing activities may change.

c. (i) **Narrow and wide stakeholders**

Evans and Freeman (1993) made a distinction between narrow and wide stakeholders.

- Narrow stakeholders are those that are the most affected by the actions and decisions of an organisation. Narrow stakeholder groups for a company usually include shareholders, directors, other management, employees, suppliers and those customers who depend on the goods produced by the company.

- Wide stakeholders are those groups that are less dependent on an organisation. Wide stakeholders for a company may include customers who are not particularly dependent on the company's goods or services, for example, the government and the wider community (as distinct from local communities in which the company operates, which may be narrow stakeholders).

(ii) **Active and passive stakeholders**

Mahoney (1994) made a distinction between active and passive stakeholders.

i. Active stakeholders are those that are involved in the company's activities and decisions. These stakeholders may be a part of the company's normal decision-making and operating processes, such as management and employees. Other active stakeholders who are external to the company may include, government regulators or environmental pressure groups.

ii. Passive stakeholders are those stakeholders who are not usually involved with a company's policy-making. They may have a strong interest in what the company does, but they do not want to get actively involved in its decision-making. The government and local communities may be examples of passive stakeholders.

EXAMINER'S REPORT

The question tests candidates' ability to draw out a business plan and explain the stages involved in the classical product life cycle with the aid of graphical representation. It also tests their ability to distinguish different types of stakeholders.

Being a compulsory question, all the candidates, except one, attempted the question. Overall performance was below average. The commonest pitfall was the general inability of candidates to draw a business plan and distinguish the different types of stakeholders.

Candidates are advised to pay close attention to all the sections of the syllabus and prepare adequately for future examinations.

MARKING GUIDE

		MARKS	MARKS
a.	Identifying the 10 components of business plan @ 1 mark each	10	
	Explanation of each of the 10 points @ 1 mark	<u>10</u>	
			20
b.	Construction of the product life cycle diagram	2	
	Identifying the four stages in a classical life cycle diagram @ ½ mark each	2	
	Explanation of the four stages @ ½ mark each	<u>2</u>	
			6
c.	Explanation of each of the four types of shareholders @ 1 mark each		<u>4</u>
			<u>30</u>

SOLUTION 2

a.

The cultural web of an organisation affects or determines the way in which individuals understand the organisation in which they work. It consists of what an organisation is about: what it does; its mission; and values.

The six inter-related elements of culture within an organization are:

i) **Routines and rituals**
These convey the ways things are done in an organisation. Individual workers get used to established ways of doing things within the organisation in which they work.

ii) **Stories and myths**
These are used to describe the history of an organisation and to suggest the importance of certain individuals or events. They are usually passed by the words of mouth and create an impression of how the organisation got to where it is. It can be difficult to challenge such established myths in ways that can facilitate a change of direction in the future.

iii) **Symbols**
These can be a representation of the nature of an organisation. Example might be the brand on a company's car, the colour of an office or building, a logo or a style of language.

iv) **Power structure**
Organisations are influenced by the individuals who are in positions of authority or power. In many business organisations, power is obtained by the occupation of a management position. However, it can also come from personal influence, experience or expertise.

v) **Control systems**
Performance measurement and reward systems within an organisation establish the view about what is important and what is not so important. Individuals will focus on performance that earns rewards. For example, it has been suggested that cash bonus systems help to create the profit driven culture in investment banks.

vi) **Organisation structure**
The culture of an organisation is affected by its organisation and management structure. For example, hierarchical and bureaucratic organisations might find it difficult to adapt to change and are often conservative in their outlook.

b.

i. The professional accountant might take the view that, having given a promise, he/she must keep it. A promise is given with the intention of keeping it and there are no conditions under which the professional accountant should disclose the information to anyone else, without the prior permission of the client. This would be an **absolutist view/principle of ethics.**

ii. The accountant might give a promise not to disclose a piece of confidential information to anyone else, but in giving his promise, he/she might tell the client that there are certain circumstances in which he might feel obliged to give the information to someone else (and give an indication of what those circumstances might be, such as legal reasons). In this situation, the accountant would be saying that the right thing to do depends on the circumstances and situations. This would be a **relativist view/principle of ethics.**

iii. Confidential information about a client can be disclosed if the client so permits. Before disclosing the information, however, the accountant should consider whether the disclosure might harm a third party.

iv. Confidential information must be disclosed if a court of competent jurisdiction requires it.

v. The law might also require the disclosure of some confidential information to the appropriate authorities. For example, firms of accountants are required to disclose suspicions of money laundering by a client to the appropriate authorities.

