THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PATHFINDER

NOVEMBER 2016 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.

TABLE OF CONTENTS

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – NOVEMBER 2016

FINANICAL 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

a. IFRS 3 on Business Combination permits a non-controlling interest at the date of acquisition to be valued by one of two methods.

i. At its proportionate share of the subsidiary's identifiable Net Assets or

ii. At its Fair Value (usually determined by the directors of the parent Company).

Required:
Explain the difference that the accounting treatment of these alternative methods could have on the Consolidated Financial Statements, including where Consolidated Goodwill may be impaired. (5 Marks)

b. Harmony Limited acquired 70% interest in the equity shares of Foremost Limited for ₦3,000,000 on January 1, 2015. The abridged Statement of Financial Position of both companies at the date of acquisition were as follows:

	HARMONY LIMITED	FOREMOST LIMITED
	₦'000	₦'000
Identifiable Assets	32,800	8,000
Investment in Foremost Limited	3,000	–
	35,800	8,000
	₦'000	₦'000
Equity	24,000	4,800
Identifiable Liabilities	11,800	3,200
	35,800	8,000

The fair value of the identifiable assets of Foremost Limited amounts to ₦11,200,000 and the fair value of its liabilities is ₦3,200,000. The Non-Controlling Interest will be measured as a percentage of the Net Asset of the acquiree.

Required:

Calculate the Gain on Bargain Purchase arising from the acquisition.

(3 Marks)

c. On January 1, 2016 Kehinde Plc acquired 45million of the Equity shares of Taiwo Plc in a share exchange in which Kehinde Plc issued two (2) new shares for every three (3) shares it acquired in Taiwo Plc. This gave Kehinde Plc a holding of 90%, additionally on 31 December, 2016, Kehinde Plc will pay shareholders of Taiwo Plc ₦1.76 per share acquired. Kehinde Plc cost of capital is 10% per annum.

At the date of acquisition, the shares in Kehinde Plc and Taiwo Plc had a market price of ₦6.50 and ₦2.50 respectively.

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED SEPTEMBER 30, 2016

	KEHINDE PLC	TAIWO PLC
	₦'000	₦'000
Revenue	323,000	190,000
Cost of Sales	(256,000)	(130,000)
Gross Profit	67,000	60,000
Distribution Cost	(8,000)	(9,000)
Administrative Expenses	(19,000)	(12,000)
Investment Income	2,500	-
Finance Cost	(2,100)	-
Profit before Tax	40,400	39,000
Income Tax Expenses	(14,000)	(8,000)
Profit for the year	26,400	31,000

Equity as at October 1, 2015		
Share Capital(₦1 per share)	300,000	75,000
Retained Earnings	270,000	175,000

The following additional information is also relevant:

(i) At the date of acquisition the Fair Value of Taiwo Plc's assets and liabilities were equal to their carrying amount with the exception of two items:

- An item of plant had a fair value of ₦9million above the carrying amount. The remaining life of the plant at the date of acquisition was three (3) years. Depreciation is charged to cost of sales.
- Taiwo Plc had a contingent liability which Kehinde Plc estimated to have a fair value of ₦2.25million. This has not changed as at September 30, 2016.
- Taiwo Plc has not incorporated this fair value changes into its financial statements.

(ii) It is Kehinde Plc's policy to value non-controlling interest at fair value at the date of acquisition. For this purpose, Taiwo Plc share price at the date can be deemed to be representative of the fair value of the shares held by the non-controlling interest.

(iii) Sales from Kehinde Plc to Taiwo Plc throughout the year ended September 30, 2016 had consistently been ₦4million per month. Kehinde Plc made a mark-up of 25% on these sales. Taiwo Plc had ₦7.5million of these goods in inventory as at September 30, 2016.

(iv) Kehinde Plc's investment income is a dividend received from its investment in a 40% owned associates which it has held for several years. The underlying earnings of the associate for the year ended September 30, 2016 were ₦10million.

(v) Although Taiwo Plc has been profitable since its acquisition by Kehinde Plc, the market for Taiwo Plc's product has been badly hit in recent months and Kehinde Plc has calculated that the goodwill has been impaired by ₦10million as at September 30, 2016.

Required:

(i) Calculate the goodwill on acquisition of Taiwo Plc. (7 Marks)

(ii) Prepare the Consolidated Statement of Profit or Loss and Other Comprehensive Income for Kehinde Plc group for the year ended September 30, 2016. (15 Marks)

(Total 30 Marks)

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

QUESTION 2

a. Conceptual framework for reporting emphasises the importance that transactions should be recorded on the basis of their substance over their form. Explain the importance of substance over form and why financial statements should show the substance of the underlying transaction different from its legal form. 4 Marks)

b. Evaluate the conceptual issues involved in product development costs and the definition of an asset that may be applied in determining whether development expenditure should be treated as an expense or an asset. (5 Marks)

c. i. The conceptual framework states that there are two concepts of capital. Explain these two concepts. (4 Marks)

ii. Perfect World Limited commenced business on January 1, 2015 with a single item of inventory which costs ₦120,000. During the year it sold the item for ₦180,000 in cash. Also, during the year, general inflation was 10% but the inflation specific to the item was 12%. Calculate the profit under each concept of capital maintenance and show the effect on the Equity of the Company. (7 Marks)

(Total 20 Marks)

QUESTION 3

Magifera Plc had been trading in merchandise for several years in Garden City. The information below relates to extracts from the Financial Statements for the past two (2) years.

Statement of Profit or Loss and Other Comprehensive Income for the year ended September 30:

	2016	**2015**
	₦' Million	**₦' Million**
Revenue	100,000	160,000
Gross Profit	45,000	70,000
Administrative Expenses	22,500	27,500

Finance Cost:		
10% Loan Note Interest	1,250	1,250
	23,750	28,750
Operating Profit Before Tax	21,250	41,250
Less: Taxation Expense	8,000	16,000
Operating Profit for the year	**13,250**	**25,250**
Dividends Paid to Equity holders	6,050	8,550

Extract of Statement of Financial Position as at September 30

	2016	2015
	₦'Million	**₦'Million**
Assets:		
Non - Current Assets at Cost	50,000	70,000
Less: Accumulated Depreciation	10,000	12,500
Carrying Amount	40,000	57,500
Current Assets:		
Inventory	32,500	7,500
Trade Receivables	20,000	5,000
Bank Balance	4,000	37,500
	56,500	50,000
Total Assets	**96,500**	**107,500**
Equity and Liabilities:		
Ordinary Share Capital @ 50k each	23,000	23,000
Retained Earnings	17,200	10,000
10% Loan notes	12,500	12,500
10% Redeemable Preference Shares	—	2,000
	52,700	**47,500**
Current Liabilities:		
Trade Payables	7,500	10,750
Taxation	24,000	16,000
Bank Overdrafts	12,300	33,250
	43,800	60,000
Total Equity and Liabilities	**96,500**	**107,500**

The Board of Directors were worried over the dwindling financial performance and precarious financial position of the company. The products are ageing; the economic depression is biting as a result of the worsening exchange rate of $1 to ₦400. The company imports 60% of the goods sold in Garden City. The worsening exchange rate had affected the company's importation, consequently the revenue of the company dropped significantly. The unsafe financial performance has also affected the market price of the company's share which dropped from 12kobo/share in the year ended September 30, 2015 to 8kobo/share in 2016.

You are required to:

a. Calculate the following ratios for the year ended September 30, 2015 and 2016 in columnar form:

i. Return on Capital Employed
ii. Total Assets Turnover
iii. Quick Ratio
iv. Debt- Equity Ratio
v. Fixed Interest Cover
vi. Earnings Yield
vii. Price Earnings Ratio
viii. Dividend Yield (12 Marks)

b. Write a brief and formal technical report to the Board of Directors to assess the performance, liquidity and stability of the Company using only:

i. Return on Capital Employed
ii. Total Assets Turnover
iii. Quick Ratio
iv. Fixed Interest Cover
v. Debt Equity Ratio (8 Marks)

(Total 20 Marks)

Hint: Brevity, technical and formal report presentations are essential and will be rewarded.

QUESTION 4

The summarised Financial Statements for the year ended March 31, 2016 of Perfect World Plc are as follows:

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED MARCH 31, 2016

	₦'m
Revenue	19,350
Cost of Sales	(9,000)
Gross Profit	10,350
Operating Expenses	(4,500)
Finance Costs	(1,125)
Profit Before Tax	4,725
Income Tax Expense	(2,025)
Profit for the year	2,700

STATEMENT OF FINANCIAL POSITION AS AT MARCH 31

	2016	2015
Non-Current Assets:	₦'m	₦'m
Property, Plant & Equipment	18,900	16,650
Current Assets		
Inventories	6,750	7,200
Trade Receivables	9,900	8,100
	16,650	15,300
Total Assets	35,550	31,950
Equity		
Share Capital	5,400	5,400
Retained Earnings	9,900	8,550
	15,300	13,950
Non-Current Liabilities		
Deferred Tax	4,815	3,825
Financial Lease Liabilities	5,850	5,400
	10,665	9,225
Current Liabilities		
Trade Payables	5,625	4,905
Current Tax	1,013	923
Finance Lease Obligation	2,250	2,025
Bank Overdraft	697	922
	9,585	8,775
Total Equity & Liabilities	35,550	31,950

Additional Information include:

(i) Dividend paid during the year amounted to ₦1,350million.

(ii) Perfect World Plc finances a number (but not all) of its property plant and equipment purchased using finance lease. During the period, property, plant and equipment which would have cost ₦2,700million to purchase outright was acquired under finance lease.

(iii) There was no accrual of interest at the beginning or at the end of the year.

(iv) Depreciation charged for the year totalled ₦4,365million. There were no disposals of property, plant and equipment during the year.

Required:

a. Prepare the statement of cashflows of Perfect World Plc for the year ended March 31, 2016 using indirect method. (14 Marks)

b. Draft a Memo to the Director of Perfect World Plc summarising the major benefits that users receive from a published statement of cashflows.
(6 Marks)
(Total 20 Marks)

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

QUESTION 5

a. In many Countries of the world, Government provides financial assistance to industry in the form of grants. In accordance with IAS 20 – Accounting for Government Grants and Disclosure of Government Assistance.

Explain the term:

i. Grant related to Assets (2 Marks)

ii. Grant related to Income (2 Marks)

b. Prospect Nigeria Plc obtained a grant of ₦100million from the Federal Government of Nigeria (FGN) for an investment project to construct a plant costing ₦880million.

The principal terms of the grant are as follows:

- Grant payment will be made subject to attaining the minimum level of the plant expenditure.
- The secondary intention of the grant is to safeguard 500 jobs.
- The grant will have to be repaid pro-rata if there is an under spending on capital.
- Twenty percent (20%) of the grant will have to be paid if the jobs are not safeguarded until 18 months after the date of the cost of capital expenditure.

Prospect Nigeria Plc completed the construction of plant on January 1, 2013 at a total cost of ₦900million. The plant has an expected useful life of 20 years and is depreciated on a straight line basis with no residual value.

Required:

i. State the type of grant that Prospect Nigeria Plc has obtained giving reasons for your answer. (3 Marks)

ii. Show how the Asset and the grant would be reflected in the Statement of Financial Position and Statement of Profit or Loss for years ended December 31, 2013; 2014 and 2015 under both methods of Accounting for Grants allowed by IAS 20. (8 Marks)

(Total 15 Marks)

QUESTION 6

a. Identify the **TWO** kinds of leases stipulated in IAS 17 and compare in tabular form with at least **FIVE** differences. (7 Marks)

c. Ijaw Oil Plc has entered into agreement to lease a plant and equipment from Ogoni Leasing Company Limited. The lease period of the plant and equipment is six (6) years. The agreement provides that Ogoni Leasing Company Limited will incur upkeep expenses. The cost of the plant and equipment is ₦900,000,000,000. The economic useful life is 20 years. Ijaw Oil Plc is to pay annual lease rentals of ₦150,000,000 in advance over 6 years after which the plant and equipment revert to the lessor. The implicit interest rate is 22% per annum which is stated below:

Year	**0**	**1**	**2**	**3**	**4**	**5**	**6**
PV(N1)	1.0000	0.8197	0.6719	0.5507	0.4514	0.3700	0.3033

You are required to:

i. Calculate the present value of the lease rental of the equipment. (4 Marks)

ii. Identify with justification the kind of lease involved (3 Marks)

iii. Advise on how to treat the lease rentals paid by Ijaw Oil Plc. in the financial statements (1 Mark)

(Total 15 Marks)

QUESTION 7

Alpha Plc started a 4-year contract to build a dam. Activities commenced on February 1, 2015. The total contract price amounted to ₦30billion, and it was estimated that work would be completed at a total cost of ₦23.75billion. In the construction agreement, the customer agreed to accept increase in wages tariffs in addition to the contract price.

The following information relates to contract activities for the financial year ended December 31, 2015.

(1) Cost for the year:

	₦'million
Material	3,500
Labour	2,000
Operating Overheads	375
Subcontractors	450

(2) Current estimate of total contract costs indicate the following:

i. Material will be ₦450million higher than expected.

ii. Total labour cost will be ₦750million higher than expected. Of this amount only ₦600million will be the result of increase in wage tariffs. The remainder will be caused by inefficiencies.

iii. A savings of ₦75million is expected on operating overheads.

(3) During the year ended December 31 2015 the customer requested a variation to the original contract and it was agreed that the contract price would be increased by ₦2.250billion. The total estimated cost of this extra work is ₦1.875billion.

(4) By the end of year 2015, certificate issued by the quantity surveyors indicated a 25% stage of completion.

Required:

a. Calculate the profit to date based on:

   i. Option A – Contract cost in proportion to estimated contract costs. (6 Marks)

   ii. Option B – Percentage of work certified. (6 Marks)

b. Briefly explain **TWO** methods recognized by IAS 11 which can be used to determine the stage of completion of any contract. (3 Marks)

(Total 15 Marks)

SOLUTIONS

SOLUTION 1

a) **DIFFERENCES BETWEEN THE ACCOUNTING TREATMENT OF THE ALTERNATIVE METHODS**

THE FIRST METHOD:

- IFRS 3 allows as an option a non-controlling interest to be valued at its proportionate share of the acquired subsidiary's identifiable net assets.
- Its effects on the statement of financial position is that the resulting carrying value of purchased goodwill only relates to the parent's elements of such goodwill and as a consequence the non-controlling interest does not reflect its value of the subsidiary's goodwill.
- Any impairment of the goodwill under this method would only be charged against the parent interest as the non-controlling interest' share of goodwill is not included in the consolidated financial statement.

  The second method of valuing non-controlling interest at its fair value would (normally) increase the value of the goodwill calculated on acquisition.
- This increase reflects the non- controlling interest ownership of the subsidiary's goodwill and has the effect of grossing up the goodwill and the non-controlling interest in the statement of financial position, by the same amount.
- Under this method any impairment of the subsidiary's goodwill is charged to both the controlling (parent share) and non-controlling interest in the proportion of their holding of share in the subsidiary.

b) **GAIN ON BARGAIN PURCHASE**

	₦'000
Consideration	3,000
Add:	
Non-Controlling Interest (8,000 x 30%)	2,400
	5,400
Less:	
Net Identifiable Assets of Foremost Ltd (11,200 – 3,200)	8,000
Gain on Bargain Purchase	2,600

ALTERNATIVE SOLUTION

	₦'000
fair value of identifiable net assets acquired by Harmony	
{70% x (11200-3200)	5,600
fair value of consideration transferred	3,000
Gain on Bargain Purchase	**2,600**

c) (i) **CALCULATION OF GOODWILL**

	₦'000
Consideration Transferred:	
Share Capital $(\frac{45x2}{3} = 30$m shares x ₦6.50)	195,000
Deferred Consideration:	
(45m shares x ₦1.76 x $\frac{1}{1.1}$)	72,000
	267,000
Fair Value of NCI	
(5m shares x ₦2.50k)	12,500
	279,500
Fair Value of Assets	₦'000
Share Capital	75,000
Retained Earnings $175{,}000 + \left(31{,}000\ x \frac{3}{12}\right)$	182,750
Fair Value Adjustment to Plant	9,000
Contingent Liabilities	(2,250)
	264,500
Goodwill (279,500 – 264,500)	15,000

c) (ii) **KEHINDE PLC GROUP – CONSOLIDATED STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED SEPTEMBER 30, 2016**

	₦'000
Revenue $323{,}000 + \left(190{,}000\ x\frac{9}{12}\right)$ - 36,000 (w2)	429,500
Cost of Sales $\left(256{,}000 + 130{,}000\left(\frac{9}{12}\right)\right)$ - 36,000 + 1,500 (w2) + 2,250 (w3)	(321,250)
Gross Profit	108,250
Distribution Cost $\left(8{,}000 + 9{,}000 \text{ x}\left(\frac{9}{12}\right)\right)$	(14,750)
Administrative Expenses $\left(19{,}000 + \left(12{,}000\ x\frac{9}{12}\right)\right)$ +10,000 (Good Impairment)	(38,000)
Finance Cost (w4)	(7,500)
Share of Profit of Associates (10,000 x 40%)	4,000
Profit Before Tax	52,000
Less:	
Income Tax Expenses $\left(14{,}000 + \left(8{,}000\ x\frac{9}{12}\right)\right)$	(20,000)
Profit for the year	32,000
Profit Attributable to:	
Owners of the Parent	30,900
Non-Controlling Interest (w5)	1,100
	32,000

Working Notes

W1 Group Structure

Total Control	100%
Kehinde plc interest	90%
Taiwo plc interest	10%

Acquisition of Subsidiary during the year 9 months before year-end.

W2 Intergroup Trading

	₦'000	₦'000	₦'000
(i) Debit Revenue (4,000 x 9 months)	36,000		
Credit Cost of Sales		36,000	
(ii) unrealised Profit $\left(7{,}500 \text{ x}\left(\frac{25}{125}\right)\right)$			
Cost of Sales	1,500		
Group Inventory (SFP)		1,500	

W3	Fair Value Adjustments	₦'000	₦'000	₦'000
	Plant $\left(9{,}000 \div \text{years}\ x\left(\frac{9}{12}\right)\right)$	9,000	2,250	6,750

W4	Finance Cost	₦'000
	Kehinde per Profit or Loss	2,100
	Discount on Deferred Consideration $\left(72{,}000\ \text{x}10\%\left(\frac{9}{12}\right)\right)$	5,400
		7,500

W5	NCI	₦'000
	Profit for the year $\left(31{,}000\ \text{x}\left(\frac{9}{12}\right)\right)$	23,250
	Depreciation on Fair Value Adjustment	(2,250)
	Goodwill Impairment	(10,000)
		11,000
	NCI Share @ 10%	1,100

MARKING GUIDE

		Marks	Marks
a.	Explanation of five (5) differences @ 1mark each		5
b.	Determination of consideration	2	
	Determination of fair value of net assets	1	3
ci.	Determination of consideration	4	
	Ascertainment of fair value of net assets	3	7
cii.	Determination of Revenue	2	
	Calculation of cost of sales	$3^1/_2$	
	Determination of Gross Profit	½	
	Determination of Distribution cost	1	
	Administrative Expenses	1	
	Finance Cost	½	
	Share of Associate's profit	1	
	Profit before tax	½	
	Income tax expenses	1	
	Profit for the year	½	
	Profit attributable to owners of parent	½	
	Profit attributable to NCI	1	
	Calculation of unrealised profit	2	15
	Total Marks		30

EXAMINER'S REPORT

The question tests the following:

- Difference in the accounting treatments of non-controlling interest in accordance with IFRS 3 on business combination.
- Calculation of Gain on bargain purchase and preparation of consolidated profit or loss and other comprehensive income including calculation of Goodwill.

As a compulsory question all the candidates attempted the question, but performance was very poor. The commonest pitfalls of the candidates include:

- Inability of the candidates to differentiate between the different methods of accounting.

- Inability of some of the candidates to correctly calculate the goodwill in part 'c' of the question and failure to reflect necessary adjustments while preparing the Consolidated Statement of profit or loss and other comprehensive income.

Candidates are advised to pay more attention to all sections of the syllabus, Institute study text and pathfinder while preparing for the examinations for better performance in future.

SOLUTION 2

a. Importance of substance over form

Users desire information in general purpose financial statements for making economic decisions. Therefore, financial statements are expected to be of value to their users and as such they must possess certain important characteristics like reliability and faithful representation.

For financial statements to be reliable, they must faithfully represent an entity's underlying transactions and other events. To achieve faithful representation, transactions must be accounted for and presented in accordance with their substance and economic reality where this differs from their legal form.

For example, where an entity 'sold' an asset to a third party, but continued to enjoy the future benefits embodied in that asset, then this transaction would not be represented faithfully by recording it as a sale. In all probability this would be a financing transaction.

b. Conceptual issues in project development cost

An asset is defined by the Conceptual Framework as a resource controlled by an entity as a result of past transactions or events from which future economic benefits (normally net cash inflows) are expected to flow to the entity. However assets can only be recognised (on the statement of financial position) when these expected benefits are probable and can be measured reliably.

The Conceptual Framework recognises that there is a close relationship between incurring expenditure and creating an asset, though they do not necessarily happen at the same time. Development expenditure is an example of the relationship between expenditure and creating an asset.

Research and development expenditure is incurred with the hope that it will lead to a profitable product, process or service, but at the time that the expenditure is being incurred, entities cannot be certain or it may not even be probable that the project will be successful.

In line with accounting concepts, if there is doubt that a project will be successful the application of prudence would imply that the expenditure is expensed in the statement of profit or loss.

When management becomes confident that the project will be successful, it then meets the definition of an asset and the accruals/matching concept would mean that it should be capitalised (treated as an asset) and amortised over the period of the expected benefits.

IAS 38 Intangible Assets interprets this as write off of all research expenditure and only capitalising development costs from the point in time where they meet definition of an asset.

c. (i) Capital Concepts

<u>A financial concept of capital</u> is that the capital of an entity is measured as its net assets, which is also its equity. Where a financial concept of capital is used, the main concern of users of the financial statements is with the maintenance of the nominal financial capital of the entity.

With financial concept of capital maintenance, a profit is not earned during a period unless (excluding new equity capital raised during the period and adding back any distribution of dividends to shareholders) the financial value of equity (net assets) at the end of the period exceeds the financial value of equity at the beginning of the period.

<u>A physical concept of capital</u> is that the capital of an entity is represented by its productive capacity or operating capability. Where a physical concept of capital is used, the main concern of users of the financial statements is with the maintenance of the operating capability of the entity.

With a physical concept of capital maintenance, a profit is not earned during a period unless (excluding new equity capital raised during the period and adding back any distribution of dividends to shareholders) the operating capability of the business is greater at the end of the period than at the beginning of the period. Current value accounting reflects the concept of physical capital maintenance.

In a period of inflation, profits reported using a financial concept of capital will normally be higher than profits reported using a physical concept of capital, such as current value accounting.

Financial capital maintenance is likely to be the most relevant to investors as they are interested in maximising the return on their investment and therefore its purchasing power while Physical capital maintenance is likely to be most relevant to management and employees as they are interested in assessing an entity's ability to maintain its operating capacity.

c(ii) Profit is calculated under each concept in the following ways:-

	Financial (Money terms)	Financial (real terms)	Physical
	₦	₦	₦
Statement of profit or loss:-			
Revenue	180,000	180,000	180,000
Cost of sales	(120,000)	(120,000)	(120,000)
Inflation adjustment (inflation rate applied to opening equity:-			
10% X 120,000		(120,000)	(14,400)
12 % X 120,000	60,000	48,000	45,600

Statement of financial position:-	₦	₦	₦
Net Asset	180,000	180,000	180,000
Equity:-			
Opening equity:			
Before adjustment	120,000	120,000	120,000
Inflation reserve	-	12,000	14,400
After Adjustment	120,000	132,000	134,400
Retained profit for the year	60,000	48,000	45,600
	180,000	180,000	180,000

MARKING GUIDE

		Marks	Marks
(a)	- Explanation – importance of financial statement	1	
	- Differentiating between substance over form and legal form of transactions	2	
	- Giving relevant examples	1	4
(b)	- Giving definition of an Asset in accordance with conceptual frame work	1	
	- Explaining relationships between incurring expenditure and creating an Asset	1	
	- Giving relevant examples to justify explanation of development expenditure treatment	1	
	- Making reference to IAS 38 on the treatment of Development Expenditure	1	
	- Appropriate calculation	1	5
(ci)	- Definition/explanation of financial concept of capital maintenance	2	
	- Definition/explanation of physical concept of capital maintenance	2	4
(cii)	- Determination of Net Asset Using financial Concept (Money terms)	2	
	- Determination of Net Assets		
	- Using financial concept (Real terms)	$2^1/_2$	
	Determination of Net Assets using physical concept	$2^1/_2$	7
	Total marks		20

EXAMINER'S REPORT

The question tests candidates knowledge on conceptual framework of IASB concerning the issue of "substance" over "form" of financial transactions and the concept of capital maintenance.

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

Candidates' displayed lack of knowledge of the content of the conceptual framework of IASB and they could not distinguish between the financial concept and physical concept of capital.

Candidates are advised to study all sections of the syllabus while preparing for future examinations.