In addition, tax evasion is a crime and accountants are required to report such evasions by clients to the authorities.

vi. Disclosure is also permitted when the accountant has a professional right or duty, where such disclosure is not prohibited by law.

vii. Disclosure is also permitted, if such information is to protect the interest of members of the public.

EXAMINER'S REPORT

The question tests candidates' practical understanding of the idea of cultural web and its relevance to employees in business entities. It also tests their ability to identify some of the ethical principles that are relevant to the accounting profession.

Almost 80% of candidate attempted the question and the overall performance was less than average. Commonest pitfall was that many of the candidates did not understand the question and as such could not answer it correctly.

Candidates are advised to pay attention to the Ethics component of the syllabus.

MARKING GUIDE

		MARKS	MARKS
a.	Definition of cultural web	3	
	Identifying the elements of cultural web (1 mark for each any 6 points)	6	
	Explanation of each element (1 mark for each 6 points)	<u>6</u>	
			15
b.	Explanation of 2 ethical requirements @ 2½ marks each		<u>5</u>
			<u>20</u>

SOLUTION 3

a. The Nature of Risk: Risk is associated with the possibility that:

i. Things might go wrong;
ii. Future outcomes or events cannot be predicted with certainty;
iii. A range of different future outcomes might occur; and
iv. Events might turn out worse than expected.

A business risk threatens the health and survival of a business. The business proposal by Madoff, for example, involves the risk that the projected profit of 52% per annum on the production of shea butter, coconut oil and black soap might not be achieved. It also involves the business risk that Mallam Danladi might record an outright loss.

b. Means of controlling risks are:

i. Diversification
This involves spreading of risk, which can be achieved by investing in a range of different risk activities and build up a portfolio of different business activities. This way, the business with less risk will compensate for those with higher levels of risks.

ii. Risk Transfer
This involves the passing of risk to others. An example is insurance, where risks are transferred to insurance companies which will indemnify if the risk occurs.

iii. Risk Sharing
Collaborating with other individuals to jointly share the risk. The most common includes joint venture and partnership. Here, all members share in the cost, risk and reward.

iv. Hedging Risk
Creating a position or product that offsets an exposure to another risk. It is mostly used in the financial market and is commonly associated with management of financial risks, e.g. currency risks.

v. Risk Avoidance
This means not having any exposure to risk. This can be achieved by staying out of or leaving business.

vi. Risk Retention
This is when the risk bearer decides to accept the risk with the expectation of making a return.

c. Purpose of monitoring risk in business

Risks should be monitored. The purpose of risk monitoring is to ensure that:

i. the processes and procedures for identifying risk are effective;
ii. there are internal controls and other risk management processes in place for managing risks;
iii. risk management systems are effective;
iv. the level of risk faced by the entity is consistent with the policies on risk that are set by the board of directors;
v. failures in the control of risk are identified and investigated; and
vi. weaknesses in risk management processes are identified and corrected.

d. THREE ways of monitoring risks

There is no widely-accepted approach to the monitoring and management of risk. Each business and non-business entity develops its own risk monitoring and management structure according to its own needs and perceptions. The following are some of the major approaches to risk monitoring.

i. Risk manager

Companies and other entities might appoint one or more risk managers. A risk manager might be given responsibility for all aspects of risk. Alternatively, risk managers might be appointed to help with the management of specific risks, such as:

- Insurance;
- Health and safety;
- Information systems and information technology;
- Human resources;
- Financial risk or treasury risk; and
- Compliance (with specific aspects of the law or industry regulations).

A risk manager is not a 'line' manager and is not directly responsible for risk management. His role is to provide information, assistance and advice, and to improve risk awareness within the entity and encourage the adoption of sound risk management practice.

The role of a risk manager might therefore include:

- Helping with the identification of risks;
- Establishing 'tools' to help with the identification of risks;
- Establishing modelling methods for the assessment and measurement of risks;
- Collecting risk incident reports (for example, health and safety incident reports);

- Assisting heads of departments and other line managers in the review of reports by the internal auditors;
- Preparing regular risk management reports for senior managers or risk committees; and
- Monitoring 'best practice' in risk management and encouraging the adoption of best practice within the entity.

ii. Risk committees

Some entities establish one or more risk committees.

- A risk committee might be a committee of the board of directors. This committee should be responsible for fulfilling the corporate governance obligations of the board to review the effectiveness of the system of risk management.
- A risk committee might be an inter-departmental committee responsible for identifying and monitoring specific aspects of risk, such as:
  - strategic risks/business risks (or particular aspects of these risks);
  - operational risk (and internal controls);
  - financial risk;
  - compliance risk; and
  - environmental risk.

Risk committees do not have management authority to make decisions about the control of risk. Their function is to identify risks, monitor risks and report on the effectiveness of risk management to the board or senior management.

Internal auditors might be included in the membership of risk committees. Alternatively, the internal auditors should report to the risk committees.

Similarly, risk managers might be included in the membership of risk committees or might report to the committees.

The board of directors should receive regular reports from these risk committees, as part of their governance function to monitor the effectiveness of risk management systems.

iii. Risk Auditing

Risks can be monitored through auditing. Risk auditing involves the investigation by an independent person (the auditor) of an area of risk management. A risk audit and assessment can be defined as 'a systematic way of understanding the risks that an organisation faces. Because the range and types of risk are many and varied, risk assessment and audit can be a complicated and involved process' (David Campbell in Student Accountant, March 2009).

It is important to recognise, however, that unlike an external audit, a risk audit is not a mandatory requirement for companies (although regulators do require companies in certain industries such as financial services to carry out regular audits or stress tests).

- External auditors should monitor internal controls for financial risks as part of their annual audit process. Internal auditors might also carry out checks on internal financial controls.
- However, risk auditing can be extended to other aspects of risk, such as operational risks, compliance risks and environmental risks. The auditors might be a part of the internal audit function or risk management function within the entity. Alternatively, they might be external investigators and auditors from either an accountancy/consultancy firm or a firm that specialises in the audit of particular types of risk.

EXAMINER'S REPORT

The question tests candidates' understanding of the nature of risk and the distinctions between risk monitoring and risk controlling in business.

Over 90% of the candidates attempted the question and the overall performance was above average. Their major pitfall was their inability to differentiate between monitoring and controlling risks in business.

Candidates are advised to understand the distinctions between related concepts.

MARKING GUIDE

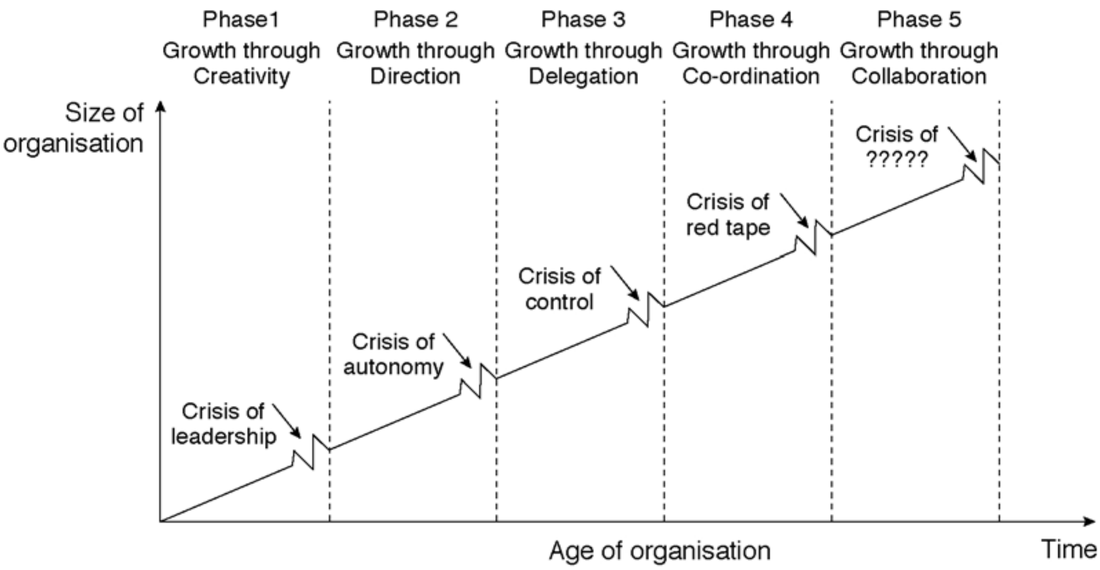
		MARKS	MARKS
a.	Definition/explanation of risk	1	
	Explanation of Business Risk	<u>1½</u>	
			2½
b.	identification of 4 means of controlling risks @ 1 mark each	4	
	Explanation of each means of controlling risks @ 1½ marks each	<u>6</u>	
			10
c.	Justification for risk Monitoring @ 1 mark each for 3 points		3
d.	1½ marks for each of the 3 ways of monitoring risks		<u>4½</u>
			<u>20</u>