SOLUTION 3

RATIO	FORMULAE	2016	2015
(a) Calculation of Ratios			
(i) Return on capital employed =	PBIT / Capital employed	21250 + 1250 / 52,700 = 42.69%	41250 + 1250 / 47,500 = 89.47%
Or	PAT / Equity	13250 / 40200 = 32.96%	25250 / 33000 = 76.52%
(ii) Total asset turnover	Revenue / TA	100,000 / 96,500 = 1.04 times	100,000 / 107,500 = 1.49 times
(iii) Quick Ratio =	CA – Inventory / CL	56,500 -32,500 / 43,800 = 0.55:1	50,000 – 7,500 / 60,000 = 0.71:1
(iv) Debt equity Ratio =	Debt / Equity	12,500 / 23000 +17,200 = 31.09%	12500 + 2000 / 23000+10,000 = 43.94%
(v) Fixed Interest Cover =	PBIT / Fixed Interest	21250 + 1250 / 1250 = 18 times	41250 + 1250 / 1250 = 34 times
(vi) Earnings yield =	EPS / Market Price per share	13250 x 50k / 23000 8k = 28.8k / 8k = 360% / 8k	25250 x 50k / 23000 12k =54.89k / 12k 457% / 12k
(vii) Price earning ratio =	MPS / EPS	13250 X 50K / 23000 / 8K = 28.8K	25250 X 50 / 23000 / 12K =54.89K

RATIO	FORMULAE	2016	2015
OR	$^1/_{EY}$	0.28	0.22
		$\frac{1}{360}\%$	$\frac{1}{457}\%$
		0.28	0.22
(Viii) Dividend yield =	$\frac{DPS}{MPS}$	$\frac{6050 \times 50k}{23000}$	$\frac{8550 \times 50k}{23000}$
		8k	12k
		= $\frac{13.15k}{8k}$	$\frac{18.59k}{12k}$
		164 %	155%

b.

REPORT

To: The Board of Directors
Magifera Plc.,
Garden City

From: Financial Accountant

REPORT ON PERFORMANCE, LIQUIDITY AND STABILITY OF MAGIFERA PLC.

The last two years have been challenging for the company. A review of the financial ratios of the company reveals the following:

Performance

The company's performance is on the decline as evidenced by the two ratios below.

(i) Return on Capital Employed

This is the Primary ratio indicating the efficiency or otherwise of management in employing or utilising the resources available. The more the efficiency of utilisation, the higher the ROCE and vice versa. The company recorded a decrease in return on capital employed from 89.47% in 2015 to 42.69% in 2016. The decline in the return on capital employed can be attributed to the declining revenue which may not be specific to the company but to all companies in Garden City as the city is currently experiencing economic depression and worsening exchange rate coupled with its ageing products of the company.

(ii) Total Assets Turnover

The ratio indicates the efficiency in utilisation of assets to generate revenue. The company recorded a total assets turnover of 1.49 times in 2015 but decreased to 1.04 times in 2016. This is an indication that in 2016 the company did not utilize its assets as efficiently as it did in 2015. This decrease in the efficiency of the utilization of assets is also due to the challenges stated in return on capital employed above.

Liquidity

The company's liquidity worsened between 2015 and 2016.

(iii) Quick Ratio

The ratio indicates the liquidity of an entity by measuring the relative amount of cash and other near liquid assets available to meet current liabilities. Thus, it is a relatively strong indicator of lLiquidity. The quick ratio of the company which is below the universal norm of 1 : 1 in 2015 and 2016 is deteriorating. It decreased from 0.71: 1 in 2015 to 0.55: 1 in 2016.

(iv) Fixed Interest Cover

This ratio is an indicator of the long term health of an entity in that it measures the number of times fixed interest is covered by the profit before deducting the fixed interest

The higher the fixed interest cover, the higher the long term solvency of an entity.

The decline by half of this ratio from 34 times in the preceding year to 18 times in the current year (2016) is an indication of the precarious nature of Magifera long term solvency.

Stability

(v) Debt Equity Ratio

This ratio also indicates an entity's long term solvency by measuring the extent of cover for external liabilities. The company's ratio of debt to equity decreased from 43.94% in 2015 to 31.09% in 2016. The ratio for both years indicates that the company has a reasonable gearing.

In conclusion the performance, liquidity and stability of the company deteriorated from 2015 to 2016.

Thank you

Yours faithfully

Financial Accountant

MARKING GUIDE

		Marks	Marks
a)	Calculation of the following ratios:		
	- Return on Capital Employed	$1^1/_2$	
	- Total Asset Turnover	$1^1/_2$	
	- Quick Ratio	$1^1/_2$	
	- Debt/Equity Ratio	$1^1/_2$	
	- Fixed Interest Cover	$1^1/_2$	
	- Earnings Yield	$1^1/_2$	
	- Price Earnings Ratio	$1^1/_2$	
	- Dividend Yield	$1^1/_2$	12
b)	Report to the Board of Directors		
	- Presentation in report format and opening comment	1	
	- Stating the correct meaning and comment on the trend of the following ratios in the report on the performance, liquidity and stability of the company:		
	- Return on capital employed	1	
	- Total Asset Turnover	1	
	- Quick Ratio	1	
	- Fixed interest cover	1	
	- Debt Equity Ratio	1	
	- Conclusion of the report	1	
	- Closing/signature	1	8
	- Total marks		20

EXAMINER'S REPORT

The question tests candidate's knowledge of ratio analysis and interpretation of financial statements. Candidates are required to calculate eight (8) different ratios and to write a formal technical report to the Board of Directors concerning the performance, liquidity and stability of the company based on some computed ratios.
Over 90% of the candidates attempted the question and their performance was very good.
Candidates are advised to keep up the performance.

SOLUTION 4

a. **PERFECT WORLD PLC**

STATEMENT OF CASHFLOWS FOR THE YEAR ENDED 31 MARCH, 2016

CASHFLOWS FROM OPERATING ACTIVITIES	**₦'m**	**₦'m**
Net Profit before Tax	4,725	
Adjustment for:		
Depreciation	4,365	
Interest Expenses	1,125	
	10,215	
Changes in Working Capital:		
Decrease in Inventories (6,750 – 7,200)	450	
Increase in Trade Receivables (9,900-8,100)	(1,800)	
Increase in Trade Payables (5,625 – 4,905)	720	
	9,585	
Interest Paid	(1,125)	
Income Tax Paid (w2)	(945)	
Net Cashflow from Operating Activities		7,515
CASHFLOWS FROM INVESTING ACTIVITIES		
Purchase of Property, Plant & Equipment (w1)		(3,915)
CASHFLOWS FROM FINANCING ACTIVITIES		
Payment of Finance Lease Liabilities (w3)	(2,025)	
Dividend Paid	(1,350)	(3,375)
Net Increase in Cash and Cash Equivalents		225
Cash and Cash Equivalents at beginning of the year		(922)
Cash and Cash Equivalents at the end of the year		(697)

WORKINGS

W1 **PROPERTY, PLANT AND EQUIPMENT(PPE)**

	₦'m		₦'m
B/d – Balance	16,650		
		Depreciation	4,365
Additions	2,700		
Cash/Bank	* 3,915		
		c/d Balance	18,900
	23,265		23,265

W2 **INCOME TAX PAYABLE**

	₦'m		₦'m
		B/d – DT	3,825
Cash/Bank (Paid)	* 945	- CT	923
		P & L	2,025
C/d – DT	4,815		
- CT	1,013		
	6,773		6,773

W3 **FINANCE LEASE LIABILITIES**

	₦'m		₦'m
Cash/Bank (Paid)	* 2,025	B/d > 1 year	5,400
		< 1 year	2,025
< 1 year	2,250	PPE	2,700
C/d > 1 year	5,850		
	10,125		10,125

b.

MEMO

To: Director of Perfect World Plc

From: Accountant

Date: November, 2016

Subject: Major Benefits to the Users of Financial Statement from the Publication of Statement of Cashflows

The Users of financial statements can be basically divided into the following groups:

(i) Shareholders
(ii) Management
(iii) Creditors and Lenders
(iv) Employer

The need of the groups are not identical and hence not all benefits listed below will be applicable to all users.

(i) Statement of Cashflows direct attention to the survival of the entity which depends on its ability to generate cash.

(ii) Statement of Cashflows indicate the ability of an entity to repay its debts when due.

(iii) Statement of Cashflow give information which can be used in decision making and stewardship process

(iv) They are more easily understood than statement of profit or loss that depends on accounting conventions and concepts.

(v) It is useful in assessing the ability of the entity to generate cash and cash equivalents.

(vi) A statement of Cashflows when used in conjunction with the rest of the financial statements provides information about liquidity and insolvency of an entity.

(vii) A statement of cashflows provides information that enables users to evaluate the changes in net assets of an entity, its financial structure and its ability to effect the amount, timing and certainty of cashflow.

(viii) It enhances the comparability of the reporting of operating performance by different entities because it eliminates the effect of using different accounting treatment for the same transaction and event.

(ix) It is also useful in checking the accuracy of past assessment of future cashflows and in examining the relationship between profitability and net cashflows

(x) A statement of cashflows provides information that helps users to evaluate changes in the net assets of an entity and its financial structure (including its liquidity and solvency)

Marking Guide

		Marks	Marks
A	Preparation of statement of cashflows:		
	- Determination of cashflows from operating activities	6	
	- Determination of cashflows from investing activities	3	
	- Determination of cashflows from financing activities	4	
	- Stating the cash and cash equivalents	1	14
b.	Memo to the Director of Perfect World Plc:		
	- Presentation in memo format	1	
	- Correctly stating any five benefits to users of financial statement associated with the publication of statement of cashflows at 1 mark each	5	6
	Total Marks		20

EXAMINER'S REPORT

The question tests candidates' ability to prepare statement of cashflows using indirect method and the benefits that users of published financial statements would derive from the inclusion of statement of cashflows in the published financial statements.

About 85% of the candidates attempted the question and performance was above average. The commonest pitfall was the inability of the candidates to clearly state the benefits to be derived from the inclusion of the statement of cashflows into published financial statements. Also some candidates could not present the cashflow strictly in accordance with format stipulated by IAS 7 on statement of cashflow

Candidates are advised to familiarise themselves with the presentation of statement of cashflows in Annual Reports of Companies while also ensuring that all relevant accounting standards are applied in the presentation of their solution to the Institute's examination questions.

SOLUTION 5

(a) **GRANT RELATED TO ASSETS**

Grant related to assets is for purchase or construction of long-term assets. Conditions may be attached to the grant, specifying the type of asset that should be purchased with the grant or the location of the assets or the period in which they are to be acquired or held. For grant related to assets, IAS 20 allow two methods for accounting for it as follows:

Method 1 –Deduct grant from the cost of the related assets. The asset is included in the statement of financial position as cost minus the grant while the Net amount is depreciated over the useful life of the assets.

Method 2 – Treat the grant as deferred income and recognize it as income on a systematic basis over the useful life of the assets.

GRANT RELATED TO INCOME

This is any other government grants, other than grant related to assets. For grant related to income. IAS 20 states that the 'INCOME APPROACH' should be used and the grant should be taken to income over the periods necessary to match the grant with the cost that the grant is intended to compensate. IAS 20 allows two (2) methods as follows:

Method 1 –Include the grant for the period as other income for inclusion in profit or loss for the period.

Method 2 – Deduct the grant for the period from the related expenses.

(b) **TYPE OF GRANT**

The grant that Prospect Nig. Plc obtained is 'AN ASSET RELATED GRANT'.

- This is because the grant obtained is used for Investment project to construct a plant.
- The employment condition is just an additional condition to prevent replacement of labour by capital.

Method 1 - STATEMENT OF FINANCIAL POSITION

	2015	2014	2013
	₦'000	₦'000	₦'000
Plant (900,000 – 100,000)	800,000	800,000	800,000
Accumulated Depreciation (800,000 ÷ 20)	(120,000)	(80,000)	(40,000)
	680,000	720,000	760,000

STATEMENT OF PROFIT OR LOSS

Depreciation charged (800,000 ÷ 20)	40,000	40,000	40,000

(ii) **USING METHOD 2 – STATEMENT OF FINANCIAL POSITION**

	2015	2014	2013
Property, Plant and Equipment	₦'000	₦'000	₦'000
Plant (Cost)	900,000	900,000	900,000
Depreciation (Accum.)	(135,000)	(90,000)	(45,000)
	765,000	810,000	855,000
Current Liabilities			
Deferred Income	5,000	5,000	5,000
Non-Current Liabilities			
Deferred Income	80,000	85,000	90,000
Statement of Profit or Loss			
Expenses			
Depreciation (900,000 ÷ 20)	45,000	45,000	45,000
Income			
Government Grant Income (100,000 ÷ 20)	(5,000)	(5,000)	(5,000)

Marking Guide		Marks	Marks
ai)	Explanation of grant related to Asset	1	
	Treatment of Grant related to Asset	1	
ii.	Explanation of Grant related to Income	1	
	Treatment of Grant related to Income	1	4
bi.	Stating the correct type of Grant	1	
	Giving two reasons for the type of Grant	2	
			3
ii.	Disclosure of Asset and grant in the financial statements Method – two		
	Statement of financial position	$2^1/_2$	
	Statement of profit or loss	2	
	Method – one		
	Statement of financial position	$2^1/_2$	
	Statement of profit or loss	1	8
	Total marks		15

EXAMINER'S REPORT

The question tests candidates' knowledge of the provisions of IAS 20 on Accounting for Government Grants and Disclosure of Government Assistance.

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

Most of the candidates that attempted the question displayed lack of understanding of the provision of IAS 20, as they could not explain the term grant related to Assets and Grant related to Income.

Similarly, only about 10% of the candidates that attempted the question could reflect the effect of the grants in the Statement of Financial Position and Profit or loss for all the relevant years.

Candidates are therefore advised to ensure that they pay adequate attention to all accounting standards relevant at this level of the Institute's examination for better performance in future.

SOLUTION 6

(ai) The two types of Leases under IAS 17 are:

- Operating lease
- Finance or capital lease

(aii) DIFFERENCE BETWEEN OPERATING LEASE AND FINANCE LEASE

OPERATING LEASE	FINANCE LEASE
(1) Ownership is not transferred at the end of the lease period.	Ownership is transferred at the end of the lease period
(2) No bargain purchase option in the contract	Bargain purchase option exist in the contract
(3) The present value of the minimum lease payment does not equal the asset fair value	The present value of the minimum lease payment substantially equal to the asset fair value
(4) The asset can be leased out again after the expiration of the initial lease period.	The assets cannot be leased out again after the expiration of the initial lease period (The assets would have been used for substantial part of the useful life)
(5) Lessor maintains and is responsible for the upkeep of the assets	The Lessee maintains and upkeeps the assets
(6) Lease rentals is expensed	Lease rental is used to reduce Lease obligation while some portion is expensed as finance cost.
(7) No value of asset is recognised in the books of the lease and no depreciation nor impairment of the asset is charged.	Value of asset is recognised as an asset and depreciation/ impairment of the asset are charged.

b.(i)

NET PRESENT VALUE

Year	Cashflow	Discount favour @22%	Present Value
	₦000		**₦000**
0	(150,000)	1	(150,000)
1	(150,000)	0.8197	(122,955)
2	(150,000)	0.6719	(100,785)
3	(150,000)	0.5507	(82,605)
4	(150,000)	0.4514	(67,710)
5	(150,000)	0.3700	(55,500)
Net Present Value			**(579,555)**

OR

Year	Cashflow	Discount favour @22%	Present Value
	₦000		**₦000**
0 – 5	(150,000)	3.8637	(579,555)

(ii) This is an operating lease because of the following reasons:

- Under the lease arrangement, Ogoni leasing Company Ltd, the lessor, will bear the upkeep (maintenance) expenses on the plant and equipment Ijaw oil Plc will lease the plant and equipment for six years which is not a substantial part of the asset life of 20 years.
- Under the lease arrangement, the present value of the lease rental of N579,555,000 is less than and not equal to the fair value of N900,000,000,000 of the plant and equipment.
- The asset can be leased out again after the expiration of the initial six years lease period.

(iii) The lease rental paid by Ijaw Oil Plc shall be expensed in the income statement of Ijaw Oil Plc as operating expenses while the outstanding lease rentals will be reported as current liability in the statement of financial position.

MARKING GUIDE

			Marks	Marks
a.	-	Identification of 2 types of lease at 1 mark each	2	
	-	Stating five differences between operating and finance lease at 1 mark each	5	7
bi.		Calculation of present value of lease rentals:		
	-	Cash flows	1	
	-	Correct discount factor	1	
	-	Correct present value	1	
	-	Correct total lease rentals	1	
				4
Ii	-	Correct identification of the kind of lease	1	
	-	Stating of two(2) correct justifications of the lease identified at 1 mark each	2	
				3
Iii	-	Correct advice of the treatment of the lease rental in profit or loss account	½	
	-	Correct treatment in statement of financial position	½	1
		Total Marks		15

EXAMINER'S REPORT

The question tests candidates' knowledge and understanding of accounting for leases – IAS 17. The candidates are required in Part (a) to identify and differentiate between the two kinds of leases and in Part (b) calculate the present value of lease rental of equipment.

About 85% of the candidates attempted the question and their performance was good as over 70% of them obtained more than 50% of the marks allocated to the question.

Candidates are advised to study all the accounting standards listed in the syllabus for this examination for better performance in future.

SOLUTION 7

CALCULATION OF PROFIT AS AT 31 DECEMBER, 2015

	Option A	Option B
	₦'m	₦'m
Contract Revenue (w4)	7,767	8,213
Contract Cost to Date (w1)	(6,325)	(6,325)
Profit recognised to date	1,442	1,888

WORKINGS

W1	**Contract Cost**	₦'m
	Material	3,500
	Labour	2,000
	Operating Overhead	375
	Sub-Contractors	450
		6,325

W2	**Contract Cost (Revised estimated Total Cost)**	₦'m
	Original Estimate	23,750
	Materials	450
	Labour	750
	Operating Overheads	(75)
	Variation	1,875
		26,750

W3	**Contract Revenue (Revised Estimate)**	₦'m
	Original Estimate	30,000
	Labour (Wage increase added to Contract Price)	600
	Variation	2,250
		32,850

W4		Option A	Option B
		₦'m	₦'m
	Based on Contract Cost in proportion estimated Total Cost: (6,325÷ 26,750 x ₦32,850)	7,767	--
	Based on Work Certified: (25% x ₦32,850)	--	8,213

b. IAS 11: Construction Contract - recognises these methods of determining stage of completion:

i. **Contract cost to date in proportion to estimated total contract costs (The cost basis)**
This estimates the stage of completion by comparing the contract costs incurred to date to the total contract costs expected to be incurred over the life of the contract. This involves estimating the future costs that will be necessary to complete the contract.

ii. **Percentage of work (Sales basis)**
This estimates the stage of completion by comparing the sales value of the work performed to date to the total contract revenue. As a contract progresses, at periodic intervals, an independent expert such as a surveyor may inspect the work, and issue a certificate stating the amount or value of the work done so far. The most recent certificate issued by the independent expert provides a basis for judging the proportion of the contract work that has been completed.

iii. Use the physical proportion of the contract work that has been completed.

MARKING GUIDE

		Marks	Marks
a.	Computation of Revenue under option A	$1^1/_2$	
	- Computation of Revenue under option B	$1^1/_2$	
	- Determination of Contract cost	3	
	- Determination of Revised Estimate of Contract cost	3	
	- Determination of Revised estimate of Contract Revenue	2	
	- Determination of profit recognised to date	1	
			12
b.	- Explanation of two (2) methods recognised by IAS II		
	- Identification of the method	1	
	- Explanation of the method	2	3
	Total marks		15

EXAMINER'S REPORT

The question tests candidates' ability to calculate profit on construction contracts using different methods recognised by IAS 11.

Less than 30% of the candidates attempted the question and performance was below average.

The commonest pitfall was the inability of the candidates to correctly calculate the Revenue of the contract, hence they could not determine the profit using the two options specified by the question.

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

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – NOVEMBER 2016

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

Mr. Adeola has been in the employment of Hope Nigeria Limited for a very long time. Over time, he has risen to the position of Senior Manager. He, however, had a trading business which he was combining with the employment. He ceased trading with effect from December 31, 2014, in order to face his employment fully. The following details are available in respect of Mr. Adeola as regards his incomes:

Trading

(i) The trading results for the recent periods are as follows:

	₦
Year ended August 31, 2012	2,400,000
Year ended August 31, 2013	1,800,000
Year ended August 31, 2014	2,625,000
Period ended December 31, 2014	360,000

(ii) The Capital Allowances for the following Years of Assessment have been agreed as follows:

	₦
2012 Assessment Year	240,000
2013 Assessment Year	180,000
2014 Assessment Year	120,000

(iii) On January 1, 2015, ₦360,000 was received from a debtor whose debt had earlier been written off.

Employment

(i) Mr. Adeola is on a salary of ₦3,600,000 per annum.
(ii) Mr. Adeola was posted to a nearby town and a sum of ₦52,000 was spent by the company in connection with the transfer.

(iii) A motor car was provided for the exclusive use of Mr. Adeola at a cost of ₦7,200,000.
(iv) He is also provided with a domestic staff who is on a salary of ₦600,000 per annum. The domestic staff is a permanent staff of the company.
(v) He also enjoys the provision of assignable luncheon vouchers to the tune of ₦360,000 per annum.

Other Information:

(i) Mr. Adeola has a property on which he derives a gross rent of ₦1,200,000 per annum. A Withholding tax of 10% was deducted before payment.
(ii) He receives interest on fixed deposit of ₦80,000 every year.
(iii) He pays ₦240,000 as annual premium on his life assurance policy.
(iv) He contributes ₦180,000 and ₦150,000 as National Housing Fund and National Health Insurance Scheme respectively.
(v) He contributes ₦596,250 annually to Pension Fund Contribution.

You are required to:

a. Compute the tax payable by Mr. Adeola in respect of 2014 Year of Assessment. (Ignore the penultimate year) (25 Marks)

Show all workings

b. Explain the provisions of the law on cessation of business. (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

The present economic recession in Nigeria has called for the review of the activities of every State Board of Internal Revenue. One State Government from the South West recently called for the forum of Tax Consultants. As one of the consultants, **you are required to explain the following:**

a. Composition of the State Board of Internal Revenue and what constitutes a quorum? (7 Marks)

b. Any **THREE** functions of the State Board of Internal Revenue (6 Marks)

c. Any **SEVEN** taxes collectible by a State Government. (7 Marks)

(Total 20 Marks)

QUESTION 3

Johnson, Seyi and Bernard based in Kaduna State have run the firm, Johnson, Seyi and Bernard (Estate Managers) for several years. The partnership agreement provides the following:

		₦
(i)	**Salary paid to partners:**	
	Johnson	288,000
	Seyi	576,000
	Bernard	1,152,000
(ii)	Profit sharing ratio:	
	Johnson	2
	Seyi	3
	Bernard	5

In April 2015, there was a decision to review the partnership agreement. Messrs Johnson, Seyi and Bernard were unable to find worthy successors to take over as partners. Rather than review the partnership agreement, they agreed to convert the partnership into a limited liability company.

In view of this, a firm of legal practitioners was contacted to incorporate a new company, JSB Consultants Limited. The Authorised Share Capital of the proposed company was agreed at ₦50,000,000, made up of 50,000,000 Ordinary Shares of ₦1.00 each.

The shareholding structure is as follows:

Johnson	20%
Seyi	30%
Bernard	50%

The Certificate of Incorporation was approved by the Registrar - General of the Corporate Affairs Commission, Abuja, on July 1, 2015. The Certificate of Incorporation was dated July 15, 2015. The company commenced business on September 1, 2015.

The cost of incorporation includes:

		₦
Payment for Stamp Duty	–	400,000
Professional fee for incorporation	–	250,000
Corporate Affairs Commissions registration fee	–	500,000
Miscellaneous cost of incorporation	–	200,000
		1,350,000

The financial results for the year ended December 31, 2015, are as follows:

	₦	₦
Revenue		20,000,000
Less:		
Cost of incorporation	1,350,000	
Transport and travelling	675,000	
Medical	600,000	
Hotel and accommodation	625,000	
Audit and accountancy	550,000	
Postages and telephone	750,000	
Salaries:		
Johnson	1,440,000	
Seyi	2,880,000	
Bernard	5,760,000	14,630,000
Net Profit		5,370,000

As the Tax Consultant, **you are required** to write a report to Messrs Johnson, Seyi and Bernard highlighting:

a. Tax implications of the decision to convert to a limited liability company, limiting yourself to the details provided. (11 Marks)

b. Your comment on the breakdown of the cost of incorporation of ₦1,350,000 and the tax implication of each item. (9 Marks)

(Total 20 Marks)

QUESTION 4

Mr. Drury is a sole proprietor who has approached you regarding the assessment given to him by the tax authority. He has registered his intention to object to the assessment and needs your professional advice.

You are required to explain briefly the following:

a. Grounds for a valid objection to a tax assessment (3 Marks)

b. The composition of the Joint Tax Board (2 Marks)

c. Functions of the Joint Tax Board (5 Marks)

d. Taxes that are exclusively collectible by the Federal Inland Revenue Service (5 Marks)

e. Taxes that are collectible by both the Federal Inland Revenue Service and State Internal Revenue Service. (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

(a) i. Discuss briefly the administration of Stamp Duties in Nigeria. (5 Marks)

ii. List and explain any **FIVE** instruments that are chargeable to Stamp Duties. (5 Marks)

(b) Olamide Limited is a textile company based in Abuja. The company sold its vatable products to a wholesaler, Qudus Enterprises, for ₦1,800,000. The wholesaler in turn sold the products to a retailer, Mr Lekan, for ₦2,500,000, who finally sold to consumers for ₦5,000,000. Assume there was no closing inventory at each stage of the transactions.

Required:

Compute total VAT payable to the Federal Internal Revenue Service. (5 Marks)

(TOTAL 15 MARKS)

QUESTION 6

John Bull Nigeria Limited, a manufacturing company, commenced business on August 1, 2011 and prepared accounts to July 31, of every year. For the purpose of the business, it incurred qualifying capital expenditure as follows:

Date of purchase	**Qualifying Expenditure**	**Amount (₦)**
July 1, 2011	Plant and Equipment	500,000
October 31, 2011	Motor Vehicle	300,000
December 13, 2011	Factory Building	400,000
January 15, 2012	Motor Vehicle	1,000,000
June 1, 2012	Plant and Equipment	200,000

The following disposals were made:

(i) Part of equipment bought for ₦200,000 on July 1, 2010 was sold for ₦50,000 on December 31, 2013.

(ii) Motor vehicle bought for ₦300,000 on October 31, 2011, was sold for ₦400,000 on December 31, 2012.