SOLUTION 4

a. **Greiner's growth model**

In the 1970s, Greiner suggested that an entity that grows in size goes through a series of changes as it gets bigger. Each change occurs in response to a 'crisis', when the existing organisation and management structure is no longer capable of handling a business as large as it has now become.

Greiner's growth model



Phase 1: **Period of growth through creativity**
The initial stage of a successful business entity is a period of creativity and innovation. The entity is managed in an entrepreneurial way and it is producing new products that appeal to customers. As the entity grows, the entrepreneurial method may be insufficient which leads the organisation to a 'crisis' of leadership.

Phase 2: **Period of growth through direction**
With a structured entity, formal systems are introduced such as planning and control systems, accounting systems, inventory control, production scheduling, communication and IT systems, etc. The hierarchical management structure becomes inefficient as the entity grows. Thereby, making management control not to be effective as it used to be as top management are far away from actual operations, which lead to a 'crisis of autonomy' between top management and local

management.

Phase 3: **Period of growth through delegation**
As the business continues to grow, central management has to delegate authority to local managers. However, a crisis of control may ensue as central management realises that it has lost most of its authority.

Phase 4: **Period of growth through co-ordination**
As the entity continues to grow, activities of all local operating divisions are consolidated for management use. However, the reporting systems starts to create a bureaucratic bottleneck at the head office which makes the local managers uncomfortable in their operations and this leads to 'crisis of red tape' involving too much form filling, report writing and bureaucracy which leads to the final phase.

Phase 5: **Period of growth through collaboration**
To overcome the problem of red tape, the head office management and local managers find ways to collaborate more constructively. More emphasis is given to teamwork and problem-solving and less emphasis on formal reporting systems and accountability. Since no entity has gone beyond Phase 5 of its development, Greiner suggested that it was too early to predict whether there will be crisis at the end of Phase 5.

b. Board diversity means having a range of directors that are different from one another. Board diversity aims to cultivate a broad spectrum of demographic attributes and characteristics.

Such attributes and characteristics include:
- Age;
- Race;
- Gender;
- Educational background;
- Professional qualification;
- Experience;
- Religion;
- Marital status;
- Personal attitudes; and
- Political affiliation.

c. Benefits of board diversity

The benefits of diversifying the board of a large company include:

1. More effective decision making.
A diversified board should help reduce 'groupthink' and hence result in more objective decisions being made. It helps the board to approach problems from a greater variety of perspectives and raise challenging questions that will result in more vigorous debate;

2. Better utilisation of talent pool of NEDs
Traditionally, the search for Non-Executive Directors (NEDs) has been restricted to candidates with similar backgrounds to existing members of the board. Broadening the target population by diversifying the board membership will foster better use of the available talent pool of NEDs; and

3. Enhancement of corporate reputation
This will lead the company to become a more responsible corporate citizen.

d. Limitations of board diversity are as follows:

i. Increased conflict and friction which may promote cliques or sub-groups;

ii. Tokenism – Board minority may feel they are only there to 'make up the number' and fill up a quota. This may not allow them to take an active role and contribute positively to decision making of the board; and

iii. Decrease in quality of decision arrived at due to insufficient business expertise of directors chosen on diversity criteria. The business entity may not enjoy the best contribution or direction from the board.

EXAMINER'S REPORT

The question tests candidates' ability to use Greiner's Growth Model to explain how organisational management structures might change in response to business growth. It also tests their understanding of the nature, advantages and disadvantages of board diversity.