Required:

a. Compute Capital Allowances of John Bull Nigeria Limited for the first **FIVE** Years of Assessment. (11 Marks)

b. Place the assets in the relevant Years of Assessment for the purpose of initial allowance. (2 Marks)

c. Compute the Balancing Charge or Allowance in relation to assets disposed. (2 Marks)

(15 Marks)

QUESTION 7

Trevor Optimal Nigeria Limited has been operating in the oil and gas sector in Nigeria since January 1, 2005. The company is engaged in the importation and sale of oil tools.

With the introduction of the Reverse Charge Mechanism in Nigeria, the company has accumulated Input VAT since 2008 and as at December 31, 2015, the amount stood at ₦6,000,000. The Input VAT resulted from importation of oil tools which the company sells to oil companies.

The company's Output VAT is withheld by its customers at source and remitted to Federal Inland Revenue Service. This practice has left the company with huge input tax without any output tax to offset it.

The Chief Executive Officer has expressed concern over this build up of Input VAT and has invited you for a meeting to discuss the issue. The CEO reasoned that as long as the company continues in its line of business, the Input VAT will continue to grow and has requested you to advise the company.

Required:

a. Provide a brief information for the Chief Executive Officer on why the company is in the current position. (5 Marks)

b. Advise the Chief Executive Officer on the best action to follow in accordance with the law. (5 Marks)

c. State the steps required by FIRS to grant tax refund to a taxpayer. (5 Marks)

(Total 15 Marks)

SOLUTIONS

SOLUTION 1

MR. ADEOLA

a) COMPUTATION OF TAX PAYABLE FOR 2014 YEAR OF ASSESESSMENT

		₦	₦
Trading Profit			2,350,000
Employment Income			4,320,000
Rental Income			1,200,000
Interest on Fixed Deposit (₦80,000 ÷ 0.9)			88,889
Gross Income			7,958,889
Consolidated Relief Allowance (₦200,000 + 20% of ₦7,958,889)		1,791,778	
Tax Exempt Items:			
i)	Pension Fund Contribution	596,250	
ii)	Insurance Premium	240,000	
iii)	National Housing Fund Contribution	180,000	
iv)	National Health Insurance Contribution	150,000	
			(2,958,028)
Chargeable Income			5,000,861

Tax Computation

					₦
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	₦1,600,000	@	21%		336,000
Balance	₦1,800,861	@	24%		432,207
	₦5,000,861				
Tax Liability					992,207
Withholding Tax on:					
Interest on Fixed Deposit				8,889	
Rent-(10% of ₦1,200,000)				120,000	128,889)
Final Tax Liability					863,318

Workings

Working 1

Trading Profits:	**₦**
Profit (i) $^{8}/_{12}$ x ₦2,625,000	1,750,000
(ii) 1/9/14 – 31/12/14	360,000
	2,110,000
Add: Bad debts recovered	360,000
	2,470,000
Capital allowances	(120,000)
	2,350,000

Working 2

Employment Income:

	₦
Salary	3,600,000
Benefits- in- kind:	
Provision of car (5% of N7,200,000)	360,000
Luncheon Voucher	360,000
	4,320,000

(b) Where a company permanently ceases to carry on a trade or business (or in the case of a company other than a Nigerian company, permanently ceases to carry on a trade or business in Nigeria) its Assessable Profits therefrom shall be:-

i. As regards the Year of Assessment in which the cessation occurs, the amount of the profits of that year.

ii. As regards the Year of Assessment preceding that in which the cessation occurs, the amount of the profits on preceding year basis or the amount of the profits of the Year of Assessment, whichever is higher.

(a)	Marking Guide	Marks	Marks
	Incomes		
	Trading Profit	2	
	Employment Income	2	
	Rental Income	1	
	Interest on fixed deposit	1	8
	Gross Income	1	7
	Reliefs		
	Consolidated Relief Allowance	1	
	a. Pension Fund Contribution($7^1/_2$% of ₦7,950,000)	1	
	b. Insurance Premium	1	
	c. National Housing Fund Contribution	1	
	d. National Health Insurance Contribution	1	
	Total Reliefs	1	
	Chargeable Income	1	7
	Tax Computation		
	7%	1	
	11%	1	
	15%	1	
	19%	1	
	21%	1	
	24%	1	
	Tax liability	1	7
	Withholding Tax on:		
	Interest on Fixed Deposit	1	
	Rent	1	
	Total Withholding Tax	1	
	Final tax liability	1	11
			25
	Year of cessation	$2^1/_2$	
	Penultimate Year	$2^1/_2$	5
			30

EXAMINER'S REPORT

The question tests candidates' knowledge of the taxation of individuals in the areas of trading, employment and investments.

Most of the candidates attempted the question and performance was above average.

The commonest pitfall was the inability of candidates to arrive at the trading profit in the year of cessation.

Candidates are advised to read the Study Texts and Pathfinders of the Institute to ensure a good performance in future.

SOLUTION 2

a) **State Board of Internal Revenue**

Section 87 of PITA 2004 (as amended), established the State Board of Internal Revenue whose operational arm is known as the State Internal Revenue Service (SIRS).

Composition

The State Board of Internal Revenue for each State of the Federation comprises:

i. The Executive Head of the State Internal Revenue Service as Chairman;
ii. The Directors and Heads of Departments within the State Internal Revenue Service;
iii. A Director from the State Ministry of Finance;
iv. The Legal Adviser to the State Internal Revenue Service;
v. Three other persons nominated by the Commissioner for Finance, on their personal merit; and
vi. The Secretary of the State Internal Revenue Service, who shall be an ex-officio member.

QUORUM

Any five members of the State Board of Internal Revenue of whom one shall be the Chairman or a Director, shall constitute a quorum [Section 87(3)].

b) **Functions of the State Board of Internal Revenue**

The State Board of Internal Revenue shall be responsible for:

i. Ensuring the effectiveness and optimum collection of all taxes and penalties due to the Government under the relevant laws;

ii. Doing all such things as may be deemed necessary and expedient for the assessment and collection of the tax and shall account for all sums so collected, in a manner to be prescribed by the Commissioner;

iii. Making recommendations, where appropriate, to the Joint Tax Board on tax policies, tax reforms, tax legislation, tax treaties and exemptions as may be required from time to time;

iv. Generally controlling, the management of the State Service on matters of policy matters, subject to the provisions of the law setting up the State Internal Revenue Service; and

v. Appointing, promoting, transferring and imposing discipline on employees of the State Internal Revenue Service.

c) **Taxes and Levies Collectible by State Governments are:**

i. Pay–As-You-Earn of individuals within the State;
ii. Withholding Tax on individuals;
iii. Capital Gains Tax on individuals;
iv. Stamp Duties on Investments executed by individuals, pool betting, lotteries, gaming and Casino taxes;
v. Road Taxes;
vi. Business Premises registration fees, for:
   - Urban areas (as defined by each State)
     ₦10,000 (maximum) for registration
     ₦5,000 for annual renewal of registration
   - Rural areas (as defined by each State)
     ₦2,000 for registration
     ₦1,000 for annual renewal of registration

vii. Development levy (individuals only),not more than ₦100 per annum on all taxable individuals;
viii. Naming of street registration fees in a State capital;
ix. Right of occupancy fees on lands owned by the State in urban cities; and
x. Market taxes and levies where State finance is invested.

MARKING GUIDE

		Marks	Marks
(a)	Composition	6	
	Quorum	1	7
(b)	Functions of SBIR(2 marks for each for any 3 points)		6
(c)	Taxes and Levies (1 mark for each point raised subject to a maximum of 7 points)		7
			20

EXAMINER'S REPORT

The question tests candidates' understanding of the provisions of tax administration in Nigeria.

Almost all the candidates attempted the question and performance was above average.

The commonest pitfall was the inability of the candidates to list correctly taxes that are collectible by the State Governments.

Candidates are advised to cover adequately the Institute's syllabus before sitting for any examination.

SOLUTION 3

The Managing Partner
Johnson, Seyi and Bernard (Estate Managers)
3, Ahmed Street
Lagos

Dear Sir,

RE: CONVERSION OF JOHNSON, SEYI AND BERNARD (ESTATE MANAGERS) TO JSB CONSULTANTS LIMITED

We write in response to your recent decision to convert your partnership business into a limited liability company.

We wish to comment as follows:-

(a) TAX IMPLICATIONS OF CONVERSION

(i) The partnership ceased business on August 31, 2015, therefore, the income of the new company will not be subject to Personal Income Tax.

(ii) Commencement rules will apply from September 1, 2015, when JSB Consultants Limited commenced business.

(iii) The incorporation expenses shall be applicable only to JSB Consultants Limited though not an allowable expense for tax purposes.

(iv) JSB Consultants Limited will be required to register with the Federal Inland Revenue Service for VAT, EDT, CIT, etc.

(v) The promoters of JSB Consultants Limited shall deduct or (remit Witholding Tax on professional fees paid during incorporation at the rate of 10% if the beneficiary is a limited liability company and 5% if the recipient is an individual or partnership.

(b) TAX IMPLICATIONS OF COST OF INCORPORATION

(i) The total cost of ₦1,350,000 though paid during the partnership period, shall be considered as pre-operational expenses of JSB Consultants Limited.

(ii) The pre-operational expenses when added back to the Net Profit will increase taxable income, thereby increasing tax payable by JSB Consultants Limited.

(iii) ₦1,350,000 charged against revenue of JSB Consultants Limited is not an allowable expense for tax purposes even if spread over a number of years.

We have commented on areas deemed necessary, nevertheless, we are willing to supply additional information if you require any further clarification.

Yours faithfully,
For: Femi Jacobs & Co

O.B. Okpobo
For: Managing Partner

Marking Guide		**Marks**	**Marks**
(a)	Address	1	
	Heading	1	
	Introduction	1	
	Tax implications of conversion(2 marks for each of any 4 points)	8	
			11
(b)	Tax implications of cost of incorporation:		
	Three (3) marks each for 3 points correctly stated(3 x 3)		9
	Total Marks		20

EXAMINER'S REPORT

The question tests candidates' knowledge of the tax implications of converting a partnership to a limited liability company.

Few Candidates attempted the question and performance was very poor.

The commonest pitfall was the complete misunderstanding of the question by the candidates.

Candidates are advised to read ICAN Study Texts and Pathfinders to broaden their knowledge on the conversion of partnerships to limited liability companies.

SOLUTION 4

(a) Grounds for a valid objection to a tax assessment

These include:

i. State the precise grounds of objection;

ii. The objection must be submitted within 30 days of receiving the Notice of Assessment; and

iii. The Notice of objection must be in writing and addressed to the Chairman, Federal Inland Revenue Service or the State Internal Revenue Service.

(b) The Composition of Joint Tax Board (JTB)

The JTB comprises:

i. The Chairman of the Federal Inland Revenue Service Board, who doubles as the Chairman of the Joint Tax Board;

ii. One member from each State, being a person experienced in income tax matters, nominated either by name or office, from time to time, by the Commissioner charged with responsibility for matters relating to income tax of the State in question;

iii. The Secretary, who is not a member of the Board, and is appointed by the Federal Civil Service Commission; and

iv. The Legal Adviser of the FIRS acts as the Legal Adviser to the JTB.

(c) Functions of The Joint Tax Board

The Board shall:

i. Exercise the powers or duties conferred on it by the PITA and other Acts;

ii. Advise the Federal Government on request, in respect of double taxation agreement with any other Country;

iii. Advise the Federal Government, on request, in respect of rates of capital allowances and other taxation matters, having effect throughout Nigeria in respect of any proposed amendment to PITA;

iv. Promote uniformity, both in the application of PITA and in the incidence of tax on individuals throughout Nigeria; and

v. Impose its decisions, on matters of procedure and interpretation of PITA, on any State, for purposes of conforming to agreed procedures of interpretations.

(d) Types of taxes that are exclusively collectible by the Federal Inland Revenue Service.

These are:

(i) Value Added Tax;
(ii) Petroleum Profits Tax;
(iii) Tertiary Education Tax;
(iv) Companies Income Tax;
(v) Withholding Tax from companies;
(vi) Information Technology Tax; and
(vii) Personal Income Tax of members of armed forces, Nigeria Police Force, residents of FCT, staff of the Ministry of External affairs and Non-resident individuals.

(e) Taxes collectible by both FIRS and SBIR

These include:

(i) Capital Gains Tax of Corporate bodies are collectible by the FIRS while that of the individuals resident in States are collectible by the SIRS;

(ii) Stamp Duties on the instruments executed by corporate bodies are collectible by Federal Government while those of individuals are collectible by State Board of Internal Revenue;

(iii) Personal Income Tax of members of the armed forces, Nigeria Police Force, residents of the FCT and staff of the Ministry of External Affairs and Non-resident individuals are to be collected by the Federal Government while others are collectible by States; and

(iv) Withholding Tax.

MARKING GUIDE

		MARKS
a)	Grounds for a valid objection (1 mark each subject to 3 points)	3
b)	Composition of Joint Tax Board ($^1/_2$ mark each subject to 4 points)	2
c)	Functions of the Joint Tax Board (1 mark each subject to 5 points)	5
d)	Taxes collectible by FIRS (1 mark each subject to 5 points)	5
e)	Taxes collectible by FIRS and SBIR($1^1/_4$ mark each subject to 4 points)	5
		20

EXAMINER'S REPORT

This question tests candidates' knowledge of objection to a tax assessment and tax administration.

Most candidates attempted the question but performance was average.

The commonest pitfall was the inability of the candidates to identify the list of taxes collectible by the State Boards of Internal Revenue and the composition of the Joint Tax Board.

Candidates are advised to pay necessary attention to the 'objections and appeals' and tax administration in Nigeria as clearly covered in the syllabus and Study Texts.

SOLUTION 5

a (i) Stamp Duties are managed by the Commissioner of Stamp Duties who may be appointed from within the Service. The duty of a Commissioner may be performed by any one of the Commissioners where there are more than one. An instrument must be sent to the Commissioner of Stamp Duties for adjudication.

The Federal Government is the only competent authority to impose, charge and collect duties on instruments specified in the schedule to the Act, if such instruments relate to the matters executed between a company and an individual group or body of individuals.

State Governments impose, charge, collect Stamp Duties on instruments executed by individuals.

(ii) Instruments subject to Stamp Duties are:

- Lease;
- Contract notes;
- Bills of lading;
- Agreements;
- Duplicate and counterparts;
- Marketable securities;
- Mortgages;
- Notarial Acts;
- Insurance policies;
- Receipts;
- Settlements;
- Share warrants;
- Warrants of goods;
- Appraisement;
- Instrument of apprenticeship;
- Capital of companies;
- Other conveyances;
- Letter of powers of attorney and voting papers;
- Bank notes, bills of exchange and promissory notes; and
- Exchange partition or division;

b.

OLAMIDE LIMITED

COMPUTATION OF VAT PAYABLE TO FEDERAL INLAND REVENUE SERVICE

Description	Sales Value	Input VAT	Output VAT	VAT payable
	₦	₦	₦	₦
Olamide Limited	1,800,000	-	90,000	90,000
Qudus Enterprises	2,500,000	90,000	125,000	35,000
Mr Lekan	5,000,000	125,000	250,000	125,000
Total VAT payable				**250,000**

Marking Guide

			Marks	Marks
(a)	i.	Stamp Duties – Explanation	2	
		Competent authority	2	
		Imposition of Stamp Duties	1	5
	ii.	1 mark for each instrument subject to a maximum of 5 points		5
(b)		½ mark for each correct entry		5
				15

EXAMINER'S REPORT

The question tests candidates' knowledge of the law on Stamp Duties and the calculation of Value Added Tax (VAT) remittable to Federal Inland Revenue Service.

Many candidates did not understand the question and performance was just average. The commonest pitfall was the poor knowledge of the provisions of the Stamp Duties Act.

Candidates are advised to pay attention to the content of ICAN Study Text and the Institute's Pathfinder.

SOLUTION 6

a.

JOHN BULL NIGERIA LIMITED
COMPUTATION OF CAPITAL ALLOWANCES
FOR 2011 TO 2015 YEARS OF ASSESSMENT

	Plant & Machinery	Motor Vehicle	Factory Building	Total Capital Allowance
	%	%	%	
Initial Allowance	50	50	15	
Annual Allowance	25	25	10	
Investment Allowance	10	-	-	
A.Y. 2011	₦	₦	₦	₦
Cost	500,000	300,000	400,000	
Initial Allowance	(250,000)	(150,000)	(60,000)	460,000
Annual Allowance	(26,042)	(15,625)	(14,167)	55,834
Investment Allowance	(50,000)	0	0	50,000
W.D.V. c/f to A.Y. 2012	223,958	134,375	325,833	565,834
A.Y. 2012				
Cost - Additions	200,000	1,000,000	(0)	
Investment Allowance	(20,000)	(0)	(0)	20,000
Initial allowance	(100,000)	(500,000)	(0)	600,000
Annual allowance. Old	(62,500)	(37,500)	(34,000)	134,000
Annual allowance. New	(25,000)	(125,000)	(0)	150,000
W.D.V. c/f to A.Y. 2013	236,458	471,875	291,833	904,000
A.Y 2013				
Annual allowance	(87,500)	(162,500)	(34,000)	284,000
W.D.V. c/f to A.Y. 2014	148,958	309,375	257,833	
A.Y 2014				
Annual Allowance	(87,500)	(125,000)	(34,000)	246,500
Disposals	(0)	(59,375)	(0)	
W.D.V. c/f to A.Y. 2015	61,458	125,000	223,833	
A.Y 2015				
Disposals	(14,583)	0	0	
	(21,865)	(0)	(0)	21,865
Annual allowance - Old	(25,000)			183,990
- New		(124,990)	(34,000)	
W.D.V. c/f to A.Y. 2016	10	10	189,833	205,855

b. PLACEMENT OF ASSETS IN RELEVANT YEARS OF ASSESSMENT

Year of Assessment	Basis Periods	Capital Allowances
2011	1/8/11 – 31/12/11	1/8/11 – 31/12/11
2012	1/8/11 – 31/7/12	1/1/12 – 31/7/12
2013	1/8/11 – 31/7/12	-
2014	1/8/12 – 31/7/13	1/8/12 – 31/7/13
2015	1/8/13 – 31/7/14	1/7/13 – 31/7/14

ALLOCATION OF QUALIFYING EXPENDITURE

Date of Purchase	Qualifying Expenditure	Amount ₦	Year of Assessment
1/ 07/2011	Plant and Equip	500,000	2011
31/10/11	Motor Vehicle	300,000	2011
15/12/11	Factory Building	400,000	2011
15/01/12	Motor Vehicle	1,000,000	2012
01/06/12	Plant and Equip	200,000	2012

c. COMPUTATION OF BALANCING CHARGE/ALLOWANCE

Date Of Disposal	Qualifying Capital Expenditure	Year of Assessment	Cost ₦
31/12/13	Equipment	2015	
31/12/12	Motor Vehicle	2014	

Capital allowances claimed on equipment disposed of:

I.A/A.A.	50/25
A.Y 2011	₦
Cost	200,000
I.A	(100,000)
A.A (5 Months)	(10,417)
W.D.V. c/f to A.Y. 2012	**89,583**
A.Y 2012	
A.A	(25,000)
W.D.V. c/f to A.Y. 2013	64,583
A.Y 2013	
A.A	(25,000)
W.D.V. c/f to A.Y. 2014	39,583

A.Y 2014	
A.A	(25,000)
W.D.V. c/f to A.Y. 2015	14,583
A.Y 2015	
S.P	(50,000)
Balancing Charge	35,417

There is no restriction on the balancing charge of ₦35,417 as this amount is not up to the total allowances of ₦185,417 already claimed.

Capital allowances claimed on Motor Vehicle disposed of

I.A./A.A.	50/25
A.Y. 2011	₦
Cost	300,000
I.A 50%	(150,000)
A.A (5 Months)	(15,625)
W.D.V. c/f to A.Y. 2012	134,375
A.Y. 2012	
A.A	(37,500)
W.D.V. c/f to A.Y. 2013	96,875
A.Y. 2013	
A.A	(37,500)
W.D.V. c/f to A.Y. 2014	(59,375)
A.Y. 2014	
S.P	(400,000)
Balancing Charge	340,625

Balancing charge is restricted to the total Capital allowances claimed of ₦240,625.

	Marking Guide	Marks
(a)	Computation of Capital allowances (44 ticks at ¼ per tick)	11
(b)	Placement of assets in relevant Year of Assessment (10 ticks @ ¼ mark per tick subject to a maximum of 8 ticks)	2
(c)	Computation of Balancing Charge/Allowance (22 ticks @ $^1/_8$ per tick subject to a maximum of 16 ticks)	2
		15

EXAMINER'S REPORT

The question tests candidates' knowledge of the computation of capital allowances.

Candidates showed poor understanding of the calculation and presentation of capital allowances.
The commonest pitfall was the area of placing chargeable assets in the relevant years of assessment.

Candidates are advised to be conversant with the computation of capital allowances as it is a frequent examination area.

SOLUTION 7

November 27, 2016

The Chief Executive Officer
Trevor Optimal Nigeria Limited
27, Ajeromi Street
Lagos State

Dear Sir,

RE: EXCESS INPUT VAT

We refer to our meeting and your subsequent request for our advice on the above subject.

We wish to comment as follows:

a. REASON FOR THE CURRENT SITUATION

The reason why the company is in the current situation is due to the deduction of Output VAT at source by the company's customers. This practice is otherwise known as "Reverse Charge".

Reverse Charge is a provision under section 10 (2) of the VAT Act 2004 as amended (also see FIRS Information Circular number 02/2007) which obliges all companies operating in the Oil and Gas (O&G) sector in Nigeria to deduct VAT at source from payments due to vendors and remit same to the FIRS.

The practice, however, inhibits the ability of companies that rendered service or supplied goods to an O&G company to offset Input VAT arising from their direct costs of operations as is the case with your organization.

b. BEST ACTION TO FOLLOW

The best action to follow whenever a company has an overpaid tax or excess Input VAT is to apply in writing to the FIRS for a refund of the excess Input VAT.

According to section 16 (1)(b), if the input tax exceeds the output tax, a taxpayer shall be entitled to a refund of the excess tax from the FIRS on production of such documents as the Service may, from time to time, require.
Also, section 23 of the FIRS (Establishment) Act 2007 provides for a refund of excess tax to a taxpayer within 90 days after proper tax audit by the FIRS.

c. STEPS REQUIRED BY THE FIRS TO GRANT TAX REFUND

(i) Taxpayer reviews its books to determine the amount of claim and applies for refund.

(ii) FIRS reviews the application and propose a date for a special audit

(iii) FIRS carries out field audit and report accordingly.

(iv) Reconciliation meetings are held between the taxpayer and FIRS to close out all issues raised.

(v) IRS confirms the Input VAT refundable after all adjustments for any incorrect returns in the past.

(vi) The company applies for the refund of the adjusted and verified amount.

(vii) According to the FIRS, the refund shall be made within 90 days.

We have commented on areas deemed necessary, nevertheless, we shall be willing to supply additional information if required.

Yours faithfully
For: XYZ & Co

A. D. James
For: Managing Partner

Marking Guide

		Marks	Marks
(a)	Reasons for current situation	$1^1/_2$	
	Provision of the law	2	
	Practice	$\underline{1^1/_2}$	
			5
(b)	Application in writing	1	
	Provision of the law	2	
	Refund of excess tax	$\underline{2}$	5
(c)	Steps required to grant tax refund		
	(1 mark for each point subject to a maximum of 5 points)		5
			15

EXAMINER'S REPORT

The question tests the candidates' knowledge of Value Added Tax where there is Reverse Charge Mechanism.

Most of the candidates who attempted the question did not show a good understanding of its requirements and performance was poor.

The commonest pitfall was the inability of the candidates to distinguish between the Input and Output VAT.

Candidates are advised to have a good understanding of situations where there is a Reverse Charge Mechanism.

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%

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – NOVEMBER 2016

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

1. Hicenta Limited makes three products Soyi, Milco and Yoghurt. All the three products must be offered for sale each month in order to provide a complete market service. The products are fragile and their quality deteriorates rapidly shortly after production.

The products are produced on two types of machine and worked on by a single grade of direct labour. Fifty direct employees are paid ₦80 per hour for a guaranteed minimum of 160 hours per month.

All the products are first pasteurised on a machine type A and then finished and sealed on a machine type B.

The machine hour requirements for each of the products are as follows:

	Soyi	Milco	Yoghurt
	Hours per unit	Hours per unit	Hours per unit
Machine type A	1.5	4.5	3.0
Machine type B	1.0	2.5	2.0

The capacity of the available machines type A and B are 6,000 hours and 5,000 hours per month respectively. Details of the selling prices, unit costs and monthly demand for the three products are as follows:

	Soyi	Milco	Yoghurt
	₦ per unit	₦ per unit	₦ per unit
Selling price	910	1,740	1,400
Concentrate cost	220	190	160
Other direct material cost	230	110	140
Direct labour cost @ ₦80 per hour	60	480	360
Overheads	240-	620	520
Profit	160	340	220
Maximum monthly demand (units)	1200	700	600

Although, Hicenta Limited uses marginal costing and contribution analysis as the basis for its decision making activities, profits are reported in the monthly management accounts using the absorption costing basis. Finished goods inventories are valued in the monthly management accounts at full absorption cost.

You are required to:

a. Calculate the monthly machine utilisation rate for each product and explain which of the machines is the bottleneck/limiting factor. (6 Marks)

b. Use current system of marginal costing and contribution analysis to calculate the profit maximising monthly output of the three products. (6 Marks)

c. Explain why throughput accounting might provide more relevant information in Hicenta's circumstances. (6 Marks)

d. Use a throughput approach to calculate the throughput-maximising monthly output of the three products. (6 Marks)

e. Explain the throughput accounting approach to optimizing the level of inventory and its valuation. Contrast this approach to the current system employed by Hicenta. (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

Tadesco Limited manufactures Compact Disks. It is planning to introduce a new model and production will begin very soon. It expects the new product to have a life cycle of three years and the following costs have been estimated.

Year 0	**Year 1**	**Year 2**	**Year 3**
Units manufactured and sold	50,000	200,000	150,000
Price per unit	₦900	₦800	₦700
R&D costs	₦1,700,000	₦180,000	-

Year 0	Year 1	Year 2	Year 3
Production Costs			
Variable cost per unit	₦300	₦250	₦250
Fixed cost	₦5,000,000	₦5,000,000	₦5,000,000
Marketing Costs			
Variable cost per unit	₦50	₦40	₦30
Fixed cost	₦3,000,000	₦2,000,000	₦2,000,000
Distribution Costs			
Variable cost per unit	₦10	₦10	₦10
Fixed cost	₦1,900,000	₦1,900,000	₦1,900,000
Customer service costs per unit	₦30	₦20	₦20

You are required to:

a. Explain Life Cycle Costing and state what distinguishes it from traditional costing technique. (10 Marks)

b. Calculate the cost per unit over the whole life cycle and comment on the price to be charged. (10 Marks)

(Total 20 Marks)

QUESTION 3

Adelab Nigeria Limited is a manufacturer of industrial gear. Over the years, the company has collected, allocated and absorbed overhead cost based on the traditional absorption costing technique.

The current economic recession in the country and stiff competition in the market are seriously affecting the company's performance and market share as its competitors have in recent times, introduced discounts to their customers. The customers of Adelab have therefore been putting pressure on the company to follow suit and few of these customers have started patronising the company's competitors who offer discounts on every purchase.

To address these problems and other strategic and operational issues affecting the company, the Board of Directors of Adelab decided recently to appoint a seasoned management expert as Business Process Executive (BPE). The BPE recently advised the Board to organise a management retreat. The focus of the retreat is strategic management, cost control and performance management. During the course of the retreat, new costing techniques such as activity based management, life cycle

costing, target costing, Kaizen costing, throughput accounting, backflush accounting, just in time approach to inventory management, etc., were discussed by the BPE. The need to also consider both financial and non-financial performance measurements was also discussed. The BPE further highlighted the need for the company to link its Key Performance Indicators (KPIs) to its strategic and operational Critical Success Factors (CSF), to achieve a better focus and improve its financial performance.
In a board meeting after the retreat, the following discussions took place:

Technical Director: "To improve our financial performance I think I will have to agree with the BPE's submission at the retreat that we replace absorption costing approach with an Activity Based Costing (ABC) system. I believe this will help us to put a tap on cost and thus improve cost control and increase profit margins. We can then pass some of these costs reduction to our customers in form of discounts".

Managing Director: "Yes, I agree with your opinion but I also think we need to monitor our performance in both financial and non-financial terms. For example, loss of sales could be due to charging a higher price than our competitors and as well as producing bad quality product. I therefore think that, while we should consider introducing activity based costing, we should also consider ways in which the company could monitor and assess performance on a wider basis".

You are required to:

a. Describe **FIVE** key features of Activity Based Costing (ABC) and provide **SIX** advantages and **FOUR** disadvantages of adopting Activity Based Costing (ABC) approach to cost accumulation. (10 Marks)

b. Explain the need for the measurement of organisational and managerial performance giving examples of the range of financial and non-financial performance measures that might be used. (10 Marks)

(Total 20 Marks)

QUESTION 4

Aghobe Air owns a single aircraft which operates between Lagos and Kano. The normal flight schedule is that flights leave Lagos on Mondays and Thursdays and depart from Kano on Wednesdays and Saturdays. Aghobe Air cannot offer any more flights between Lagos and Kano. The only seat available on the aircraft is economy class.

The following information is available:

Seating capacity of the aircraft is 360 passengers.

Weekly average number of passengers per flight is as follows:

First week	250	Passengers
Second Week	150	"
Third week	200	"
Fourth week	150	"
Flights per week	4	
Flights per year	208	
Average one-way fare	₦25,000	
Variable fuel costs	₦700,000	Per flight

Additional information:

(i) Food and beverages service cost ₦1,000 per passenger but at no charge to the passengers;

(ii) Commission to travel agents paid by Aghobe Air (All tickets are booked by travel agents) is 8% of fare;

(iii) Fixed annual leased costs allocated to each flight is ₦2,650,000 per flight;

(iv) Fixed ground services (maintenance, check in baggage handling, etc.) cost allocated to each flight ₦350,000 per flight;

(v) Fixed flight crew salaries allocated to each flight is ₦200,000 per flight; and

(vi) Fuel cost is unaffected by the actual number of passengers on the flight.

Required:

a. Determine the net operating income made by Aghobe Air on each one way flight between Lagos and Kano. (5 Marks)

b. The market research unit of Aghobe Air indicates that lowering the average one way fare to ₦24,000 will increase the average number of passengers per flight to 212. Should Aghobe Air lower its fare? (5 Marks)

c. A tourist group known as Sea Bird Tour Operator approaches Aghobe Air on the possibility of chartering the aircraft twice each month from Lagos to Kano and back from Kano to Lagos. If Aghobe Air accepts the offer, it will only offer 184 flights in each year. Other terms of the offer include:

   - For each one way flight, Sea Bird Tour Operator will pay Aghobe Air ₦3,750,000 which covers cost of charter for one way, use of flight crew and ground service staff. Sea Bird Tour operator will pay for fuel costs, food and beverages.

Should Aghobe Air accept the offer from Sea Bird Tour Operator? (5 Marks)

d. What factors should be taken into consideration in taking the decision in (c) above? (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

Okeke and Sons produces a new petroleum additive called 'EPBC' used in increasing petrol engine efficiency, while at the same time reducing its fuel consumption. The actual and budgeted quantities in litres of materials required to produce 'EPBC' and the budgeted prices of materials in October 2016 are as follows:

S/N	Chemical	Actual Quantity (litres) and Price (₦)	Budgeted Quantity (litres)	Budgeted Price (₦)
1	E-chem	48,160 @ ₦25	50,400	20
2	Pr-chem	30,960 @ ₦47	33,600	45
3	Be-chem	72,240 @ ₦14	67,200	15
4	Chamochem	20,640 @ ₦30	16,800	30

You are required to:

a. Calculate the individual chemical and total direct materials price and usage variances for October 2016. (4 Marks)

b. Calculate the individual chemical and total direct materials yield and mix variances for October 2016. (4 Marks)

c. What conclusions would you draw from the various variances calculated in (a) and (b) above? (4 Marks)

d. State **ONE** possible cause of each of the variances computed in (a) and (b) above. (3 Marks)

(Total 15 Marks)

QUESTION 6

Michael Porter, in his book "*Competitive Advantage: Creating and Sustaining Superior Performance,"* suggested that a firm must assess the industry's market attractiveness by considering the following:

- The extent of the rivalry between existing competitors;
- The bargaining power of suppliers;
- The bargaining power of buyers;
- The threat of substitutes; and
- The threat of new entrants.

Required

a. Recommend **FIVE** factors that should be included in the monitoring system implemented by the firm, if a firm wishes to monitor the bargaining power of buyers. (5 Marks)

b. Explain **FOUR** different methods whereby a firm can reduce the threat of new entrants to an industry. (7 Marks)

c. Explain the reason why firms often continue to operate in an industry which is generating below normal returns in the short run. (3 Marks)

(Total 15 Marks)

QUESTION 7

Adak Nigeria Limited sells its products through the internet. Many people around the world have access to its website to transact various businesses. Recently, the company has been having problems with the security of its business processes.

The management of the company has been trying to find solutions to the following problems:

(a) How to protect its data from the activities of hackers;
(b) How to prevent the files from being destroyed by virus.

As a Performance Management Expert, you have been consulted by the management to provide advice to the company to address the above problems. Advice is required in the following areas:

(i) How to protect the company's data from the activities of hackers;
(ii) Type of viruses that can affect the company's files.

Required:

Prepare a paper that will address the above concerns. **(15 Marks)**

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

$$P = a - bQ$$

$$b = \frac{\text{Change in Price}}{\text{Change in quantity}}$$

a = price when Q = 0

$$MR = a - 2bQ$$

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

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

where

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

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

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

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

Annuity Table

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

Where r = discount rate

n = number of periods

Discount rate (r)

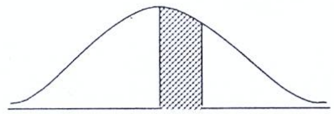
Period

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

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

NORMAL DISTRIBUTION

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



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

SOLUTIONS

SOLUTION 1

a. Machine Utilization Rate:

	Product			
	Soyi	Milco	Yogurt	Total
Machine hours required:				
Type A (Rate & Maximum Demand)	1,800	3,150	1,800	6,750
Type B (Rate & Maximum Demand)	1,200	1,750	1,200	4,150

Machine utilization rate:

Type A	=	6750 / 6000	=	1.125 or 112.5%
Type B	=	4150 / 5000	=	0.83 or 83%

Machine type A has the higher utilization rate and the rate is above 1 or 100%. Therefore, machine type A is the bottleneck / limiting factor.

b. Contribution analysis:

	Product		
	Soyi	Milco	Yogurt
Contribution per unit	₦400	₦960	₦740
Machine type A hour	1.5	4.5	3.0
Contribution per hour	₦266.67	₦213.33	₦246.67
Ranking	1	3	2

Allocation of machine type A hours

Soyi	1,200 units x 1.5	=	1,800 hours
Yogurt	600 units x 3	=	1,800 hours
			3,600
Milco (6,000 -3,600)/4.5 = 533.333units x 4.5 =			2,400 hours
			6,000 hours used

c. A major concept underlying throughput accounting is that the majority of costs, except material and concentrate costs, are fixed.

In Hicenta's case, it is clear that the labour cost which is treated as a variable cost in traditional marginal costing, is indeed a fixed cost. The employees are paid for a guaranteed 8,000 hours (160 x 50) each month; whereas the number of labour hours required to meet the maximum demand can be calculated as 7,800 hours as follows:

	Product			
	Soyi	Milco	Yogurt	Total
Labour hours per unit	0.75	6	4.5	
Maximum demand	1,200	700	600	
Total hours required	900	4,200	2,700	7,800

Therefore, labour is a fixed cost that will not alter within the relevant range of activity. Throughput accounting recognizes this in the calculation of throughput.

d. Given the perishable nature of Hicenta's product, throughput accounting approach to inventory maximization and maximization of throughput would be more appropriate.

	Product		
	Soyi	Milco	Yogurt
	₦ per unit	₦ per unit	₦ per unit
Sales revenue	910	1,740	1,400
Concentrate cost	220	190	160
Other direct materials	230	110	140
Throughput per unit	460	1,440	1,100
Machine type A hour	1.5	4.5	3.0
Throughput per hour	₦306.67	₦320	₦366.67
Ranking	3	2	1

Allocation of machine type A hours according to this ranking:

Yogurt	600 x 3 hours	1,800 hours
Milco	700 x 4.5 hours	3,150 hours
		4,950
Soyi (1,050/1.5)	700 x 1.5 hours	1,050 hours
		6,000 hours used

e. The conventional cost accounting approach used by Hicenta views inventory as an asset. In the throughput accounting approach, inventory is not viewed as an asset, but rather as a result of unsynchronized manufacturing. The existence of inventory is thus viewed as a breakdown in synchronization and a barrier to generating profits. In throughput accounting, the ideal inventory level is zero, with the exception that a buffer inventory should be held prior to the bottleneck machine.

As regards the valuation of inventory, the throughput philosophy is that no value is added to inventory items and no profit is earned until the items are actually sold. The inventory is valued at its material cost until it is sold.

This approach to inventory valuation is the contrast to the full absorption costing system used by Hicenta. The latter approach encourages managers to produce output just to add to work in progress or finished goods inventory, since this helps with the absorption of overheads and boosts reported profits. This behaviour will be avoided and managers will be more likely to be willing to minimize inventory if it is valued at material cost only.

Workings

(b) Contribution Computation

	Soyi	Milco	Yogurt
	₦	₦	₦
Selling Price	910	1,740	1,400
Less Unit Variable Cost:			
Concentrate Cost	220	190	160
Other Direct Materials	230	110	140
Direct Labour Cost	60	480	360
	510	780	660
Contribution per unit	400	960	760

MARKING GUIDE

		Marks	Marks
a.	Machine utilisation rate: machine hours required		
	For Type A(the three products and total)	2	
	Type B (the three products and total)	2	
	Utilisation rate for each machine		
	Type A	½	
	Type B	½	
	Bottleneck/limiting factor	1	6
b.	Calculation of profit maximising monthly output		
	Contribution/unit for the 3 products	¾	
	Contribution/hour for the 3 products	¾	
	Ranking of the products	¾	
	Allocation of machine type A hours for the 3 products	3	
	Total hours used	¾	6
c.	Description of throughput accounting	2	
	Throughput relevance and hours required	4	6
d.	Calculation of profit maximising output using throughput approach		
	Throughput/unit for the 3 products	1	
	Throughput/hour for the 3 products	1	
	Ranking	1	
	Allocation of machine type A hours for the 3 products	3	6
e.	Comparison of throughput approach with Hicenta's current approach		
	Throughput approach (3 points)	3	
	Hicenta's current approach (3 points)	3	6
			30

EXAMINER'S REPORT

The question tests candidates' knowledge of Throughput Accounting and Marginal Costing. The points expected to be raised include computation of machine utilization rate and Profit maximizing output.

Candidates' performance was not encouraging as less than 40% of the Candidates showed understanding of the requirements of the question.

The major pitfall remains the inability of candidates to understand the requirements of the question due to lack of technical understanding of the topic.

It is advised that candidates should make use of ICAN Study Text in addition to other relevant textbooks.

SECTION B

SOLUTION 2

a. Life Cycle Costing

Life cycle costing is a cost accounting system which tracks and accumulates costs and revenues attributable to each product over the entire product's life cycle. The product's life cycle costs are incurred from the design stage, development to market launch, production, marketing and sales, and finally to its eventual withdrawal from the market. The product's life cycle by summary involves:

i) Development costs
ii) Introduction costs
iii) Growth costs
iv) Maturity costs
v) Acquisition costs
vi) Product distribution costs
vii) Maintenance costs
viii) Operation costs
ix) Training costs
x) Inventory costs
xi) Decline costs
xii) Disposal costs

The differences between Life Cycle Costing and Traditional Costing Methods are as follows:

i. Traditional costing does not relate research and development costs to the products that caused them.
ii. Traditional costs accumulation systems usually total all non-production costs and record them as period costs.
iii. Traditional costing system does not consider the life span of a product.
iv. Traditional costing system does not consider the decline stage of a product.
v. Traditional costing system does not consider the end of life costs or withdrawal costs.
vi. Traditional costing system does not analyse the cost/ benefits of each option at each stage.

b. Computation of Life Cycle Cost per unit

	₦
R & D costs	1,880,000
Variable production costs	102,500,000
Variable marketing costs	15,000,000
Variable distribution costs	4,000,000
Fixed production costs	15,000,000
Fixed marketing costs	7,000,000
Fixed distribution costs	5,700,000
Customers service costs	8,500,000
Total life cycle cost	159,580,000

Life cycle cost = $\frac{₦159,580,000}{400,000\text{units}}$

= ₦398.95

Working Notes

1. Variable Production Costs

		₦
Year 1 (₦300 x 50,000units)	=	15,000,000
Year 2 (₦250 x 200,000units)	=	50,000,000
Year 3 (₦250 x 150,000units)	=	37,500,000
		102,500,000

2. Variable marketing Costs

		₦
Year 1 (₦50 x 50,000units)	=	2,500,000
Year 2 (₦40 x 200,000units)	=	8,000,000
Year 3 (₦30 x 150,000units)	=	4,500,000
		15,000,000

3. Variable distribution Costs

		₦
Year 1 (₦10 x 50,000units)	=	500,000
Year 2 (₦10 x 200,000units)	=	2,000,000
Year 3 (₦10 x 150,000units)	=	1,500,000
		4,000,000

4. Customer service cost

		₦
Year 1 (₦30 x 50,000units)	=	1,500,000
Year 2 (₦20 x 200,000units)	=	4,000,000
Year 3 (₦20 x 150,000units)	=	3,000,000
		8,500,000

MARKING GUIDE

		Marks	Marks
a.	Explanation of Life Cycle casting	5	
	Distinction from other costing Technique	5	
			10
b.	Calculation of variable cost (workings)		
	Production Year 1 -3	½	
	Marketing year 1-3	1½	
	Distribution year 1-3	1½	
	Customer Year 1-3	1½	
			06
	Total of variable and Fixed		
	¼ mark x 8	2	
	Cost per unit	2	04
			20

EXAMINER'S REPORT

The question tests candidates knowledge of Life Cycle Costing technique in comparison with the Traditional Costing Approach. The points expected from the question bordered on differentiating Life Cycle Costing from other costing approaches.

Candidates showed a good understanding of the question. About 90% of the candidates who attempted the question scored above half of the allocated marks.

The commonest pitfall observed was candidates' display of poor knowledge of other costing techniques.

It is advisable that an in-depth study of ICAN Study Text and other relevant textbooks will widen candidates' appreciation of the requirements of the topic in future.

SOLUTION 3

a. Activity Based Costing (ABC) involves the identification of the factors which cause the costs of an organization's major activities. Support overheads are charged to products on the basis of their usage of the factor causing the overheads. The major idea behind activity based costing are as follows:

   i. Activities cause costs. Activities include ordering, materials handling, machining, assembly, production scheduling and dispatching.

   ii. Producing products creates demand for the activities.

   iii. Costs are assigned to a product on the basis of the product's consumption of the activities.

The principal idea of ABC is to focus attention on what causes costs to increase, ie the cost drivers. Those costs that do vary with production volume, such as power costs, should be traced to products using production volume –related cost drivers as appropriate, such as direct labour hours or direct machine hours. Overheads which do not vary with output but with some other activity should be traced to products using transaction – based cost drivers, such as number of production runs and number of orders received. Traditional costing systems allow overheads to be related to products in rather more arbitrary ways producing, it is claimed, less accurate product costs.

Advantages of ABC

i. The complexity of manufacturing has increased, with wider product ranges, shorter product life cycles and more complex production processes. ABC recognizes the complexity with its multiple cost drivers.

ii. In a more competitive environment, companies must be able to assess product profitability realistically. ABC facilitates a good understanding of what drives overhead costs.

iii. In modern manufacturing systems, overhead functions include a lot of non – factory – floor activities such as product design, quality control, production planning and customer services. ABC is concerned with all costs and so goes beyond "traditional" factory floor boundaries.

iv. It is easy to compute.

v. It establishes long run product costs.

vi. It provides the basic data for activity based management and decision making.

vii. It provides more accurate and more reliable cost information.

viii. It provides the basic data for costs control by adjusting the activities or cost drivers.

ix. Reduces or eliminates costly and non-value adding activities.

x. Provides better ways of allocating overheads.

Disadvantages of ABC

i. Some measure of (arbitrary) cost apportionment may still be required at the cost pooling stage for items like rent, rates and building depreciation.

   Unless costs are caused by an activity that is measureable in quantitative terms and which can be related to production output, cost drivers will not be usable. What drives the cost of the annual external audit, for example?

ii. ABC is sometimes introduced because it is fashionable, not because it will be used by management to provide meaningful product costs or extra information. If Adelab's management is not going to use ABC information, an absorption costing system may be simpler to operate. Put another way, the cost of implementing and maintaining an ABC system can exceed the benefits of improved accuracy.

   Implementing ABC is often problematic. Recent journal articles have highlighted the following issues:

   - An incorrect belief that ABC can solve all organization problems.
   - Lack of the correct type of data
   - Difficulty in determining appropriate cost drivers.
   - Time consuming

iii. ABC does not conform to accounting standards and should not be used for external reporting.

iv. Misinterpretation of data: Interpreting ABC data along with regular accounting information can be confusing and lead to bad decision making.

b. Performance measurement is a part of the system of financial control of an enterprise, as well as being important to investors. The need for managerial performance and organizational performance are linked, since the decisions that managers make will influence how well or otherwise the organization performs. This performance needs to be measured as part of Strategic Planning are concerned with:

i. Setting targets for the achievement of the entity's main strategic objective;
ii. Setting targets for each strategy that is implemented for achieving the main strategic object;
iii. Setting targets at all levels of management within the entity; all planning targets (all levels within the entity) should be consistent with the strategic targets and objectives;
iv. Measuring actual performance;
v. Comparing actual performance with the targets;
vi. Where appropriate, taking control measures; and
vii. Where appropriate, changing the targets.

The usual assumption in financial management for the private sector is that the primary financial objective of the company is to maximize shareholders' wealth. Financial targets may include target for earning; earning per share; dividend per share; gearing levels; profit retention and operating profitability.

There are a variety of ways that such performance can be measured. As part of the system of financial control in an organization, it will be necessary to have ways of measuring the progress of the enterprise, so that managers know how well the company is doing. A common means of doing this is through ratio analysis, which is concerned with comparing and quantifying relationships between financial variables, such as those variables found in the statement of financial position and comprehensive profit statement of an organisation.

Ratios can be grouped into the following four categories: profitability and return; debts and gearing; liquidity: control of cash and other working capital items; shareholders' investment ratio ('stock market ratios'). The ratios can be seen to be interrelated.

Alternative examples of financial performance measures:

i. Profitability measures such as net profit & gross profit margin return on capital employed, asset turnover.
ii. Liquidity measures such as current ratios, acid test ratios.
iii. Gearing ratios such as interest cover.
iv. Investors ratios such as EPS, divided cover, dividend yield, earning yield, shareholders value.

It is therefore important that a range of non – financial indicators be developed to provide better predictors for the attainment of long – term profitability goals. Here are some examples:

1. Quantity
2. Number of customer complaints
3. Lead times
4. Delivery to time
5. Non – productive hours
6. System (machine) down time
7. Market share
8. Brand preference
9. Customer/employee satisfaction
10. Product service quality
11. Number of new products/innovation
12. Services performed late versus total service performed

MARKING GUIDE

		Marks	Marks
a.	Description of Key features of ABC	5	
	Advantages of ABC (any 6 ticks @ ½)	3	
	Disadvantages of ABC (any 4 ticks @ ½)	2	
			10
b.	Explanation of the Need Measurement of management and organisation performance (any 5 ticks @ 1 mark)	5	
	Examples of financial performance measures (any 3 ticks @ 1 mark)	3	
	Examples of non-financial performance measures (any 4 ticks @ ½ marks)	2	10
			20

EXAMINER'S REPORT

The question tests candidates' understanding of Activity Based Costing (ABC) as well as financial and non-financial performance measures.

The key points expected to be raised in the question include explanation of ABC, its advantages and disadvantages and measure of performance (financial and non-financial).

Candidates' understanding of the question was however high while those who did not understand same performed poorly.

Their commonest pitfall was inability to explain the concepts and their features as well as the differences between financial and non-financial measures.

Candidates are encouraged to devote more time in their preparations for future examinations using ICAN Study Text and other relevant textbooks.

SOLUTION 4

AGHOBE AIR – DECISION MAKING

a. Net operating income made by Aghobe Air on each one way flight between Lagos and Kano.

		₦	₦
One way flight cost	=	One way fare x Average Number of Passengers	
	=	₦25,000 x 188	4,700,000
Less commission of 8% of ₦4,700,000			376,000
Net fare			4,324,000
Less Variable Cost of one-way flight:			
Fuel Cost		700,000	
Food and beverages (₦1,000 x 188)=		188,000	888,000
Contribution per flight			3,436,000
Less fixed costs			
Lease Costs		2,650,000	
Ground cost on Luggage		350,000	
Flight Crew		200,000	3,200,000
Net Operating Income			236,000

b. Should Aghobe Air lower its fare to ₦24,000?

	₦	₦
Revenue (₦24,000 x 212)		5,088,000
Less Commission of 8%		407,040
Net fare		4,680,960
Less variable costs		
Fuel costs	700,000	
Food and beverages (212 x₦1,000)	212,000	912,000
Contribution		3,768,960
Fixed Costs:		
Lease costs	2,650,000	
Ground costs/baggage	350,000	
Flight crew	200,000	3,200,000
Net Operating Income		568,960

Yes, based on the computation above, Aghobe Air is advised to lower its fare.

c. 184 flights x 188 passengers = 34,592 passengers

		₦
Revenue from charter (₦3,750,000 x 24)		90,000,000
Revenue (34592 x ₦25,000)		864,800,000
Total revenue		954,800,000
Cost		
	₦	
Commission (8% of ₦954,800,000)	76,384,000	
Fuel (184 x ₦700,000)	128,800,000	
Food (184 x 188 x 1000)	34,592,000	239,776,000
Contribution		715,024,009
Fixed cost		
(₦350,000 + ₦2,650,000 + 200,000) = ₦3,200,000 x 208		665,600,000
Net Income		49,424,000

Contribution per flight = ₦715,024,000 ÷208

= ₦3,437,615

Charter fee ₦3,750,000

∴ It pays to charter (based on the computation above)

Alternative approach:

	₦	₦
Revenue of Agbobe Air: 188 x ₦25,000 =		4,700,000
Variable costs		
Fuel Cost	700,000	
Food and beverage	188,000	
Commission (8% of ₦ 4,700,000)	376,000	1,264,000
Contribution		3,436,000
Charter fees		3,750,000

∴ It pays to charter (based on the computation above)

d. Other factors to be taken into consideration in facilitating this decision are as follows:

i. The charter will disrupt regular weekly flights
ii. The stability of the relationship of the two companies may not be guaranteed as it is seen as a short term affair – No adverse regulation
iii. Competitors may take over the business
iv. No increase in the various costs

v. Availability of aviation fuel
vi. Reliability of the estimates

Workings:

Weekly average number of i.e. passengers per flight is as follows:

1st week = 250 passengers
2nd week = 150 passengers
3rd week = 200 passengers
4th week = 150 passengers
Total = 750 passengers

$\therefore$ Average = 750 /4 = 187. 50 $\cong$ 188 Passengers

MARKING GUIDE

		MARKS	MARKS
a.	Determining Net operating income by Aghobe Air per flight		
	Calculation of income per flight	1	
	Calculation of Variable cost	1	
	Calculation of contribution	1	
	Calculation of fixed cost	1	
	Calculation of Net operating Income	1	5
b	Determining whether Aghobe should lower fare		
	Calculation of income per flight	1	
	Calculation of Variable cost	1	
	Calculation of contribution	1	
	Calculation of fixed cost	1	
	Calculation of revised Income	½	
	Decision to accept	½	5
c.	Calculation of Revenue	1	
	Calculation of Variable Cost	1	
	Calculation of Contribution	1	
	Charter fee	1	
	Decision to charter	1	
			5
d.	Other factors		
	Risk of uncertainty	1	
	Disruption of regular flight	1	
	Stability of relationship	1	
	Competitors may take over	1	
	No increase in variation costs	1	
	Reliability of the estimates	1	5
	Any 5 points		20

EXAMINER'S REPORT

The question tests candidates' knowledge of the use of contribution approach in decision making.