About 30% of the candidates attempted the question and their overall performance was below average.

Commonest pitfall was that many of the candidates could not correctly label Greiner's Growth Model's diagram and explain the model adequately. In addition, many candidates could not provide an adequate explanation of the nature, advantages and limitations of board diversity.

Candidates should ensure that they are able to draw, label and inteprete diagrams correctly. They should also endeavour to have a full grasp of the topics and issues listed in the syllabus.

MARKING GUIDE

		MARKS	MARKS
a.	Construction of Greiner's Diagram	5	
	Explanation of diagram	<u>5</u>	
			10
b.	Explanation of board diversity	2	
	Mentioning any 3 categories of diversity	<u>3</u>	
			5
c.	Benefits of board diversity		
	(1 mark each for any 3 points)		3
d.	Limitation of board diversity		
	(mentioning any 2 points @ 1 mark each)		<u>2</u>
			<u>20</u>

SOLUTION 5

a. ISO 31000 uses the 7Rs and 4Ts as framework for implementing risk management system. Its purpose is to promote international standardisation in risk management system.

The 7Rs are:

1. Recognition/identification of risk;
2. Ranking or evaluation of risk;
3. Responding to significant risk;
4. Risk treatment which includes to:
   (a) Tolerate;
   (b) Treat;
   (c) Transfer; and
   (d) Terminate the risks (4 Ts);
5. Resources control;
6. Reporting and monitoring risk performance; and
7. Review of risk management framework.

b. ISO 31000 suggests a framework for risk management that has three main elements.

i. **Risk Architecture**
This consists of the roles and responsibilities for risk management within the organisation and the risk reporting structure. Examples are the roles of Internal Auditors, Risk Manager, Audit Committee, Board and the Chief Executive Officer (CEO).

ii. **Risk strategy**
The risk strategy of the organisation should be specified, including the risk appetite of the board. There should be a risk management action plan and resources to support risk management activities.

iii. **Risk protocols**
These are the rules and procedures for implementing risk management and the risk management methodologies that should be applied. For example, there should be rules, procedures and methodologies for risk assessments, risk responses, and incident reporting.

EXAMINER'S REPORT

The question tests candidates' practical understanding of ISO 31000 Framework and its essential elements for risk management.

About 30% of the candidates attempted the question and their overall performance was poor. Commonest pitfall was their inability to distinguish and explain the three main elements of risk management contained in ISO 31000. They were also unable to clearly explain what an organisation may do to manage risks.

Candidates are advised to pay attention to the details of all the topics in the syllabus.

MARKING GUIDE

		MARKS	MARKS
a.	State any 6 of the 7R's @ 1½ marks each		9
b.	Identifying the 3 elements of ISO 31000 @ 1 mark each	3	
	Explanation of each of the 3 elements @ 1 mark each	3	
			6
			15

SOLUTION 6

a. Agency problem is a conflict of interests inherent in any relationship where one party is expected to act in another's best interest. In corporate entity, the agency problem usually refers to a conflict of interest between a company's management and the company's shareholders.

The managers, acting as agents for the shareholders or principals are supposed to make decisions that will maximize shareholder's wealth even if it is in the managers' best interest to maximise his own wealth.

The agency problem does not exist without a relationship between a principal and an agent. The agency problems arise due to an issue with incentives. An agent may be motivated to act in a manner that is not favourable for the principal, if the agent is presented with an incentive to act in this way. The agency problem may be minimised by altering the structure of compensation. Agency conflict exists in organisation and may be experienced in the following ways:

i. **Moral hazard**
A manager has an interest in receiving benefits from his or her position as a manager. These include all the benefits that should come with a status or position. These may include a company car, a private chauffeur, use of a company airplane, lunches, attendance at sponsored sporting events, etc. A manager's incentive to obtain these benefits is higher when he has no shares, or only a few shares, in the company;

ii. **Effort level**
Managers may work less hard than they would have if they were the owners of the company. The problem will exist in a large company at middle levels of management as well as at senior management level. They may have different interests if, for instance, senior management is given pay incentives to achieve higher profits but the middle managers are not;

iii. **Earnings retention**
The remuneration of directors and senior managers is often related to the size of the company rather than its profits. Management are more likely to want to re-invest profits in order to make the company bigger rather than pay out the profit as dividend;

iv. **Risk aversion**
Executive directors and senior managers usually earn most of their income from the company they work for. They are, therefore, interested in the stability of the company because this will protect their job and their future income. This means that management might be risk-

averse. In contrast, shareholders might want a company to take bigger risks; and

v. **Time horizon**
Shareholders are concerned about the long-term financial prospects of their company. In contrast, managers might only be interested in the short-term prospects. This is partly because they might receive annual bonuses based on short-term performance.