The question requires the determination of the Net Operating Income using a sensitivity approach and the impact of chartering out a facility.

Candidates' performance was poor as less than 35% of those who attempted the question scored below the allotted marks.

Candidates are advised to do a diligent appraisal of questions in future examinations before attempting to proffer a solution as that will reduce incidence of failure

SECTION C

SOLUTION 5

a)

i. Material Price Variance

Material	Std Price	Act Price	Mat Price Variance	Act Qty	Mat Price Variance
	₦	₦	₦	Ltr	₦
E-chem	20	25	5A	48,160	240,800A
Prechem	45	47	2A	30,960	61,920A
Be-chem	15	14	1F	72,240	72,240F
Chamochem	30	30	0	20,640	0
	Total Material Price variance				230,480A

ii. Material Usage Variance

Material Price	Std Qty (boao)	Actual Qty	Mat usage Variance	Std Price	Mat usage Variance
	Ltr	Ltr	Ltr	Ltr	Ltr
E-chem	50,400	48,160	2,240F	20	44,800F
Prechem	33,600	30,960	2,640F	45	118,800F
Be chem.	67,200	72,240	5,040A	15	75,600A
Chamochem	16,800	20,640	3,840A	30	115,200A
	Total Material Usage Variance				27,200A

Note

It is assumed that the budgeted output is same as actual output.

b) Material Mix Variance

i) Standard Mix of materials

Material	budgeted qty	standard mix
	Ltr	%
E-chem	50,400	30
Pr chem	33,600	20
Be chem	67,200	40
Chemochem	16,800	10
	168,000	100

(ii) Standard mix of actual quantity

Material	Total Actual Qty		Std mix of actual Qty
E-chem	172,000	x 30% =	51,600
Prechem	172,000	x 20% =	34,400
Bechem	172,000	x 40% =	68,800
Chemochem	172,000	x 10% =	17,200
			172,000

(iii) Material mix variance

Material	Act Qty (Std Mix)	Actual Qty	Mat Mix Variance	Std Price	Mat Mix Variance
		Ltr	Ltr	₦	₦
E chem	51,600	48,160	3,440F	20	68,800F
Prechem	34,400	30,960	3,440F	45	154,800F
Be chem.	68,800	72,240	3,440A	15	51,600A
Chamochem	17,200	20,640	3,440A	30	103,200A
Total	172,000	172,000			68,800F

(iv) Material Yield Variance

Material	Std Qty	Actual qty Std mix	Mat yield Variance	Std Price	Material yield variance
	Ltr	Ltr		₦	₦
E chem.	50,400	51,600	1,200A	20	24,000A
Prechem	33,600	34,400	800A	45	36,000A
Be chem.	67,200	68,800	1,600A	15	24,000A
Chamochem	16,800	17,200	400A	30	12,000A
Total	168,000	172,000			96,000A

c.

i. The price variance depicted an unfavourable figure of (₦230,480) showing that on average, all actual prices paid were higher than budgeted prices.

ii. The usage variance depicted unfavourable figure of ₦27,200 showing inefficiency in material usage (wastages).

iii. On mix variance, a favourable variance was made showing that actual mix contained more of cheaper input materials.

iv. The yield variance was unfavourable by (₦96,000), if the quality of the product was to be improved on, more of costlier materials could be used.

d. Possible causes of the variances:

S/N	Variance	Reason for variances
1	Direct Material Price variance	Unrealistic materials price standard (Unrealistic SP). Change in purchase price (e.g. new supplier, change in quantity of materials purchased, change in purchase discount). Accounting error (in the actual price of materials). Inflation factors Inefficiency in procurement
2	Direct material Usage or efficiency Variance	Unrealistic materials quantity Standard (Unrealistic SQ). Accounting error (in quantity of materials used). Inexperienced machine operator Poor quality of materials. Machine malfunctioning
3	Direct material mix variance	Abnormal mix in production process, Non adherence to normal mix. Inexperienced machine operator Machine malfunctioning
4	Direct material yield variance	Change in quantity of spoiled materials due to the changes in quality/equipment/technology, equipment malfunction, etc.

MARKING GUIDE

			Marks	Marks
a.	i.	Material Price Variance		
		E-Chem	½	
		Pre-chem	½	
		Be-chem	½	
		Chama Chem	½	2
	ii.	Material usage Variable		
		E-Chem	½	
		Pre-chem	½	
		Be-chem	½	
		Chamo chem.	½	2
b.		Material Mix Variance		
	i.	Standard Mix of Material		
		E-Chem	½	
		Pre-chem	½	
		Be-chem	½	
		Chamo Chem	½	1
	ii.	Standard Mix of actual quantity		
		E-Chem	½	
		Pre-chem	½	
		Be-chem	½	
		Chamo Chem	½	1
	iii.	Material Mix Variance		
		E-Chem	½	
		Pre-chem	½	
		Be-chem	½	
		Chamo Chem	½	1
	iv.	Material Yield Variance		
		E-Chem	½	
		Pre-chem	½	
		Be-chem	½	
		Chamo Chem	½	1
c.		Price Variance	1	
		Usage Variance	1	
		Mix Variance	1	
		Yield Variance	1	4
d.				
		Usage Variance	1	
		Mix Variance	1	
		Yield Variance	1	
				3
				15

EXAMINER'S REPORT

The question tests candidates' understanding of Material Cost Variance viz: Price Usage, Mix and Yield.

The question requires the determination of Material Price, Mix, Yield and Usage variances for a mix of input materials and their causes.

Candidates displayed poor understanding of the requirements of the question as less than 30% showed understanding of the requirements of the question. The poor performance was sequel to their inability to distinguish between mix and yield variances and their causes.

Candidates are advised to devote more time in preparing for future examinations using the ICAN Study Text and other relevant textbooks.

SOLUTION 6

a) The bargaining power of buyers also referred to as bargaining power of customers, is a tool under Porter's 5 forces model used in assessing the ability of buyers to influence an organization in a competitive situation. The bargaining power of buyers represents a major factor in establishing the attractiveness of an industry. It is therefore important that the power of buyers is monitored in order that organisations are aware of the forces which are important in the development of a strategic plan. Factors which will influence the relative bargaining strength of the buyers include:

i. The number of different buyers and sellers in the market;
ii. The relative size of both the buying and selling organisations;
iii. The buyer's purchases are large in relation to the total sales of each seller, as a major customer can often dictate terms and conditions, especially if the cost structure of the seller includes a high level of fixed costs;
iv. The level of profit earned by the buyers is low;
v. The product is undifferentiated;
vi. The quality of the component purchased is not particularly important in the final product;
vii. The extent to which buyers can undertake backward integration.

b) There are a number of different barriers to entry that are likely to reduce the number of potential entrants to the industry. Potential competitive advantage retained by any of the following:

i. *Patents, licences and government/legal constraints.* It is possible for a firm to use any of these as a form of protection and to prevent new entrants to the industry. Once this type of legal barrier has been obtained by a firm, it can be of great value in retaining competitive advantage.

ii. *Branding or customer loyalty (differentiation).* Often at considerable expense, an organisation will try to establish customer loyalty which will ensure that people will buy the product in preference to other brands and substitutes that are available.

iii. *Economies of scales including the learning curve.* In some industries, large- scale operations can produce the products at a lower cost than the smaller producers. This provides an example of 'overall cost leadership' which can be very significant in planning for competitive advantage

iv. *Access to cheaper factors of production.* Some firms are able to produce products at a lower cost, as they have been able to obtain materials, labour, finance or other expenses at a lower rate than their competitors.

v. *Switching costs.* The ability to change to another supplier without many costs being incurred. Incumbent firms can increase these by offering volume discounts, special delivery facilities or electronic ordering systems.

vi. *Control of unique distribution channels.* If a firm can exclude other producers from distributing their products through the most effective distribution channels, then this can represent a significant entry barrier.

vii. *The scale of investment needed to establish the operation.* If the amount of investment is so large that most competitors are unable to consider entering the industry, this represents a way in which potential competitors can be excluded and the existing firm have competitive advantage and possibly even a monopoly.

viii. *Technological advantages that result in cost leadership.* Successful research and development often results in a firm having a process that reduces the cost of production so that competitors are unable to compete on a level playing field. This gives the firm that has invested in the R& D an important edge over their competitors and this will exclude potential entrants to the industry.

c. (i) There are exit barriers that result in firms remaining in an industry, even though the returns are below the normal level. When a firm realises that the probability of success is low or acknowledges that there is excess capacity in the industry, a decision to shut down may be appropriate. However, decisions of this kind are often postponed. This is likely to occur if the closure will result in substantial costs being incurred by the firm. These are termed exit costs. In general terms, the costs of closure are estimated to be higher than continuing the operation.

(ii) Apart from the exit costs, a firm may decide to stay in an industry because the market has a strategic importance to the firm. For example, a commercial bank may continue to provide current accounts despite their low profitability because they are cornerstone of a client relationship from which more valuable products can be sold.

(iii) Where a particular good or service which is generating below normal returns in the short run makes customers buy or demand for other services of the company with high yield.

(iv) Producing equipment whose accessories are in rapid demand and are profitable.

(v) Overcoming frequent technology change cost

(vi) Where life circle is almost expiring and the product still gives some marginal profit.

MARKING GUIDE

		MARKS	MARKS
a.	Valid introduction	1	
	4 correct points at 1 marks	4	5
b.	Valid introduction	1	
	Any 4 correct points at $1^1/_2$ marks	6	7
c	Any 3 valid points at 1 mark		
		3	3
			15

EXMANER'S REPORT

The question tests candidates' understanding of Michael Porter's Analysis of Competitive Advantage in situations where a firm is upscaling and sustaining its performance.

Candidates showed full grasp of the requirements of the question and that manifested in their performance. Over 70% of those who attempted the question scored about half of the marks allocated to the question.

Candidates' understanding of Part 'C' of the question was however discouraging.

Adequate preparation is advised to help candidates in future examinations.

SOULTION 7

INTERNAL MEMORANDUM

To: The Managing Director

From: Performance Management Expert

Date: November 16, 2016

Subject: **PREVENTING COMPANY'S DATA FROM ACTIVITIES OF HACKERS AND VIRUS**

Various measures might help to prevent hacking into a system, or to detect when a hacker has gained unauthorized access. The following controls can be used to prevent or detect hacking:

a. Physical security measures to prevent unauthorized access to the computer terminals of the Company;
b. The use of passwords;
c. The encryption of products that are sent via internet;
d. Uses of audit trails, so that transactions can be traced through the system when hacking is suspected;
e. Network logs, whereby network servers record attempts to gain access to the system;
f. Use of firewalls;
g. Data masking; and
h. Data scrambling.

VIRUS

Viruses are computer softwares that are designed to deliberately corrupt computer systems. Virus can be introduced into a system on a file containing the virus. A virus may contain:

a. In a file attachment to an e-mail; or
b. On backing storage device such as a CD.

Types of virus

The following are the commonest viruses:

a. Trojan horses: This is a type of virus that disguises itself, often hidden with other software or files;
b. Worms: This is a corrupt data that replicates itself within the system, moving from one file or programme to another;
c. Logic bombs: This is a virus that is designed to start working (corrupting the files or data processing) when a certain event occurs;
d. Time bombs: This is a virus that is designed to start working (corrupting the files or data processing) on a certain date;
e. Denial of service: This virus renders the system unusable by legitimate users; and
f. Trap doors.

The following steps can be taken to guide against virus attack:

a. Installation of anti-virus software which must be updated yearly;
b. Restriction on the use of floppy disks, re-writeable CDs and USB storage medias;
c. Firewall software and hardware should be used to prevent unauthorized access from the internet;
d. Staff should be encouraged to delete suspicious e-mails without opening any attachments; and
e. There should be procedures, communicated to all staff, for reporting suspicion of any virus as soon as they appear.

Thank you.

Signature

NAME

MARKING GUIDE

	MARKS	MARKS
Report Outline (Header)	1	1
How to prevent Hacking	6	6
Types of Virus	5	5
How to prevent virus attack	3	3
		15

EXAMINER'S REPORT

The question tests candidates' understanding of online business challenges as they relate to hacking.

Candidates' performance in this question was high as over 60% of those who attempted the question did credibly well.

The commonest pitfall was non-provision of the answers in a report format.

It is advised that candidates prepare themselves properly using the Institute's Pathfinders, ICAN Study Text and other relevant textbooks for future examinations.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – NOVEMBER 2016

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

KEMTA Nigeria Limited is a private electrical and mechanical engineering company. The company is one of the major players in the provision of cutting edge engineering construction services in the Nigerian electrical, mechanical and communication engineering industry. The company has sites in the 36 States of the Federation, including Abuja. They also work for major financial institutions, educational institutions, Federal, States and Local Governments. The company has on its payroll over 500 professionals, skilled and unskilled workers.

You have been the auditor of the company for the past five years. During your audit, you observed some weaknesses in the internal control system of the company. Your review of the domestic reports showed that your firm has been recommending the establishment of an internal audit department for the past three years. However you observed that it appears that the Managing Director is not favourably disposed to this idea. He saw your suggestion as an additional cost to the company; because they have to furnish their new offices and employ qualified personnel for the new department. He requested to know more about the possibility of outsourcing the internal audit department.

Required:

a. State and explain the purpose and functions of internal audit in an organisation. (5 Marks)

b. Enumerate the fundamental differences between the internal and external auditors. (10 Marks)

c. Present:
   i. The main reasons for outsourcing internal audit. (3 Marks)
   ii. The benefits of outsourcing (2 Marks)
   iii. Possible problems of outsourcing (4 Marks)

d. Identify and explain the **THREE** main categories of risks usually considered by internal auditors. (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

Audit practice around the world is generally a business and its objective is to make profit. However, this does not mean that the practice should automatically accept every audit engagement that is offered to it in order to maximise profit. Circumstances may arise where it is appropriate to decline the offer of an audit engagement for either commercial or ethical reasons.

Required:

a. Discuss the ethical issues to be considered by an independent auditor in the following matters.
   i. Client Acceptance
   ii. Engagement Acceptance (5 Marks)

b. Explain in brief the measures to be taken by incoming Independent Auditors after accepting an appointment and when there is change in professional appointment. (5 Marks)

c. Discuss in details the content of an engagement letter to be issued to a new client. (5 Marks)

d. Explain briefly the technique used by an audit firm known as "low-balling" when it tenders for audit work. (5 Marks)

(Total 20 Marks)

QUESTION 3

Clear View Cinemas Nigeria Limited operates in the entertainment industry in five different locations. Access into the Cinema Hall is based on tickets purchased at the point of entry. The entity's ticketing process is manually driven. At the beginning of every day, the ticketing staff collects and signs for manual tickets from the Accountant. Unused tickets are returned to the Accountant, while the ticketing staff prepares sales report for the day which is reviewed and signed off by the Accountant. Concession items such as popcorn and soft drinks are also sold to customers. Both the ticketing and concession transactions are paid for in cash. All cash received are handed over to the Accountant who posts the transactions to SAGE Line 50 Application at the end of every day's transactions. In view of the Company's prime location and level of awareness, it records high volume of transactions daily.

To ensure there are no delays in payment of routine bills and also reduce exposure to bank charges, the Accountant disburses cash from daily collections and the balance is lodged into the bank on irregular basis. Bank reconciliation statements are prepared at the end of the financial year in readiness for the audit.

Required:

a. As the Auditor in charge of this engagement, identify and evaluate the relevant internal control issues in the above scenario (12 Marks)

b. State and explain **FOUR** categories of control activities. (8 Marks)

(Total 20 Marks)

QUESTION 4

Polyet Nigeria Plc is into the manufacture of plastic materials. It has its factory in Apapa, Lagos, with distribution outlets spread across the country. A new Managing Director, Mr. KO has just been appointed. Shortly after the new Managing Director was appointed, your firm concluded the audit of the Company's Financial Statements. A request was made from the newly engaged Managing Director for a letter of representation. He informs you in no uncertain terms that the company engaged you as the auditor to take responsibilities for your audit opinion, and that he is not ready to repeat in writing the information that the Chief Finance Officer, other accounting staff and himself provided to you during the audit exercise. You tried to explain to him that it is the standard practice to request for a letter of representation from the Management but he remained adamant.

Required:

a. Explain the need for the auditor to obtain a letter of representation from the management. (5 Marks)

b. Itemise **TEN** contents of a Letter of Representation. (10 Marks)

c. What steps should you take as the auditor, if the Managing Director still persists in his refusal to sign the letter? (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 Nigerian Standard of Auditing (NSA 1) and International Standard on Auditing (ISA 200) deal with the objective and general principles governing an audit of financial statements. It sets out the overall objectives of the independent auditor and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives.

Required:

a) Explain the term "Audit of the financial statement". (4 Marks)

b) Describe the overall objectives of the independent auditor in conducting the audit of financial statements in accordance with NSA 1 and ISA 200. (6 Marks)

c) Sections 360 and 363 of Companies and Allied Matters Act CAP 20 LFN2004 stipulate the rights of the independent auditors in the conduct of the statutory audit. State these rights. (5 Marks)

(Total 15 Marks)

QUESTION 6

Hypermart Plc operates a chain of modern hyper stores, an on-line and real-time airline ticketing agency and a mail order section selling goods over the internet.

Required:

a. Analyse the controls that should be in place to minimise risks that may arise from the operations of the on-line and real-time airline ticketing system. (7 Marks)

b. Hypermart Plc operates Electronics Data Interchange (EDI) system for the transmission of business documents.

Required:

Analyse the problems the EDI system may create for the auditor and what controls are expected to be in place to minimise the risks in the EDI system. (8 Marks)

(Total 15 Marks)

QUESTION 7

Savealife Nigeria is the local member of Savealife International, a Non-governmental Donor Agency.

Required:

a. Summarise the main audit areas to consider in relation to the audit of Savealife Nigeria (10 Marks)

b. Highlight other factors peculiar to such not-for-profit organisations that the Auditor needs to consider. (5 Marks)

(Total 15 Marks)

SOLUTIONS

SOLUTION 1

a. Internal Audit is a function or department set up within an entity to provide an appraisal or monitoring process as a service to other functions or to senior management within an entity. It is an independent objective assurance and consulting activity designed to add value and improve an organisation's operations.

Functions of Internal Audit;

i. **Monitoring of internal control**: Internal audit is usually given specific responsibilities by the management for reviewing internal controls, monitoring their operations and recommending improvements via a report to the directors or those charged with governance.

ii. **Examination of financial and operating information**: This may include review of the means used to identify, measure, classify and report such information or specific enquiry into individual items including detailed testing of transactions, balances and procedures. Work in this area is very similar to that carried out by the external auditor.

iii. **Review of the economy, efficiency and effectiveness of operations**: This could include a review of non-financial controls. The reviews are called Value for Money Audit.

iv. **Review of compliance**: Compliance with laws, regulations and other requirements such as management policies and directives.

v. **Special investigations**: Investigations into particular areas - such as suspected frauds. The majority of these activities here will be classified as operational internal assignments. The investigations are usually required by management or those charged with governance or the Audit Committee.

(b) Fundamental differences between the external and internal auditors

External Auditor	Internal Auditor
Role and work – To express an opinion on the truth and fairness of the annual financial statements.	To examine systems and control and assess risk in order to make recommendations to management for improvements.

External Auditor	Internal Auditor
Qualification to Act– Set out by statute. This ensures that the external auditor is independent of the entity and suitably qualified.	No statutory requirements – Management selects a suitably competent person to act as internal auditor.
Appointment – Appointed by share holders. This assures independence from Management	Employed by the Management in accordance with company's condition of service and may not claim total independence from management.
Duties – Set out by statute and the external auditor may not vary the scope	As set out by Management who approves the scope of duties
Report – Reports to shareholders or members at the Annual General Meeting	Reports to the highest level of management or those charged with governance and even the Audit Committee
Responsibility for fraud:- Has no primary responsibility for discovery of fraud and error other than to report the truth and fairness of the financial statements	The internal auditor may be given specific responsibility for investigating suspected fraud or error by management or those charged with governance or the Audit Committee.

c.

i. Outsourcing involves the transfer of management's day-to-day execution of an entire business function to an external service provider. The main reasons for outsourcing internal audit functions include:

- Technical expertise: The internal audit function can be contracted to external service provider in areas where the internal audit department does not have the required skills and expertise.

- Cost: The organisation may not have enough resources to establish an audit department hence arrangement can be made to outsource the entire functions to an external service provider

- Company size: A smaller company may need the services of an internal auditor but not on a permanent basis hence the functions can be outsourced to an external body.

ii. **Benefits of outsourcing:**

- **Staff recruitment**: There is no need for the company to recruit and train its own internal audit staff.

- **Audit skills**: The outside service provider is likely to have specialist staff available such as computer audit experts. Internal auditors with an IT skills may be difficult and expensive to recruit as full time employees.

- **Cost and flexibility**: The cost of an internal audit function outsourced is a variable cost rather than a fixed cost. The entity therefore pays for the audit time that it uses.

- **Quantum of audit work** : Outsourcing may be more economical for a small entity that does not have enough audit work to justify full time internal audit team.

iii. **Possible problems of outsourcing**:

- **Changing personnel**: The internal auditors provided by an external firm may change continually and there may be lack of continuity as a consequence. The internal auditors being used may not have an immediate understanding of the clients business.

- **Cost**: An accountancy firm could charge high fees for internal audit services.

- **Confidentiality**: The internal auditors provided by an external firm will be expected to maintain complete confidentiality about the client's affairs. However, the risk of a leak may be higher than if full time internal auditors are employed.

- **Control**: An entity may not have the same control over its internal audit work if the work is outsourced.

- **Conflict of interest**: If internal audit work is carried out by the entity's firm of outsourced auditors, there is likely to be conflict of interest bordering on loyalty which in turn affects independence and objectivity in reporting. The hired auditors and external auditors may have a conflict of interest (on independence and objectivity in reporting).

d. Three main categories of risks usually considered by internal auditors

i. **Operational risk**: These are the risks that the operating activities of an entity may be disrupted, either deliberately or unintentionally. Employees may make mistakes, and do something wrong or forget to do something necessary. Machines may break down, there may be poor security arrangement, poor supervision, weak management or an ineffective organisation structure. Operational risk refers to anything that might go wrong with operational activities.

ii. **Financial risk**: These are the risks of what might happen if there are changes in the financial environment, such as interest rates, taxation law or exchange rates. Financial risk also includes credit risk which is the risk of non-payment or late payment by customers.

iii. **Compliance risks**: These are risks that the entity may fail to comply with relevant rules and regulations, resulting in penalties being imposed by regulatory authorities or fines being paid to injured parties. Examples of compliance risks include risks of non-compliance with health and safety laws, anti pollution laws, pension laws, employment laws and establishment laws.

	MARKING GUIDE	Marks	
(a)	For definition of internal audit	1	
	1 mark for each function (maximum of 4 points	4	5
(b)	1 mark for each point under heading	5	
	1 mark for each point under fundamental differences maximum of 5 points	5	10
(ci)	1 mark for each reason(Maximum 3 points)	3	
(ii)	1 mark each for benefit listed maximum of 2 points	2	
(d)	1 mark for each problem listed maximum of 4 points	4	9
(e)	2 marks for each category stated and explained		6
	Total marks		30

EXAMINER'S REPORT

The question, in four parts, tests candidates knowledge on Internal Audit. Almost all the candidates attempted the question. Candidates showed good understanding of the question in parts (a) to (c), but limited understanding in part (d). Even though candidates performed generally well in this question, there is still a dire need for them to cultivate the habit of marshalling and presenting their points better to earn more marks.

Candidates should also interprete the specific requirements of questions before attempting them. Candidates are advised to pay special attention to ICAN Study Texts on this subject.

SOLUTION 2

a) Ethical issues to be considered by an Independent Auditor in the following matters.

i. Client acceptance
Before accepting a new client relationship, a Chartered Accountant in public practice should consider whether acceptance would create any threats to compliance with the fundamental principles. Potential threats to integrity or professional behaviour may be created from, for example, questionable issues associated with the client (its owners, management and activities).

Client issues that, if known, could threaten compliance with the fundamental principles include, for example:

- Client involvement in illegal activities (such as money laundering, fraud, dishonesty, or questionable financial reporting practices)

The significance of any threats should be evaluated. If identified threats are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate or reduce them to an acceptable level. Appropriate safeguards may include:

- obtaining knowledge and understanding of the client, its owners, managers and those responsible for its governance and business activities
- securing the client's commitment to improve corporate governance practices or internal controls. Where it is not possible to reduce the threats to an acceptable level, a Chartered Accountant in public practice should decline to enter into the client relationship. Acceptance decisions should be periodically reviewed for recurring client engagements.

ii. Engagement acceptance
A Chartered Accountant in public practice should agree to provide only those services that he is certified and competent to perform. Before accepting a specific client engagement, a Chartered Accountant in public practice. should consider whether or not acceptance would create any threats to compliances with the fundamental principles.

For example, a self-interest threat to professional competence and due care is created if the engagement team does not possess, or cannot acquire, the competencies necessary to properly carry out the engagement.

A Chartered Accountant in public practice should evaluate the significance of identified threats and, if they are other than clearly insignificant, safeguards should be applied as necessary to eliminate them or reduce them to an acceptable level. Such safeguards may include but are not limited to:

- Acquiring an appropriate understanding of the nature of the client's business, the complexity of its operations, the specific requirements of the engagement and the purpose, nature and scope of the work to be performed.
- Acquiring knowledge of relevant industries or subject matters.
- Complying with quality control policies and procedures designed to provide reasonable assurance that specific engagements are accepted, only when they can be performed competently.

When a Chartered Accountant in public practice intends to rely on the advice or work of an expert, he should evaluate whether or not such reliance is warranted, by considering factors such as reputation, expertise, resources available and applicable professional and ethical standards, information which may be gained from prior association with the expert or from consulting others.

b. Procedures after accepting an appointment

After accepting the appointment as auditor, the following measures should be taken by him:

- He should ensure that the current auditor (if any) has resigned from the audit in a proper manner, or has been removed from office in accordance with any appropriate local legislation.
- He should ensure that his appointment his valid in law and is properly documented.
- He should prepare and submit an engagement letter to the board of the new client.

Changes in professional appointment

The incoming auditor should communicate with the current auditors to establish if there are any matters that he should be aware of when deciding whether or not to accept the appointment. Although this is partly a matter of courtesy between professionals, this will involve discussion of the appointment, the client and the audit work.

Such discussion will allow the firm to decide if the client is someone for whom it would wish to act.

The following points should be noted in connection with communicating with the current auditors:

- When a member is first approached by a prospective client to act or be nominated, he should explain that he has a professional duty to communicate with the existing auditor or advisor.
- Client permission is required for any such communication. If the client refuses to give its permission, the appointment as auditor should not be accepted.
- If the client does not give the current auditor permission to reply to any relevant questions, the appointment as auditor should not be accepted.
- If the current auditor does not provide any information relevant to the appointment, the new auditor should accept or reject the engagement based on other available knowledge.
- If the current auditor does provide such information, the new auditor should assess all the available information and take a decision about whether or not to accept the audit work.

c. Having accepted an appointment of a new client, the Auditor should submit an engagement letter to the board of directors of the client organistion. An engagement letter can be regarded as the basis for the contract between the client and the Auditor. The contents of an engagement letter to be issued to a new client are briefly explained as follows:-

The objective and scope of the audit:- The Auditor should state in the letter the objective of the audit work to be carried out and the scope of the assignment which must have been jointly agreed upon, as relevant, during the preliminary meeting held with the Management of the entity.

The responsibilities of the Auditor:- The Auditor will state his responsibilities in this paragraph to include, to express an opinion on the true and fair view of the financial position and performance of the entity.

The responsibilities of the directors:-The directors (or those charged with governance) are responsible for the preparation of the financial statements. In addition to this, the directors must ensure that:-

- Internal controls are instituted to safeguard the assets, prevent and detect fraud and other irregularities.
- Proper accounting records are maintained.

- Applicable accounting and reporting standards are followed.
- Suitable accounting policies are adopted and consistently applied.
- Judgments and estimates made are reasonable and prudent
- The going concern basis is used unless it is inappropriate to presume that the entity will continue in business.

Identification of the underlying financial reporting framework:- Any financial framework to be adopted must be stated under this paragraph.

Reference to the expected form and content of any reports to be issued:- The Auditor must have references to the format and content of the report to be used at the end of the audit assignment which will ensure adequate disclosure of the figures in the financial statements.

More details on scope of the audit work:- Additional details of the scope of work to be done in the course of the audit assignment must be stated in this paragraph with reference to applicable legislations, regulations, standards, ethical and professional pronouncements.

Arrangement regarding the planning and performance:- The Auditor must make adequate plan for the performance of the audit assignment. The highlights of the audit planning memorandum can be stated in this paragraph to enable the directors have insight on how the assignment will be carried out.

Inherent limitations.
As a result of the inherent limitations of an audit and internal control, there is an unavoidable risk that some material misstatements may not be detected even though the audit was properly planned and performed in accordance with International Standards on Auditing.

The expectation that the Management will provide written representation:- There is a need to state in this paragraph the need for obtaining representation letter to be signed by both the Managing Director and the Finance Director of the entity.

The basis on which fees are computed:- The Auditor must state the agreed audit and other professional fees to be charged for the assignment and the basis used to arrive on the fees must be stated.

Request for Management to acknowledge receipt of the engagement letter:- The Auditor should state in this paragraph that the engagement letter should be signed with date as evidence of their agreement with the contents of the letter.

Arrangements concerning the involvement of other auditors, experts or internal auditor etc:- The paragraph must contain a statement on the need for an expert on certain areas of the audit assignment which the Auditor is not competent to handle. Anywhere there is restriction on the liability of the Auditor, it must be stated in this paragraph.

d) The term "low-balling" is a technique used by an Auditor when he tenders for audit work. It means deliberately quoting a low and perhaps an unprofitable fee in order to obtain the audit work. Low balling strategy may be linked to an intention to increase the fee to a more realistic level over a period of time or to make up for the shortfall in the fee for the basic audit work with more profitable fees for non-audit services. 'Lowballing' itself is not considered unethical but it creates a potential self-interest threat to independence.

<u>Marking Guide</u>		**Marks**
a.	2½ mark each for client acceptance and engagement acceptance respectively.	5
b.	1 mark for each of the five points explained	5
c.	1 mark for each of the five points explained.	5
d.	Explanation of low-balling technique.	<u>5</u>
	Total Marks	<u>20</u>

EXAMINER'S REPORT

The question is in four parts. It is on audit engagement. About 90% of the candidates attempted the question. Candidates exhibited shallow understanding of part (a), but understanding of parts (b) to (d) was average. Performance was therefore average in parts (b) to (d) and poor in part (a).

The commonest pitfall of the candidates was mixing up requirements of different question parts thereby giving answers of a question part to another and vice versa.
Candidates are advised to study well for examinations, interprete questions very well and proffer correct solutions to specific question parts.

SOLUTION 3

a. The relevant control issues in the scenario include the following:

i) **Custody of ticket booklets:-** The custody is under the control of the Accountant who is also in charge of accounting and reporting on the sales of tickets. The custody of the tickets should have been under the control of another senior officer of the Company.

ii) **Manual ticketing process:-** Fraudulent staff can take advantage of the manual ticketing process to defraud the Company. The ticketing process should have been automated to avoid too much of human intervention.

iii) **Returned unused tickets:-** The unused tickets are returned to the Accountant who is also the custodian of the ticket booklets. The unused tickets are supposed to be submitted to another officer who should also be the custodian of the ticket booklets and not the Accountant.

iv) **Sales reporting:-** The sales report prepared by the ticketing staff on daily basis is reviewed and countersigned by the Accountant instead of the Head of Ticketing department to whom ticket staff members report for control purpose.

v) **Cash payment:-** Payment for both tickets and concession items bought is by cash and the cash is collected by the ticketing staff who hands cash collected over to the Accountant. This is a weakness in the system as it could encourage teeming and lading fraud by the Accountant.

vi) **Use of cash collections for expenses:-** The disbursement of part of daily cash collections for expenses incurred is a weakness which can encourage fraud in the system. This practice negates the internal control system which requires all sales proceeds to be lodged intact into the bank and payment for expenses made from the cash withdrawn from the bank account and cash payments made on an imprest system.

vii) **Irregular lodgment of sales proceeds:-** The irregular lodgment of sales proceeds could encourage teeming and lading fraud and as well expose the Company to loss of funds in case of any robbery incident. Sales proceeds are expected to be lodged timely into the designated bank account and this should be done on a daily basis to avoid accumulation of cash in the safe.

viii) **Bank reconciliation:-** Bank reconciliation is done at the end of the financial year in readiness for the yearly audit. This is another weakness in the system which will not allow for early discovery of frauds and any other malpractices that might have been perpetrated in the system. The bank reconciliation should be done at least at the end of every month.

ix) **Posting of Transactions**
Posting not done on line and real time –posting of sales is delayed till later in the day. Posting should be done as transactions occur.

x) **Insurance Policies**
Even though there is an indication of high volume of transactions daily and high cash takings, there may not be in existence insurance policies on cash handling, cash-in-safe and staff fidelity policies.

b) The categories of control activities include:

i. Performance reviews
ii. Segregation of duties
iii. Physical controls
iv. Information processing controls

i. Performance reviews
These include reviews and analyses of actual performance against budgets, forecasts and prior period performance. Most of these control activities are performed by management and are often referred to as management controls.

ii. Segregation of duties
This control involves assigning different people the responsibilities of authorising and recording transactions and maintaining the custody of assets. This reduces the likelihood of an employee being able to carry out and conceal errors or fraud.

iii. Physical controls
These include controls over the physical security of assets and records to prevent unauthorised use, theft or damage. Examples include limiting access to inventory areas to a restricted number of authorised personnel, and requiring authorisation for access to computer programs and data files.

iv. Information processing controls
These are controls used to check the accuracy, completeness and authorisation of transactions. Information processing controls are categorised into two: General IT Controls and Application controls.

MARKING GUIDE

			Marks
3a	1mark for each control weakness identified (maximum of 4 Weaknesses)	4	
	2 marks for each weakness explained	8	12
3b	1 mark for each control activity listed	4	
	1mark for each control activity explained	4	8
			20

EXAMINER'S REPORT

The question is in two parts. Part (a) requires candidates to identify and evaluate Internal control issues in a given scenario and part (b) requires candidates to explain four categories of control activities. About 90% of the candidates attempted this question. The candidates showed poor understanding of the question, hence the performance was generally below average.

The major undoing of the candidates was their inability to identify and evaluate the internal control issues in the given scenario. Candidates should learn how to apply their knowledge to given practical scenarios.

SOLUTION 4

a. An auditor is expected to obtain relevant and reliable audit evidence sufficient to enable him to draw reasonable conclusions therefrom. The evidence which an auditor obtains will be drawn from many different sources, one of which will be the representation obtained from management. It is likely that oral representations will be made throughout the conduct of an audit in response to specific enquiries. Management representations will constitute valid audit evidence, however, an auditor should not in respect of his audit rely solely on the unsupported oral representations of Management as being sufficient reliable evidence. Corroborations of most representations will be possible by checking with sources which are independent of the entity or with other evidence generated by the auditor himself. However, adequate corroboration is not and could not reasonably be expected to be available. An auditor should ensure that there is no evidence which conflicts with the representations made by Management. Furthermore, the auditor should endeavour to see that the representations made by Management are confirmed in writing.

b. **Contents of Letter of Representation**

A written representation letter may include the following statements;

(i) The written representation letter relates to the audit of the client company.

(ii) The Management of the entity have fulfilled their responsibilities for the preparation of the financial statements and it gives a true and fair view and are free from material misstatements.

(iii) The assumptions made by Management to make accounting estimates and reach fair values are reasonable.

(iv) Related party relationships and transactions have been disclosed.

(v) All events after the reporting period have either been adjusted or disclosed.

(vi) The effect of any uncorrected misstatements (which should be attached to the letter) is immaterial.

(vii) The auditors have been provided with all relevant materials, including the books of account and unrestricted access to individuals within the entity.

(viii) All transactions have been recorded and are included in the financial statements.

(ix) Management has disclosed to the auditors all information that is relevant to fraud or suspected fraud.

(x) Management has disclosed all known instances of non-compliance with laws or regulations that are relevant to the preparation of the financial statements.

(xi) Representations may also be included that refer to specific assertions in the financial statements if the auditors require that such assertions should be made.

(xii) All plans or intentions that may materially alter the carrying value or classification of assets and liabilities in the financial statements have been accounted for or disclosed in accordance to International Financial Reporting Standards(IFRS).

(xiii) The entity has satisfactory title to or control over all assets disclosed in the financial statements and where appropriate, all liens or encumbrances on these assets have been disclosed in accordance with IFRS.

c. If the Managing Director persists in his refusal to sign the letter of representation, the auditor may himself prepare a statement in writing, setting out his understanding of the principal representations that they have made to him during the course of the audit and he should send his statement to the management with a request for a confirmation that his understanding of the representation is correct. If the Management disagrees with the auditor's statement of representations, discussions should be held to clarify the matters in doubt and if necessary a revised statement prepared and agreed. Should Management fail to reply, the auditor should follow up with the matter by ensuring that management understands the position set out in his statement. If he is unable to satisfy himself, even after discussion with management of their oral representations, the auditor may have to conclude that he has not received all the information and explanations that he requires and he will then need to consider qualifying his audit report to this effect on the grounds of limitation in the scope of his audit procedures.

MARKING GUIDE

		Marks
(a)	For explanation of need to obtain letter of representation	5
(b)	1 mark for each point (maximum of 10 points)	10
(c)	for explanation of steps to be taken	5
		20

EXAMINER'S REPORT

The question tests candidates' knowledge on audit representations by management. About 40% of the candidates attempted the question. Performance was poor. The commonest pitfall was exhibition of lack of proper understanding of the requirements of the question.

Candidates are advised to adequately use the Institute's study texts in future when preparing for the examinations.

SOLUTION 5

(a) **Audit of financial statement**

Audit of financial statement is an independent examination of and the expression of an opinion on the financial statement of an enterprise by an appointed independent auditor in accordance with the terms of his appointment. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements.

This is achieved by the expression of an opinion by the auditor on whether or not the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether or not the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with International Statements on Auditing (ISAs) and relevant ethical requirements enables the auditor to form that opinion.

The financial statements subject to audit are those of the entity, prepared by management of the entity with oversight from those charged with governance. ISAs do not impose responsibilities on management or those charged with governance and do not override laws and regulations that govern their responsibilities. However, an audit in accordance with ISAs is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged certain responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

(b) **Overall objectives of the independent auditor in conducting the audit of financial statements**

In conducting an audit of financial statements, the overall objectives of the auditor are:

- To obtain reasonable assurance about whether or not the financial statements as a whole, are free from material misstatements, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

- To report on the financial statements and communicate as required by the Nigerian Standards on Auditing (NSAs) and International Standards of Auditing(ISAs), in accordance with the auditor's findings. In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, the NSAs and the ISAs require that the auditor disclaims an opinion or resigns from the engagement.

(c) Rights of the Auditor

The main statutory rights of the auditor as provided by the Companies and Allied Matters Act Cap c20 LFN 2004 (Sections 360 and 363) include the following:

- The right of access to all accounting books and records at all times.

- The right to all information and explanations (from management) necessary for the proper conduct of the audit.

- The right to receive notice of all meetings of the shareholders (such as the annual general meeting) and to attend those meetings.

- The right to speak at shareholders' meetings on matters affecting the auditor. This can be important when the auditors are in disagreement with the directors of the client entity and are unable to communicate with the shareholders effectively by any other method.

- If the company adopts written resolutions, the auditors should have a right to receive a copy of all such resolutions.

MARKING GUIDE

		Marks
(a)	For explanation of need to obtain letter of representation	5
(b)	1 mark for each point (maximum of 10 points)	10
(c)	For explanation of steps to be taken	5
		20

EXAMINER'S REPORT

The question is in three parts. Parts (a) and (b) test candidates on audit of financial statements, while part (c) requires candidates to state the rights of auditors as given by Companies and Allied Matters Act CAPC20 LFN 2004.

About 90% of the candidate attempted the question.

The candidates' generally exhibited poor understanding of parts (a) and (b), but comparatively good understanding of part (c). Performance is generally below average. The candidates' main pitfall was lack of understanding of the question especially parts (a) and (b). Candidates are hereby advised to relate their solutions to the particular requirements of a particular question section and candidates should study hard and utilise the Institute's Study Text in the course of their study.

SOLUTION 6

(a) In the operation of the on-line and real time airline ticketing system, the controls the auditor should find established include:

General Controls:
These relate to the environment within which the computer-based accounting systems are developed, maintained and operated. The controls include:

- Access Controls – Access controls need to be robust especially because transactions are processed immediately by the on-line and real time system -passwords, access codes and restricted physical access are some of the controls applied here.

- Programming controls - Programming controls should be built in to prevent or detect unauthorised changes to programs and standing data. Program changes should be tested before being put to use.

- Transaction logs - Transaction logs should be used to create an "audit trail" which is the record of how the computer has processed any transaction. The "audit trail" may not be in paper-form in an online system but the computer program should be written so as to generate the audit trail on request for any transaction.

- Firewalls should be in use – the firewalls are software or hardware devices that protect the computer network server from unauthorized access via the internet.

- Physical security to safeguard against the dangers of fire or other physical risks.

- Standby arrangements – There should be in existence, standby procedures which should be established in that in the event of system breakdown, especially the computer equipment, the standby arrangements either by the use of another computer equipment or manual document preparation can be employed. The standby arrangement should incorporate their own controls which should be reviewed and tested periodically.

Application Controls

Application system that runs on online system should have application (input, processing, output and master file) controls that are suitable for the nature of the processing system. These include:

- Pre-processing authorization operators or individuals should be required to log on to the system before they can use the program.

- Data validation or editing or program checks.
These checks which can be carried out on the input data include check digit verification, range or limit checks, existence and completeness checks. These programmed checks help to ensure the completeness and accuracy of the processing.

- "Balancing": This relates to the immediate checking of control totals of data submitted from a remote terminal before and after processing.

- File Maintenance Controls: Controls should be established to ensure the authorization and completeness of amendment to the master file and standing data.

(b) The Electronic Data Interchange (EDI) system allows the direct electronic transmission of documents like orders, invoices, payroll information and electronic funds transfer.

The likely problems the EDI system can create for the auditor include:

- Since there is a lack of paper audit trail, the EDI needs an electronic audit trail which only the computer system should be able to provide.

- There is much dependency on the computer systems. Any computer failure may have significant impact on the client organisation and its operations.

- There is a risk of loss or corruption of data during transmission.

- There are security risks in the transmission of data. Unauthorised persons may intercept or read transmitted data.

The controls the auditor expect to be in place to minimize risks in the EDI system include:

- General Information Technology (IT) controls
- Controls of transmission (data encryption, acknowledgment systems, authentication codes)
- Virus protection systems
- Contingency plans and back up arrangements.

MARKING GUIDE

		Marks
(a)	Explanation of the term	4
(b)	Objectives of the Independent Auditor(3 marks for each maximum of 2 points)	6
(c)	1 mark for each point (Maximum of 5 points	5
		15

EXAMINER'S REPORT

The question, in two parts, tests candidates on the applicable controls in an on-line and real-time environment and the problems Electronic Data Interchange System may create for the auditor.

About 45% of the candidates attempted the question. The understanding of the question was very poor and so was the performance. It is evident that candidates did not cover the syllabus very well nor used the Institute's Study Text.

Candidates are advised to make a good use of the Institute's Study Text which adequately covers the syllabus.

SOLUTION 7

a) The main audit areas to consider in the audit of Savealife Nigeria include the following:

i) Planning: The auditor should consider the following matters
- Specific nature and features of Savealife
- The objectives and scope of the audit work which should have been mutually agreed.
- Any local regulations that apply.
- The environment in which the organisation operates.
- The form and content of the final financial statements and the audit opinion

ii) Risk

The auditor should carry out a risk analysis under the usual headings of inherent risk, control risk and inherent risk.
- Inherent risk – reflecting the nature of Savealife activities and the environment
- Control risk – Internal controls and the risk that there may be inadequate controls over some control activities
- Detection risk- the risk that the auditor will fail to identify any material error or misstatement on performing the audit.

iii) Internal control

The main areas of Internal Control in Savealife might include
- Segregation of duties
- Authorisation of spending
- Cash controls
- Controls over income- donations, grants, bequests, cash collections, levies, fees, etc.
- the use of funds only for authorized purposes.

iv) Audit Evidence
- A substantive testing approach will address key areas such as completeness of recordings of transactions, assets and liabilities
- Analytical procedures may be used, as appropriate
- Review of the financial statements and appropriateness of accounting policies

v) Reporting

- Since the audit of Savealife is on voluntary basis and in line with the parent body's policy, the report will be according to the agreed objective. It is though good practice for the report to follow the structure laid down by the International Standard on Auditing 700.
- Title
- Addressee
- Scope of the report
- Responsibilities of auditors versus the responsibilities of management.
- The audit work done
- The audit opinion
- Date, name and address of auditor

b. Other factors that are peculiar to such not –for-profit organisations and which the auditor needs to consider include:

- Cash may be significant in small Not-for-profit organisations and controls are likely to be limited.
- There may be a limitation on the scope of the audit if obtaining audit evidence in an issue.
- Income could be a risk area, particularly where money is donated or raised informally
- There may be a lack of predictable income or identifiable relationship between expenditure and income which should make analytical review less appropriate or useful.
- There may be sensitivity to key statistics such as the proportion of revenue used in administration especially in the case of a charity.
- Restricted funds may exist where the organisation is only allowed to use certain funds for specific purposes

MARKING GUIDE		**Marks**
(a)	2 marks each for the 5 audit areas	10
(b)	Peculiar risk feature/area (maximum of 5 points)	5
		15

EXAMINER'S REPORT

The question which is in two parts addresses the audit areas and other factors the auditor need to consider in the relation to the audit of a Not-For-Profit Organisation.

About 60% of the candidates attempted the question.
The general understanding displayed by candidates was poor, hence the performance. It is an indication of lack of covering all the relevant sections of the syllabus. Candidates should brace up and prepare well for professional examinations.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – NOVEMBER 2016

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 Office of the Accountant-General of Federal Republic of Mazobia presented the following financial data (estimates) concerning the budget for 2017:

	₦'000
Federation Account Budget	66,955,000
Total Value Added Tax Collections	36,690,000
Federal Independent Revenue	6,380,000
Total Expenditure by the Republic	52,715,000

The revenue accruable to Federal Republic of Mazobia is based on the following revenue sharing formula among the three tiers of government:

	%
Federal Government	56
State Governments	24
Local Governments	20
Total	**100**

The total expenditure of Federal Republic of Mazobia is distributable as follows:

		%
(i)	Statutory Transfers	08
(ii)	Debt Services	12
(iii)	Other Service- wide votes	06
(iv)	Capital Expenditure	32
(v)	Personnel Cost	34
(vi)	Consolidated Revenue Fund (CRF) Pensions	03
(vii)	Subventions to Parastatals	05
	Total	**100**

Share of Value Added Tax collections are as follows:

	%
Federal Republic (as collection costs)	15
State governments (based on derivation)	50
Local governments (based on derivation)	35
Total	**100**

Federal Republic of Mazobia (FRM) share its own portion of Federation Account (56%) as follows:

	%
FRM CRF available for FRM budget	48.5
Federal Capital Territory	01.0
Share of Derivation & Ecology	01.0
Statutory Stabilisation	01.5
Derivation of Natural Resources	04.0
Total	**56.0**

Based on the available data; you are required to:

a. Calculate the revenue estimates accruable to the Federal Republic of Mazobia from:

   i. Federation Account (2 Marks)

   ii. From Value Added Tax (2 Marks)

   iii. Total revenue accruable to the Federal Republic of Mazobia. (3 Marks)

b. Calculate the share of Federation Account allocation to the Federal Government among the various beneficiaries. (16 Marks)

c. How much of the Federal Government of Mazobia budget will be by deficit financing? (2 Marks)

d. Enumerate any **FIVE** exclusive Internally Generated Revenue payable into the Consolidated Revenue Fund. (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

In an effort to promote accountability and transparency in governance, the administration has adopted and implemented the International Public Sector Accounting Standards (IPSAS) from January 2014. The governments (Federal, State, Local) and other public institutions adopted IPSAS in the reporting and presentation of financial statements to improve the quality and comparability of financial information, and to be in conformity with other advanced nations of the world. IPSAS-CASH is already adopted in the budgeting, accounting and presentation of financial statements, while IPSAS-ACCRUAL takes effect from January 2016.

You are required to:

a. Identify any **SIX** benefits of migration from IPSAS-CASH basis to IPSAS ACCRUAL basis. (12 Marks)

b. Enumerate any **FOUR** benefits in the adoption of Public Sector Accounting Standards (IPSAS). (6 Marks)

c. Identify any **TWO** characteristics of Governmental Business Enterprise. (2 Marks)

(Total 20 Marks)

QUESTION 3

The Atlantic Staff Housing Corporation is preparing its budget for 2015. You have been engaged as a Consultant to the Corporation to assist in the preparation of the budget. The following information have been made available:

(i) The total annual subventions from the Federal Government in 2014 was ₦36,000,000. There is expectation that this amount will increase by 10% in year 2015. The expected 10% increase will be received in the first six months of the year along with the normal monthly allocations.

(ii) The management has decided to reduce transport and travelling by 5% in year 2015. The total amount in 2014 was ₦3,780,000 and the expense will accrue evenly throughout the year.

(iii) Capital grant of ₦14million is expected in February, May and November.

(iv) Salaries and wages for 2014 was ₦28million. In 2015, salaries and wages will increase by $12^1/_2$% of the amount paid in 2014. Housing allowance is 33% of salaries and wages.

(v) Ground rent for industrial estates will be received as follows; January ₦2.8million; February ₦1.5million and March ₦2.08million.

(vi) The training and development expenses of ₦700,000 to increase by 10% in year 2015. The total amount will be spent on equal basis in February and October, 2015.

(vii) The Corporation will commence construction of 100 low-cost housing units in year 2015. The following are the commitments through LPOs in 2014 which will be met in the New Year.

Date Purchased	Particulars	LPOs	Time to pay	Amount (₦'Million)
15/8/2014	Cement	121	February	9.5
15/9/2014	Iron-rod	111	March	2.8
31/10/2014	Gravels	120	30/1/2015	1.5
1/11/2014	Plumbing Materials	122	20/2/2015	0.75
5/12/2014	Sands	119	March	1.2513

(viii) Rent receivable from the shopping complex of the Corporation are; January ₦1.7million, February ₦1.5million and March ₦2.5million.

(ix) The cash balance as at December31, 2014 was ₦1.5million.

You are required to:

a. Prepare a cash flow projection for the first quarter of year 2015.

(15 Marks)

b. Calculate the ratio of recurrent expenditure to total inflow for each month and make a brief comment on the ratio. (5 Marks)

(Total 20 Marks)

QUESTION 4

a. Loss or shortage of public fund is depletion in government fund at a given time.