b. The Tucker's Five Question Model for Ethical Decision Making in Business is based on the view that the profit motive is justified and the purpose of decision-making in business should be to make a profit. However, profit should be made in an ethical way. In order to be ethically correct, business decisions and actions should be legal.

The Tucker's Five Question Model involves asking five questions before making a business decision. The five questions about business decisions are:

i. Is it Profitable? It must be noted that companies are owned by shareholders and the primary reason for ownership is usually to maximise profit;

ii. Is it legal? This is a general statement regarding the legality of doing business;

iii. Is it fair? Fairness suggests an element of equality among stakeholders;

iv. Is it right? Rightness relate to moral standard beyond the legal standard. Rightness and fairness are similar; and

v. Is it sustainable or environmentally sound? Products are often designed to meet environmental needs as a base for its competitive advantage.

EXAMINER'S REPORT

The (a) part of the question tests candidates' understanding of the nature and forms of agency conflicts and problems. Part (b) tests their knowledge of Tucker's Five Questions Model for Ethical Decisions Making in Business.

About 70% of the candidates attempted the question and overall performance was average. Their commonest pitfall was their inability to identify and explain the nature and forms of agency conflicts and problems. Besides, while many of them were able to identify Tucker's five questions, they had problems explaining each of them.

Candidates are advised to pay attention to the issues discussed in ICAN Study Text.

MARKING GUIDE

		MARKS	MARKS
a.	Introduction	3	
	Mentioning 5 agency conflicts @ ½ mark each	2½	
	Explaining 5 agency conflicts @ ½ mark each	<u>2½</u>	
			8
b.	Explaining Tucker's Five Questions Model	2	
	Mentioning each of Tucker's Five Questions Model @ ½ mark each	2½	
	Explaining each of Tucker's Five Questions Model @ ½ mark each	<u>2½</u>	
			<u>7</u>
			<u>15</u>

SOLUTION 7

a. Nolan's' principles of public life is a concept that applies to public sector entities, not–for–profit entities and privately owned companies.

The principles were issued in United Kingdom by the Nolan's' committee on standards of behaviours among politicians, civil servants and other public sector bodies. They are meant to guide the conduct and activities of personnel in diverse sectors of public life.

b. The Nolan's' Committee identifies seven principles that should guide the activities of personnel in various sectors. These are:

i) Selflessness
Holders of public office should not make decisions that are in their personal self-interest. Their decisions should be based entirely on a concern for the interest of the public.

ii) Integrity
Holders of public office should not put themselves under any financial obligations or other obligations to another individual or organization that might influence how they act in the course of their duties.

iii) Objectivity
In awarding contracts or making recommendations, officeholders should base their decisions on merit.

iv) Accountability
Officeholders are accountable to the public and should submit themselves to public scrutiny.

v) Openness
Officeholders should be as open as possible about the decisions they take and the reasons for those decisions. They should only withhold information when this is in the interest of the public.

vi) Honesty
Officeholders have a duty to declare any conflicts of interest they might have, and should take steps to resolve them whenever they arise.

vii) Leadership
Officeholders should promote and support these principles by setting an example with their own behaviour and giving a lead to others.

EXAMINER'S REPORT

The question tests candidates' knowledge of Nolan's Seven Principles of Public Life and their ability to adequately explain each of the seven principles.

About 70% of the candidates attempted the question and overall performance was above average. Their major pitfall was their inability to provide an in-depth explanation of each of the seven principles of public life discussed by Nolan.

Candidates should ensure that they fully understand the details of all the concepts, theories and principles discussed in ICAN Study Text.

MARKING GUIDE

	MARKS	MARKS
Introduction	1	1
Mentioning the 7 Principles @ 1 mark each	7	
Explaining each of the 7 Principles @ 1 mark each	7	14
		15