You are required to:

Enumerate **SIX** sources through which loss of fund may arise in the public sector. (9 Marks)

b. i. Distinguish between Board of Survey and Board of Enquiry. (5 Marks)

ii. Under what conditions would a Board of Enquiry be constituted? (6 Marks)

(Total 20 Marks)

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

QUESTION 5

a. Discuss how external borrowing can bailout the Nigerian Economy from the economic recession. (9 Marks)

b. Explain any **THREE** ways by which public debt can constitute a burden to the nation. (6 Marks)

(Total 15 Marks)

QUESTION 6

a. Distinguish carefully between Cost Benefit Analysis (CBA) and Cost Effectiveness Analysis (CEA). (5 Marks)

b. The following estimated costs and benefits relate to **FIVE** different divisible projects of Eleweran Local Government. The local government has budgeted the sum of ₦100,000,000 to undertake the following projects:

	A (₦'000)	B (₦'000)	C (₦'000)	D (₦'000)	E (₦'000)
Estimated Costs of Investment	20,000	40,000	24,000	48,000	60,000
Estimated Benefits	50,000	44,000	40,000	52,000	72,000

You are required to:

i. Calculate the benefit/cost ratio of each of the five projects. ($1^1/_4$Marks)

ii. Compute the net benefit/cost ratio of each project ($3^3/_4$Marks)

iii. Compare the results in (i) and (ii) and advise the chairman of the local government on the project to be undertaken. (5 Marks)

(Total 15 Marks)

QUESTION 7

"An equitable system of public finance aims at even distribution of income and wealth among the various sections of a country".

You are required to discuss the following:

a. The income distribution function and any **THREE** instruments that could be used by government. (9 Marks)

a) Any **THREE** criteria for income distribution. (6 Marks)

(Total 15 Marks)

SOLUTIONS

SOLUTION 1

a) **Calculation of the revenue estimates accruable to the Federal Republic of Mazobia:**

i) **Federation Account**

56% X ₦66,955,000,000 = ₦37,494,800,000.00

ii) **Value Added Tax**

15% X ₦36,690,000,000 = ₦5,503,500,000.00

iii) **Total Revenue Accruable to the Federal Republic of Mazobia**

	₦
Federation Account	37,494,800,000
Value Added Tax	5,503,500,000
Federal Independent Revenue	6,380,000,000
Total Revenue Accruable	**49,378,300,000**

b) **Calculation of the share of Federation Account Allocation to the Federal Government among the various beneficiaries.**

Consolidated Revenue available for Budget		**₦**
Federation Account (48.5% X ₦66,955,000,000)	=	32,473,175,000
Federal Capital Territory (1% X ₦66,955,000,000)	=	669,550,000
Share of Derivation & Ecology (1% X ₦66,955,000,000)	=	669,550,000
Statutory Stabilisation (1.5% X ₦66,955,000,000)	=	1,004,325,000.
Derivation of National Resources (4% X ₦66,955,000,000)	=	2,678,200,000
Total		**37,494,800,000**

c) **Calculation of Deficit Financing of Federal Government of Mazobia Budget**

	₦
Total Revenue Accruable	49,378,300,000
Total Expenditure by the Republic	52,715,000,000
Deficit Financing (Total Expenditure – Total Revenue)	**3,336,700,000**

d) **Internally Generated Revenue payable into the Consolidated Revenue Fund**

i) **Direct Taxes:** These include PAYE of the Armed Forces and Police Personnel, Foreign Service Officers and Residents of the Federal Capital Territory.

ii) **Licence & Internal Revenue:** These are realized from the issuance of licences, e.g. arms and ammunition licence fees, goldsmith licence fees, radio & T.V Licence fees, gold dealer's licence fees.

iii) **Mining:** These include mining fees, rent of mineral lands, royalties on gold, tin, iron ore, and coal mines.

iv) **Fees:** They are fees received on services rendered by government officials, e.g., court fees, court fines and medical fees.

v) **Earnings and Sales:** Earnings and sales are derived from the use and subsequent disposal of government property e.g. sale of stores, publications and stamps, commission on money order and poundage on postal orders.

vi) **Rent of Government Property:** The incomes include rent on government quarters, land and buildings.

vii) **Interest & Repayments (General):** These are interest and repayment of loans granted to individuals by the Government, Corporations, and Government companies. An example is the repayment of motor vehicle loans.

viii) **Interest & Repayments (State):** They are interest and repayment of loans granted to the State Governments.

ix) **Armed Forces:** The sale of Armed Forces' property such as old vehicles and stores constitute revenue.

x) **Reimbursements:** These are refunds for services rendered to the State and Local Government Councils, Public Corporations and other Statutory Bodies by the Federal Government officers. Examples are reimbursements of audit fees and refunds of overpayments made to Government workers.

xi) **Operating Surplus/ Dividends from Investments.** All government are expected to pay 80% of their Operating Surplus to Consolidated Revenue Fund as required by Fiscal Responsibility Act, 2007. Dividends from shares purchased from quoted or limited liability companies by the government must also be paid to the Consolidated Revenue Funf.in

xii) **Miscellaneous:** These are other sources of revenue apart from those stated above. Examples are overpayments refunded, lapsed deposits.

MARKING GUIDE

			Marks	Marks
A				
	I	Calculation of Federation Account	1	
		Correct Federation Account figure	1	2
	Ii	Calculation of Value Added Tax	1	
		Correct Value Added Tax figure	1	2
	iii	Stating the components and figures correctly	1½	
		Correct Total Revenue accruable	1½	3
B		Correct calculation of CRF figure	3	
		Correct calculation of Derivation & Ecological figure	3	
		Correct calculation of FCT figure	3	
		Correct calculation of Stabilisation figure	3	
		Correct calculation of Natural Resources figure	3	
		Correct calculation of Total figure	1	16
C		Stating the figure of Total Revenue accruable correctly	½	
		Stating the figure of Total Expenditure correctly	½	
		Calculation of Deficit Financing figure correctly	1	2
D		Any Five IGR sources at 1 mark each		5
		Total		30

EXAMINER'S REPORT

The question tests candidates' knowledge of Revenue budget and apportionment between the three tiers of government.

All the candidates attempted the question and their performance was average.

The major pitfall of the candidates was their inability to apportion the estimated revenue among the Federal Government and its various beneficiaries.

Candidates are advised to prepare very well for future examinations by making use of the Institute's Study Texts and the Pathfinder.

SOLUTION 2

a) The benefits of migration from IPSAS-CASH basis to IPSAS ACCRUAL basis are as follows:

(i) It takes a realistic view of financial transactions;

(ii) It reveals an accurate picture of the state of financial affairs at the end of the period;

(iii) It could be used for both economic and investment decision-making as all parameters for performance appraisal are available;

(iv) It aligns with the 'matching concept;

(v) It makes allowances for the diminution in the value of assets used to generate the revenue of the enterprise;

(vi) It provides aggregate information useful in evaluating the entity's performance in terms of service costs, efficiency and accomplishments;

(vii) The accrual method makes it easier to track receivables as well as payables;

(viii) Accrual basis accounting can provide forward-looking cash flow analysis. An entity does not have to wait to physically receive payment for goods supplied and services rendered. It continuously keeps track of revenue/ income receivable in future – a process that helps the entity to plan and make smarter business decisions;

(ix) Accrual accounting gives companies a truer depiction of their resources and financial responsibilities. This serves as an advantage because, it allows businesses to properly manage the ebb and flow of financial activity. Income and debts can be more accurately assessed with accrual accounting;

(x) Accrual accounting is effective for financial management and monitoring activities. In an accrual accounting system, companies receive a more immediate reflection of how much money they have and what they can expect to see in future expense reports. With this type of recording methodology, business analysts can look for financial trends and compute current cash flow statements on a regular basis; keeping everybody up-to-date as much as possible;

(xi) Highlights critical policy areas that cash accounting would not reveal e.g. private finance initiatives, long-term pension liabilities;

(xii) focuses on long-term financial sustainability;

(xiii) Improves policy decision- making;

(xiv) Gives the external users of accounts better quality information about debtors, creditors and assets;

(xv) Allows for identification of cost of capital;

(xvi) Reduces the scope of selective accounting policies; and

(xvii) Provides valuable information about the value of assets and liabilities.

b) Benefits in the adoption of Public Sector Accounting Standards (IPSAS)

i. **Accountability:** IPSAS requirement for increased disclosure in accounting reports increases the level of accountability in government.

ii. **Transparency:** Where IPSAS is adopted, full disclosure become an imperative of Public Sector Accounting.

iii. **Improved Credibility/Integrity:** Government accounting/reporting are not credible if government itself decides the rules.

iv. **Building Confidence in Donor Agencies and Lenders:** Adoption of IPSAS increases the country's eligibility to access economic benefits from donor agencies (UNDP, USAID etc), private sector financial institutions (Bonds and Bonds rating agencies), International institutions (IMF and World Bank) etc.

v. **Improved Service Delivery:** As a result of greater accountability and transparency, adoption of IPSAS will improve Value-for-Money (VFM).

vi. **Aggregate Reporting:** Adoption of IPSAS will ensure a holistic reporting of government financial transactions and positions.

vii. **Political Leverage:** Government may be required to provide accounting information by a higher or legal authority e.g. UN, ICJ, etc.

viii. **International Best Practice and Comparability:** IPSAS seeks to ensure that financial statements prepared on the basis of it are internationally comparable.

ix. Comparable information assists the stakeholders in assessing how well their resources have been utilized.

x. **Enhanced Public-Private Partnership arrangements:** Collaborative efforts between the public and private sectors are enhanced with both running on similar set of accounting standards- IPSAS and IFRS.

xi. **Economic Leverage:** Sovereign nations are induced with the prospect of commensurate benefits. Governments susceptible to economic leverage are more likely to adopt IPSAS.

xii. An IPSAS compliant economy keeps abreast of the latest market trend thereby becoming competitive in the global market place.

xiii. **Greater Disclosures:** IPSAS encourages full disclosure, which induces transparency, integrity and accountability.

xiv. **Increased Control of Public Agencies:** The increased disclosure, transparency and comparability IPSAS engenders will permeate the public sector thus bringing about greater accountability.

xv. **Increased Cross-border Investment and Foreign Direct Investment:** The adoption of IPSAS will put the country on the same accounting pedestal as several other countries of the world, thereby increasing the propensity to generate more cross-border and foreign direct investments through greater transparency and a lower cost of capital for potential investors.

xvi. Strategic plans and reports become more meaningful as increased transparency provides a basis for member states to assess whether resources are being used effectively and efficiently.

xvii. **Enhanced Implementation of the Freedom of Information (FOI) Act 2011:** The accountability and transparency requirements of IPSAS are consistent with and supports the provisions of the Nigerian FOI Act 2011 which seeks to promote access to government information.

xviii. Provide better quality information to stakeholders.

xix. Adoption of IPSAS will provide a unified approach to managing all funds- regular; specific; voluntary; trust and service funds, and will allow for benchmarking with similar institutions and forecasting future flow of all resources to the organization.

xx. IPSAS supports efficient internal controls and results-based management.

c) Government Business Enterprise means an entity that has all the following characteristics:

(i) The power to contract in its own name;

(ii) Has been assigned the financial and operational authority to carry on a business,

(iii) Sells goods and services in the normal course of its business to other entities at a profit or full cost recovery;

(iv) Is not reliant on continuing government funding to be a going concern (other than purchases of outputs at arm's length); and

(v) Is controlled by a public sector entity.

MARKING GUIDE

		Marks
a)	Any Six benefits for 2 marks each	12
b)	Any Four benefits of Adoption of IPSAS for 1½ marks each	6
c)	Any Two characteristics for 1 mark each	2
	Total	20

EXAMINER'S REPORT

The question tests candidates' knowledge of the benefits of migration from IPSAS – Cash basis to IPSAS Accrual basis and the basic features of Government Business Enterprise.

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

Candidates' major pitfall was their inability to identify correctly the basic features of Government Business Entity.

Candidates are advised to read widely to cover all parts of the examination syllabus for future examinations by making use of International Public Sector Accounting Standards, Pathfinder and the Institute's Study Texts.

SOLUTION 3

a) **Atlantic Staff Housing Corporation**

Preparation of Cash Flow Projection for the First Quarter of year 2015

Details	Workings	January	February	March
Inflow		₦	₦	₦
Annual Subventions	I	3,600,000	3,600,000	3,600,000
Capital Grant		-	14,000,000	-
Ground Rent		2,800,000	1,500,000	2,080,000
Rent Receivable		1,700,000	1,500,000	2,500,000
Total Inflow	A	8,100,000	20,600,000	8,180,000
Outflow				
Recurrent				
Transport and Travelling	II	299,250	299,250	299,250
Salaries and Wages	III	2,625,000	2,625,000	2,625,000
Housing Allowance	IV	866,250	866,250	866,250
Training and Development	V	-	385,000	-
Total Recurrent Outflow	B	3,790,500	4,175,500	3,790,500
Capital				
Cement		-	9,500,000	-
Iron-rod		-	-	2,800,000
Gravels		1,500,000	-	-
Plumbing Materials		-	750,000	-
Sands		-	-	1,251,300
Total Capital Outflow	C	1,500,000	10,250,000	4,051,300
Total Outflow	D	5,290,500	14,425,500	7,841,800
Cash B/F		1,500,000	4,309,500	10,484,000
A-D		2,809,500	6,174,500	338,200
Cash C/F		4,309,500	10,484,000	10,822,200

Workings

i. Annual Subventions per month for the First Quarter of year 2015

	₦
₦36,000,000.00/ 12 =	3,000,000
Increase = 10% of ₦36,000,000/ 6	600,000
Total	**3,600,000**

ii Transport and Travelling

95% of ₦3,780,000/ 12 = ₦299,250

iii. Salaries and Wages

112½% of ₦28,000,000.00 = ₦31,500,000/ 12 = ₦2,625,000

iv. Housing Allowance

33% of ₦31,500,000.00 = ₦10,295,000/12 = ₦866,250

v. Training and Development

110% of ₦700,000.00 = ₦770,000./2 = ₦385,000

b) Calculation of the Recurrent Expenditure/ Total Inflow

	January	**February**	**March**
	₦	**₦**	**₦**
Recurrent Expenditure	3,790,500	4,175,500	3,790,500
Total Inflow	8,100,000	20,600,000	8,180,000
Ratio	**1: 2.14**	**1: 4.93**	**1: 2.16**

Comment

From the above computations, it was observed that:

i) The recurrent expenditure to total inflow ratio is averagely reasonable. It was high in February while it was average in January and March, 2015 respectively. This is as a result of lower cash inflows into the corporation during the two months (January and March, 2015) which had serious impact on the ratio for the two months compared to high cash inflows in February, 2015, that resulted in high ratio.

ii) The Corporation had huge excess cash balances from January to March 2015 which could be invested in short term investment instrument after due consideration of necessary operational cash requirements

MARKING GUIDE

		Marks	Marks
a	Heading	½	
	Each cash flow correct entry at ¼ per entry = 46 X ¼	11½	
	Workings	3	15
b	Recurrent expenditure/total inflow at 1 mark/ month	3	
	Comment on the ratios calculated	2	5
	Total		20

EXAMINER'S REPORT

The question tests candidates' knowledge of preparation of cash flow projections and expenditure/revenue ratio.

About 75% of the candidates attempted the question and their performance was poor.

Candidates' major pitfall was their inability to interpret the question correctly. In addition, some of the candidates took the question for cash flow statement. Candidates are advised to prepare very well for future examinations by making use of Pathfinder and the Institute's Study Texts.

SOLUTION 4

a) The types of losses that can arise in the public sector include:

(i) Misappropriation of funds;
(ii) Falsification of records;
(iii) Conversion of funds to personal use;
(iv) Fraudulent payments;
(v) Theft;
(vi) Negligence;
(vii) Abandonment of revenue receivable;
(viii) Abandonment of advance granted from recurrent expenditure;
(ix) Loss of Cash; and
(x) Loss of fund through natural disaster.

b)i) **Boards of Survey** is to be held after the close of business on the last business day of each financial year, or before the commencement of business on the first working day of the new financial year. The Board shall be appointed to examine the cash, bank balances and stamps, held by the Accountant-General at the Sub-Treasury, Federal Pay Offices and Cash Offices in ministries/extra-ministerial offices and other arms of government.

A 'Board of Enquiry' is a group of one or more persons set up for a specific purpose that is to conduct an investigation.

ii) A Board of Enquiry shall be constituted under the following conditions if:

(a) Fraud is probable;
(b) The loss is substantial;
(c) Several officers are involved;
(d) The responsibility of the officers are not clearly defined;
(e) The loss took place over a period of time; and
(f) Collusion is suspected.

MARKING GUIDE

			Marks	Marks
a		Any Six sources of loss of fund for 1 ½ marks each		9
b	I	Definition and features of Board of Survey	2 ½	
	ii	Definition and features of Board of Enquiry	2 ½	5
		Any Four conditions for 1½marks each		6
		Total		20

EXAMINER'S REPORT

The question tests candidates' knowledge of the management of public funds and distinguishing between the Board of Survey and Board of Enquiry.

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

Candidates' major pitfall was their inability to answer the part (b)of the question.

Candidates are advised to prepare very well for future examinations by making use of Pathfinder and the Institute's Study Texts.

SOLUTION 5

a) The Nigerian economy officially slid into recession following two consecutive quarters of negative real Gross Domestic Product (GDP) growth rates during the first and second quarters of year 2016 *(source: National Bureau of Statistics Nigeria, 2016).* Given the fast dwindling government revenue, increasing rates of inflation and unemployment, widespread hunger and poverty, the Federal Government has an option to take loans from sources outside the economy, such as from foreign governments (bilateral loans), commercial creditors (London and Paris Clubs) and multilateral sources (World Bank Groups, International Monetary Fund, African Development Bank ,etc.) to bridge budgetary gap. Such external debts incurred can be used in the following ways to bail Nigerian economy out of recession.

i). **Eliminate Deficit of Infrastructural Facilities:** External funds can be used to provide new social and economic infrastructural facilities like roads, railways, electricity and hospitals and upgrade existing ones. Rapid economic growth and welfare improvement would be achieved if borrowed external funds are utilized to finance economically and socially viable projects;

ii) **Promote Economic Stability:** A stable economy naturally provides an enabling environment for economic growth and development. External fund may be used to reduce excessive pressure on the country's foreign reserve and currency depreciation thereby controlling inflation and stimulating economic activities;

iii) **Expand Public Works:** If borrowed funds are spent on public works, standard of living will improve, especially via creation of new jobs and the transformation of the environment;

iv) **Diversify the Economy:** External funds can be used to develop the agricultural and mining sectors. For instance, to acquire critical inputs such as equipment and machines needed to support massive production of agricultural products, especially where it is not immediately possible to generate such technology locally. Furthermore, external resources will be needed to support private sector exploitation of the country's solid mineral resources; and

v) **Reduce Income Inequality:** Public debt reduces income inequalities if it is spent on social and security projects that are of more benefit to the lower income groups in the society.

b) Generally, the adverse consequences of public debts include the following:

i. Excessive government borrowing within the economy tends to crowd out private investments, that is, government competes with private companies in the financial market and deprive them of loanable funds needed to grow their activities;

ii. 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;

iii. Funding excessive interest rate on public debt in hard currency deprives the nations of foreign exchange needed to procure critical inputs, especially in a country like Nigeria 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;

iv. Borrowing comes along with some conditionalities of the International Monetary Fund (IMF), like trade liberalization, withdrawal of subsidies on essential products, expenditure reduction, non-increase of salary of public servants and other stiff conditions that carry grave repercussion on living standards of the people;

v. It has inflationary effect. As a matter of fact, debt servicing itself may create inflationary effects. Specially, the financing of domestic debt usually cause aggregate demand to increase when creditors bring the income generated through their investment in government securities into circulation to patronise nonessential goods and services; and

vi. Debt servicing problem is aggravated when short and medium term loans are committed to long term projects with amortization becoming due before projects are completed.

MARKING GUIDE

		Marks	Marks
a	Identification of the ways of securing the bail out	1	
	Explanation of the ways	2	
	3 marks for any three points	3 X 3	9
b	2 marks for each of any three (3) ways	2 X 3	6
	Total		15

EXAMINER'S REPORT

The focus of the question is on the relevance of external debts as they relate to the management of the economic recession in contemporary Nigeria. The candidates are required to provide copious discussion on this and, at the same time, examine the attendant problems associated with the country's external debt obligations.

Virtually 95% of the candidates attempted the question, but only about 40% of them scored pass mark.

The common pitfall was misinterpretation of the question to mean debt management strategies.

Candidates are advised to have thorough grasp of the orientation and requirements of questions before answering them.

SOLUTION 6

(a) **Cost Benefit Analysis (CBA)** is a technique which enables a systematic comparison to be made between the estimated costs of undertaking a project and the estimated benefit which may arise from the implementation of such project. In a period of capital rationing, it is essential for the government to select the optimal project. In CBA, the decision is often taken by ranking alternative projects after the calculation of Benefit/Cost ratio or Net Benefit/Cost ratio.

Cost Effectiveness Analysis (CEA) is a technique of project appraisal which enables the management to determine the cheapest strategy to meet a well defined objective or to determine the optimal strategy to meet an objective when given a fixed budget cost. In CEA, costs are calculated and alternative investments are compared for achieving a specific set of results. CEA does not give information about the benefits of meeting the objectives of investments.

(b) Benefit/Cost ratio of each project

	A	B	C	D	E
	(₦)'000	**₦'000**	**₦'000**	**₦'000**	**₦'000**
(a) Estimated Benefit	50,000	44,000	40,000	52,000	72,000
(b) Estimated Cost	20,000	40,000	24,000	48,000	60,000
(c) Net Benefit	30,000	4,000	16,000	4,000	12,000
(i) Benefit/Cost Ratio ($\frac{a}{b}$)	2.5: 1	1.1: 1	1.67: 1	1.08: 1	1.2: 1
(ii) Net Benefit/Cost Ratio ($\frac{c}{b}$)	1.5: 1	0.1: 1	0.67: 1	0.08: 1	0.2: 1
Ranking	1st	4th	2nd	5th	3rd

Ranking	**Estimated Cost of Investment Budgeted (N)**	**Cumulative of Money for Investment (N)**
Amount Budgeted		100,000.000
A	20,000,000	80,000,000
C	24,000,000	56,000,000
E	60,000,000	(4,000,000)

The chairman of the local government should embark on project A, C and part of project E since the project is divisible. He can complete $\frac{56}{60} x\ 100$ = 93.33% of project E.

MARKING GUIDE

		Marks	Marks	Marks
a	Definition of Cost Benefit Analysis	1		
	Explanation	1½	2½	
	Definition of Cost Effectiveness Analysis	1		
	Explanation	1½	2½	5
B (i)	Calculation of Benefit/Cost ratio		$1^1/_4$	
(ii)	Net benefits/Cost Ratio:			
	Determination of Net benefit	$1^1/_4$		
	Calculation of Net benefit/Cost ratio	$1^1/_4$		
	Ranking of Project	$1^1/_4$	$3^3/_4$	5
(iii)	Comparison and advice			
	Determination of Projects		3	
	Advice		2	5
	Total			15

EXAMINER'S REPORT

The question tests candidates' understanding of the methods of public project appraisal with particular reference to the Cost Benefits Analysis (CBA) and the Cost Effectiveness Analysis (CEA). Apart from differentiating between CBA and CEA, the question requires candidates to be able to compute the benefits/cost and the net benefit/cost ratios and use the results to make appropriate recommendations on the five projects.

About 50% of the candidates attempted the question and the performance was poor. Virtually all of them could not provide clear distinction between CBA and CEA, while majority of them failed to compute simple ratios.

Candidates are advised to always prepare well for future examinations, have thorough grasp of the public project appraisal methods and be able to demonstrate proficiency in their presentation in line with the requirements of questions.

SOLUTION 7

a) (i) **Income distribution function:**

This is the process by which government transfers income from one group to another. An equitable system of public finance aims at an even distribution of income and wealth among the various sections of a country. The use of market forces, in which factors are rewarded under the condition that Price=Marginal Cost=Marginal Revenue, may lead to unfair/uneven income distribution. Thus, income distribution is seen as a matter of government policy in which the gap between the rich and the poor is bridged.

(ii) Instruments of income redistribution that can be used by the government:

i) **Taxation:** Government may apply progressive tax system whereby income gap between the haves and the have-nots is bridged.

ii) **Government expenditure:** Government can redistribute income and opportunity through functional classification of public expenditure.

iii) **Subsidy:** Government can decide to subsidize the cost of essential commodities like petroleum products and other goods consumed majorly by the poor people.

iv) **Special or Social benefits:** Income payments in form of unemployment benefits, sick benefit, family allowance could be provided by the government

(b) Criteria for income distribution:

i) **Factor endowment-based criterion**: This criterion is based on the principle that an individual has the right to keep whatever that individual could earn through the use of his resources. The distribution of income is then determined by the process of factor pricing, which in a competitive market sets factor returns equal to the value of marginal product i.e., (factor reward=Price x MPP of factor). The distribution of income, however, depends on their factor endowments and the market prices.

ii) **Utilitarian criterion**: This criterion simply states that an individual A should be given more income than another individual B if individual A's utility level or ability to derive satisfaction from personal income is higher. Equal distribution would be called for if the marginal income utility schedules for all individuals are the same and equally declining. It implies a criterion that achieves the maximum satisfaction for the entire society.

iii) **Equity criterion**: This criterion stipulates fairness in distribution in which every person's subjective valuation of their own share of income is the same. The government provides all citizens, regardless of identity, equal life chances to possess the basic and equal minimum of income. The implication is that income distribution in a society must of necessity be a public issue where government effort is geared towards equating welfare position for all individual.

MARKING GUIDE

		Marks	Marks
A	Definition of income distribution function	1	
	Discussion of income distribution function	2	3
	Identification of instrument	1	
	Discussion of instrument	1	
	(2 marks for each of any 3 points)	2 X 3	6
B	Identification of criteria	1	
	Discussion of criteria	½	
	Implication of criteria	½	
	(2 marks for each of any 3 points)	2 X 3	6
	Total		15

EXAMINER'S REPORT

The question tests candidates' understanding of the role of government in effecting even distribution of income, using instruments of public finance. The requirements of the question involve defining the income distribution functions of government, the instruments and criteria for income distribution.

About 45% of the candidates attempted the question. The general performance was below average.

Some of the candidates provided a fair treatment of the definition of income distribution and listed the instruments correctly. However, virtually all the candidates failed to provide quality response for the income distribution criteria.

The question is a textbook question. Candidates are advised to study this aspect of the syllabus from ICAN Study Texts, the Pathfinder and other relevant textbooks on Public Finance.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – NOVEMBER 2016

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

Pallat Manufacturing Company Limited was incorporated in Nigeria in 2004 and has made significant progress since its inception. The company manufactures cosmetics which it distributes throughout the country. However, the company is currently experiencing problems arising from major changes in its business environment. To deal with these challenges, the company set up a team of managers drawn from various departments. The team was required to evaluate the company's current strategies in the light of the challenges occurring in its environment.

a. With the aid of the PESTEL model, write a brief, to be presented at the next scheduled meeting of the team, highlighting the significant factors in the macro environment of the firm. (18 marks)

b. Discuss **TWO** limitations of using the PESTEL analysis. (7 marks)

c. As an Accountant, determine the **FOUR** stages involved in risk audit. (5 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

Quite a number of factors determine the success of a company. The structure of its corporate governance is one.

Required:

a. Clearly articulate the idea of corporate governance in a way that will underscore its relevance to business success. (8 Marks)

b. What kind of company is a good company? (2 Marks)

c. Discuss any **FIVE** corporate governance issues. (10 Marks)

(Total 20 Marks)

QUESTION 3

An indigenous company wants to set up a retail mega store in the city of Ibadan. The city was chosen because of its population density that promises a vast market for the company's products. Besides, it was discovered that in Ibadan, overhead cost (which includes salaries, rent, transportation and power supply) would just be about half of what it would be in Lagos. For instance, there is usually a minimum of 20-hour daily supply of electricity in Ibadan compared with the barely 10-hour daily supply in Lagos. Were the store to be located in Lagos, it would have to spend double the amount of money required in Ibadan to generate electricity. Invariably, the store would, everything being equal, record a higher profit in Ibadan than in Lagos. Also, its operations in Ibadan would be more environmentally friendly than in Lagos as it would be emitting less carbon dioxide into the atmosphere because it would use less of its diesel operated power generating set. Furthermore, the taxes the store would be paying would enhance the revenue generation of the state government.

The government has already approved the building of the new mega store and the local population is anxiously awaiting the commencement of construction. This would provide immediate jobs for a good number of people in the city apart from those that would be employed when the store becomes fully operational.

Required:

Employ Tucker's five-question model for ethical decision-making in business to determine if the decision to build the mega store in Ibadan and not Lagos is ethical.

(20 Marks)

QUESTION 4

a. The board of directors of a company, recently listed on the Nigerian Stock Exchange, has just resolved to put in place a robust enterprise-wide risk management framework to ensure consistency in the approach to risk management across the firm. This will include introducing the ISO 31000 framework for risk management to ensure international best practices in risk management.

Draft a presentation to the board of directors on:

i) Key elements of ISO 31000 framework (6 Marks)

ii) The role of the board of directors and management in risk management (9 Marks)

b. As the chairman of the board of directors of Health Pharmaceutical Company, you are required to educate newly elected members of the board on the roles of the board and management in identifying and assessing risks.

(5 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. With the aid of Johnson and Scholes Model, explain the **FOUR** possible ethical stances that a business entity should focus on. (10 marks)

b. Present any **FOUR** fundamental ethical principles that should guide the actions of professional accountants in a way that would motivate a newly qualified accountant to comply with them. (5 marks)

(Total 15 marks)

QUESTION 6

Strategic Analysis in any company is the balance of power between the stakeholder groups and the relative power and influence of each group.

Required:
Prepare a presentation using Mendelow's Framework to analyse the stakeholders' influence over strategic actions or decisions. **(Total 15 Marks)**

QUESTION 7

a. "Structure follows strategy". Discuss (5 marks)

b. Discuss any **FIVE** types of structure, explaining the kinds of strategy that might necessitate each type. (10 marks)

(Total 15 marks)

SOLUTIONS

SOLUTION 1

(a) The nature of PESTEL analysis

The macro environment of a business entity consists of factors that are external to the business but have significant influence on its survival and growth. The factors or variables of the external environment are usually not within the control of the business entity. However, an effective analysis of the environment enables the business enterprise to generate viable strategies to achieve its objectives. One model that may be used in this analysis is PESTEL analysis.

PESTEL analysis is a structured approach to analysing the external environment of an entity. The influences (current influences and possible future influences) of the environment on the entity are grouped into categories. For each category of environmental influence, the main influences are identified.

There are six categories of environmental influence. These are:

P – Political environment
E – Economic environment
S – Social and cultural environment
T – Technological environment
E – Ecological or environmental influences environment
L – Legal environment

i. Political environment

The political environment consists of political factors that can have a strong influence on business entities and other organisations.

Investment decisions by companies will be influenced by factors such as:

- the stability of the political system in particular countries;
- the threat of government action to nationalise industry and seize ownership of private business;
- wars and civil unrest; and
- the threat of terrorist activity.

Political considerations are particularly important for business entities operating in countries with unstable political regimes or dictatorship.

ii. Economic environment

The economic environment consists of the economic influences on an entity and the effect of possible changes in economic factors on future business prospects. Factors in the economic environment include:

- the GDP and its rate of growth;
- the rate of inflation;
- interest rates and the probability that they may rise or fall;
- foreign exchange rates, and the probability that particular currencies will get weaker or stronger;
- unemployment levels and the availability of skilled or unskilled workers;
- government tax rates and government subsidies to industry;
- the existence or non-existence of free trade between countries, and whether trade barriers may be removed; and
- the existence of trading blocs of countries, such as the ECOWAS or European Community.

Economic factors can influence a decision by a company on where to invest. Tax incentives, availability of skilled labour, a good transport infrastructure, a stable currency, energy supply (and its impact on the cost of production) and other economic factors can influence strategic choices.

iii. Social and cultural environment

An entity is affected by social and cultural influences in the countries or regions in which it operates. These include diverse social customs and attitudes. However, some influences are more significant than others.

Factors in the social and cultural environment include the following:

- the values, attitudes and beliefs of customers, employees and the general public;
- patterns of work and leisure, such as the length of the working week and popular views about what to do during leisure time;
- the ethnic structure of society;
- the influence of religion and religious attitudes in society; and
- the relative proportions of different age groups (demography) in society.

iv. *Technological environment*

The technological environment consists of the science and technology available to an organisation (and its competitors), and changes and developments in science and technology.

Some aspects of technology and technological change affect virtually all organisations. Developments in IT and computer technology, including the Internet, are the most obvious examples. Business entities that do not respond to changes in IT risk losing their share of the market to competitors.

For strategic planning, companies need to be aware of current technological changes and the possible nature of changes in the future. Technology could have an important influence, for example, on investment decisions in research and development, and investment in new technology.

v. *Ecological or environmental influences*

For business entities in some industries, environmental factors have an important influence on strategic planning and decision-making. They are particularly important for industries that are:

- subject to strict environmental legislation or the risk of stricter legislation in the future. For example, legislation to cut levels of atmospheric pollution;
- faced with the risk that their sources of raw materials will be used up. For example, parts of the fishing industry and timber production industry; and
- at the cutting edge of technological research, such as producers of genetically modified foods.

In some countries, companies have seen a commercial advantage in presenting themselves as 'environment-friendly'. Several companies have adopted a policy of reducing carbon dioxide emissions, air, water and soil pollution, wasteful use of natural resources and destruction of the natural habitat.

Stakeholders activism has forced companies to pay attention to environmental issues. For example, oil companies operating in the Niger Delta area of Nigeria have been forced to deal with oil pollution due to increasing hostility from the host communities. In addition, many companies are investing in the development of energy from renewable energy sources such as the sea and wind.

vi. Legal environment

The legal environment consists of the laws and regulations affecting an entity. Laws and regulations vary across countries, although international regulations are accepted in certain areas of commercial activity, such as banking.

Strategic decisions by an entity might be affected by legal considerations.

For example:

- an international company might locate some operations, for tax reasons, in a country with a favourable tax system;
- decisions to relocate operations from one country to another could be affected by the differences in employment laws in the two countries;
- in many industries, companies are faced with environmental legislation or health and safety legislations affecting the ways they operate as well as the design of the products they make and sell.

(b) Limitations of PESTEL analysis

PESTEL analysis is a useful framework for identifying environmental influences on an entity. However, it has several limitations.

i. While it is easy to use PESTEL analysis to identify past and present environmental influences, it cannot be easily used to identify the environmental influences that will be of significance in the future.

ii. It is a method of identifying environmental influences that provides a framework for qualitative analysis, but not for quantification.

iii. PESTEL analysis may be subjective, especially when it is based on a manager's personal judgement. That is, element of bias is not completely ruled out.

(c) There are four stages in a risk audit.

Stage 1: Identification. The first step in a risk audit is to identify what the risks are in a particular situation, strategy, procedure or system because risks change continually in nature. Existing risks may disappear and new risks may emerge. It is therefore essential to identify what the current risks are, especially for companies that operate in a volatile business environment.

Stage 2: Assessment. When the risks have been identified, the next step is to assess them. The probability of an adverse event or outcome and the impact of an adverse event should be measured. A risk can be assessed by its expected loss. The expected loss = Probability x Impact.

Stage 3: Review. The controls in place to manage the risk in the event of an adverse outcome are evaluated for effectiveness. Management may take measures to transfer the risk, for example, to insure certain risks, or to reduce the risks by introducing control and monitoring systems.

Stage 4: Report. The outcome of the risk audit is reported to the board of directors or to management, depending on who commissioned the audit.

MARKING GUIDE

	HEADING		MARKS
(a)i	Identifying the elements of PESTEL (1 mark each x 6 points)	6	
ii.	Explanation of PESTEL (2 marks each x 6 points)	12	
			18
(b).	Identification and explanation of 2 limitations (3½ marks x 2 points)		7
(c)	Identification and explanation of the four stages (1¼ marks each x 4 points)		5
	TOTAL		**30**

EXAMINER'S REPORT

The question is testing candidates' understanding and ability to apply PESTEL analysis in a practical situation. It also tests their understanding of the limitations of PESTEL analysis as well as the important stages of risk audit in an organisation.

The question, being compulsory, was attempted by all the candidates and the overall performance was average. While many of the candidates could explain PESTEL analysis, quite a number of them had problems discussing the limitations of the PESTEL model and the stages involved in risk audit.

Candidates are advised to pay attention to the details of all the topics discussed in ICAN's Study Text.

SOLUTION 2

a. **Idea of corporate governance**

Corporate governance has been defined as the system by which companies are directed, monitored and controlled. It is concerned with questions such as:

- In whose interests is a company governed?
- Who has the power to make decisions for a company?
- For what aims or purposes are those powers used?
- In what manner are those powers used?
- Who else might influence the governance of a company?
- Are the people in charge of the governance of a company held accountable for the way in which they use their powers?
- How are risks managed?

Corporate Governance and Business Success

With the understanding that corporate governance is about monitoring and controlling decisions as well as giving leadership and direction to business entities, it follows that the extent to which a business entity will succeed would be a function of the type and quality of corporate governance. Indeed, if governance is about seeing that a business is run properly, the better governed a business is, the more properly it would run, and the more properly it runs, the better positioned it would be to succeed in its objectives and core goals.

b. A good company is necessarily one that is well-governed such that it:

i. earns good profits;
ii. responds to the needs of its customers;
iii. is a good employer;
iv. is environmentally-friendly; and
v. responds favourably to the concerns of the host community.

c. **Corporate Governance Issues**

The following are the main issues covered by codes of corporate governance:

i. **The roles and responsibilities of the board of directors:** The board of directors should provide suitable leadership to the company. Governance is therefore concerned with establishing what the responsibilities of the board should be and making sure that these are carried out properly.

ii. **The composition and balance of the board of directors:** A board of directors, collectively, and individual directors, should act with integrity, and bring independence of thought and judgment to their roles. The board should not be dominated by a powerful chief executive or chairman. It is therefore important that the board should have a suitable balance, and consist of individuals with a range of backgrounds and experience.

iii. **Financial reporting, narrative reporting and auditing:** The board should be accountable to its shareholders and should be open and transparent with investors generally. To make a board accountable, high standards of financial reporting, narrative reporting and external auditing must be upheld. The major 'scandals' of corporate governance in the past have been characterised by misleading financial information.

iv. **Directors' remuneration:** Directors work for a reward. To encourage their commitment to achieving the objectives of their company, they should be given suitable incentives. Linking remuneration to performance is considered essential for successful corporate governance. However, linking directors' pay to performance is complex, and remuneration schemes for directors have not been particularly successful. Directors' pay is an aspect of corporate governance for which companies are frequently criticised.

v. **Risk management and internal control:** Directors should ensure that their company operates within acceptable levels of risk, and should ensure through a system of internal control that the resources of the company are properly used and its assets are protected.

vi. **Shareholders' rights:** Shareholders' rights vary between countries. These rights might be weak or might not be exercised fully. Another aspect of corporate governance is encouraging the involvement of shareholders in the companies in which they invest through more dialogue with the directors and through greater use of shareholder powers – such as voting powers at general meetings of the company.

MARKING GUIDE

	HEADING		MARKS
(a)i	The idea of Corporate Governance (1 mark each x 6 points)	6	
ii	Corporate Governance and Business Success	2	
			8
(b).	Definition of "good" company (2 marks)		2
(c)	Corporate Governance issues (2 marks each x 5 points)		10
	TOTAL		**20**

EXAMINER'S REPORT

The question tests candidates' knowledge of the relevance of corporate governance to business success and their ability to identify what constitutes a good company. It also tests candidates understanding of corporate governance issues.

About 80% of the candidates attempted the question but overall performance was below average. A major pitfall was that while many showed a fair understanding of corporate governance issues, they were unable to clearly articulate the idea of corporate governance. They were also unable to establish the relevance of corporate governance to business success and to specify what makes a company good.

Candidates should ensure that they pay adequate attention to the details of the concepts, theories and issues discussed in ICAN Study Text.

SOLUTION 3

By Tucker's model, the decision to establish the mega store in Ibadan and not Lagos is ethical.

Tucker's five-question model

Tucker's five-question model for ethical decision-making in business holds that the purpose of decision-making in business is to ensure that profit is made in an ethical way. The model identifies five questions to be asked before making an ethical business decision. If the answers to all five questions are 'Yes', the decision is ethically sound. The five questions to be asked are:

a) Is it profitable?
b) Is it legal?
c) Is it fair?
d) Is it right?
e) Is it sustainable or environmentally sound?

Application of the model to the scenario

Question a: Is the decision to locate the business in Ibadan profitable? The answer is Yes as the city of Ibadan was chosen because of its low overhead cost.

Question b: Is the decision to locate the business in Ibadan legal? The answer is Yes, because the government has given permission for the store to be built.

Question c: Is the decision fair? There is no reason to suppose that it is not fair. All the stakeholders referred to in the case study, including the government and the local population, will benefit from the store and are in support of its establishment. This suggests that the project is fair.

Question d: Is the decision right? The answer is Yes as the project will bring jobs, thereby generate income for people and also revenue for government. It will also facilitate an overall economic growth. As such, there are no obvious reasons to say that the project is 'not right'.

Question e: Is the decision sustainable or environmentally sound? The answer is Yes because the location of the store in Ibadan is based on considerations that it would be more environmentally friendly in Ibadan than in Lagos.

MARKING GUIDE

	HEADING		MARKS
(a)	Determination of ethical status of decision		2½
(b) i.	Explanation of Tuckers Five question model (½ mark each x 5 points)	2½	
(b) ii.	Application of Tuckers Five questions to scenario (3 marks x 5 points)	15	17½
	TOTAL		**20**

EXAMINER'S REPORT

The question tests candidates' understanding of Tucker's five-question model for ethical decision-making in business. It also tests their ability to apply the model in practice.

About 80% of the candidates attempted the question and their performance was above average. However, some of them were unable to apply Tucker's five-question model to the scenario presented in the question.

Candidates are advised to develop the practical skills of applying models, frameworks and theories in ethics to real life situations.

SOLUTION 4

a. i. **Key elements of ISO 31000**

ISO 31000 puts forward a framework for risk management that has three main elements:

Risk Architecture: This consists of the roles and responsibilities for risk management within the organisation and the risk reporting structure. It consists of the respective roles and responsibilities of the Board, the Audit Committee, the Chief Executive Officer, Business Unit Managers, individual employees, Risk Managers and Internal Auditors.

Risk Strategy: The risk strategy of the organisation should be specified, including the risk appetite of the board. A risk strategy and implementation plan should be in place including resources to support risk management activities.

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; a business continuity plan and arrangements for auditing the efficiency and effectiveness of controls should also be in place.

ii. **Role of board of directors and management in risk management include:**

- The board of directors has responsibility to safeguard the assets of the company and to protect the investment of the shareholders from loss of value;

- The board should therefore keep strategic risks within the limits that shareholders would expect and avoid or control operational risks;

- According to the Code of Corporate Governance in Nigeria, the duties of the board include, the identification of risk and monitoring of risk management systems. The Board may establish a Risk Management Committee to assist it in its oversight of the risk profile, risk management framework and the risk-reward strategy of the company;

- The Board is responsible for defining the company's risk policy, risk appetite and risk limits as well as ensuring that these are integrated into the day-to-day operations of the company;

- The risk oversight process begins with the board. The board is responsible for deciding the company's risk strategy and business model, and it should understand and agree on the level of risk that goes with this. It should then oversee the implementation of the strategic and operational risk management system;

- The board should undertake, at least annually, a thorough risk assessment covering all aspects of the company's business, and ensure that the company's risk management policies and practices are disclosed in its annual report; and

- The responsibilities of the board of directors and management for risk management are the same. However, while management has the responsibility for developing and implementing the company's strategic and routine operational risk management system, within the strategy set by the board, it is subject to the oversight of the board.

b. **Role of management and board of directors in identifying and assessing risks**

i. Risk identification and assessment is largely a responsibility for management. Management is normally responsible for:

- identifying key risks (although the board of directors might take on the responsibility, if it is so advised by management or auditors).
- assessing risks and for designing and implementing risk controls.
- monitoring the effectiveness of risk controls and keeping risks under review.
- regularly reporting to the board of directors on risks and risk management.

ii. The board should

- set the company's policy for risk and give clear guidance on the company's risk appetite; and
- conduct a review, at least once a year, to ascertain the effectiveness of internal controls and this includes the effectiveness of risk management systems.

MARKING GUIDE

	HEADING		MARKS
(a)i	Key elements of ISO 31000 framework (2 marks each x 3 points)	6	
ii.	Role of Board of Directors in Risk Management (1½ marks each x 6 points)	9	
			15
(b)	Role of Management and Board of Directors in identifying and assessing risks (1 mark each x 5 points)		5
	TOTAL		**20**

EXAMINER'S REPORT

The question tests candidates' knowledge of the key elements of ISO 31000 framework and the roles of the board of directors/management in risk management and the identification and assessment of risks.

About 60% of the candidates attempted the question but the overall performance was below average. A major pitfall of many of the candidates was their inability to distinguish the general roles of the board and management in the identification and assessment of risks. Besides, many candidates showed inadequate understanding of the key elements of ISO 31000 framework.

Candidates should endeavour to fully understand all the topics in the syllabus and take care to understand the similarities and differences among related topics and issues.

SOLUTION 5

a. *Johnson and Scholes: Four possible ethical stances for a business entity*

i. An ethical stance is a position that someone or an organization takes on an ethical issue. In a company, it comes from the moral values and ethical positions of key individuals who work within the company and from the corporate culture. For example, a company might decide not to do business with certain types of customers or suppliers on ethical grounds.

ii. **Four Possible Ethical Stances (Johnson & Scholes Model)**

- Maximising short term shareholders interest
- Maximising long term shareholders interest
- Multiple stakeholders obligation
- Being a shaper of society

The explanations are given below:

- **Maximising Long Term Shareholders' Interest**
  - ✓ **Corporate Stance:** An organisation needs to maintain its existence. This objective may conflict with the need for short term returns. The organisation will therefore attempt to protect the long term shareholders' interest in terms of capital growth as this ensures that shareholders retain their investments. Large scale selling of shares will be taken as weakness which may affect the going concern of the organisation.
  - ✓ **Personal Stance:** Shareholders will be concerned with security of their investment as well as capital growth. This flows with the organisation's objectives. However, the organisation will put its own interest first where there is perceived conflict between the organisation's existence and shareholders' return.

- **Maximising Short Term Shareholders' Interest**
  - ✓ **Corporate Stance:** An organisation needs to provide adequate returns to its shareholders, although there may be a conflict between the need to pay dividends now or to invest in the future of the company.

- ✓ **Personal Stance:** Short term interests will depend on the types of shareholders. Small shareholders will require some annual returns on investment while long term investors (e.g. pension schemes) will have little interest in annual returns. They will be more interested in long term growth, so dividends in the short term may not be required by long term investors.

- **Multiple Stakeholders' Obligation**

  - ✓ **Corporate Stance:** Since an organisation has many stakeholders, it will identify the stakeholders with much power and influence over the organisation and involve them in decision making or provide them with expected returns. There may be conflict as there are different obligations to different stakeholders. For example, while employees expect a safe and clean working environment, shareholders expect higher profit. This implies that the organisation may have to spend minimum amount on work place safety to provide higher return to shareholders.

  - ✓ **Personal Stance:** Each stakeholder group will expect its interest to be understood and protected by the organisation. Furthermore, lack of action may result in increased pressure on the organisation to meet these stakeholders' interests. The organisation should find a way of trading these interests off against one another.

- **Being a shaper of society:**
  Shaping society means changing conditions in the society and altering the way that society operates and perceives itself. For example, companies control resources and make decisions that can influence the future of technology.

b. Fundamental ethical principles

Professional accountants are required to comply with the following fundamental ethical principles:

i. integrity
ii. objectivity
iii. professional competence and due care
iv. confidentiality
v. professional behaviour

i. **Integrity**

An accountant must be honest and straightforward in his professional and business dealings. This includes a requirement for 'fair dealing' and a requirement to be truthful. Simply put, accountants should not lie in any way or for any reason. An example of lack of integrity in business might be where an accountant helps to cover up fraud with false accounting entries.

ii. **Objectivity**

An accountant must not allow his professional or business judgement to be affected by bias (personal prejudice), conflicts of interest or undue influence from others: for accountants in business, this includes undue pressure from the employer or senior management. An example of an accountant in business being objective is in the preparation of prepayments, accruals and provision of journals at month or year-end. They should reflect reality rather than an attempt to manage earnings and manipulate profit or tax figures.

iii. **Professional competence and due care**

- An accountant has a duty to maintain his professional knowledge and skills at a level that enables him to provide competent professional service to his clients or employer.
- This includes being up to date with developments in areas of accounting that are relevant to the work that he does.
- Accountants should also act diligently in accordance with relevant technical and professional standards.
- Professional accountants have a duty to carry out with care and skill the instructions of an employer or client, insofar as these are compatible with the ethical requirements for integrity, objectivity and (in the case of accountants in public practice) independence.

iv. **Confidentiality**

- Accountants must respect the confidentiality of information obtained in the course of their work. This applies to the confidentiality of information within the firm or employer's organisation, as well as confidentiality of information about clients (for accountants in professional practice).
- An accountant must be careful of what he says to a good friend who also happens to be a business associate, or to a wife or husband who is also a professional accountant.

- Confidentiality also applies to information obtained when working for a former employer. In addition, confidential information must never be used to obtain a personal benefit or a benefit for a third party.

- There are some circumstances in which the disclosure of confidential information is permitted or even required by law. Confidential information must be disclosed to relevant authorities in such circumstances. These circumstances depend on the laws of the country. For example, firms of accountants are expected to disclose suspicion of money laundering by a client to the appropriate authorities. In addition, tax evasion is a crime and accountants are required to report tax evasion by clients to the authorities. However, accountants are not expected to disclose client information to the authorities where the work for the client is covered by legal professional privileges. Disclosure is also permitted when the accountant has a professional right or duty, and disclosure is not prohibited by law.

- Confidential information about a client (or employer) can be disclosed if the client (or employer) has given permission. Before disclosing the information, however, the accountant should consider whether the disclosure might harm a third party.

v. **Professional behaviour**

Accountants are required to observe relevant laws and regulations, and to avoid any action that would discredit the accountancy profession. For example, in professional practice, practitioners must be truthful and must not disparage the services provided by 'rival' firms. If an accountant is convicted of a serious crime, such as murder or money laundering, he or she would be expelled from membership of the professional body for unprofessional behaviour.

MARKING GUIDE

	HEADING		MARKS
(a) i	Brief account of ethical stance	2	
ii.	Identification and explanation of Johnson and Scholes 4 ethical stances (2 marks each x 4 points)	8	
			10
(b)	Identification and discussion of 4 fundamental principles of ethics (1¼ marks each x 4 points)		5
	TOTAL		**15**

EXAMINER'S REPORT

The question is testing candidates' understanding of Johnson and Scholes' account of ethical stances in business and their ability to clearly articulate the fundamental ethical principles applicable to the accountancy profession.

While about 90% of the candidates attempted the question, performance was generally poor. Their major pitfall was their inability to identify and discuss Johnson and Scholes' account of ethical stances in business.

Candidates are advised to pay adequate attention to all aspects of the syllabus in subsequent examinations.

SOLUTION 6

Mendelow's framework on stakeholders influence over strategic decision

Strategy analysis in a company is the balance of power between the stakeholder groups and the relative power and interest of each group. Mendelow's framework can be used to understand the influence that each stakeholder group has over a company's strategies and actions. The key variables in the framework are:

i. the power stakeholders are capable of exercising; and
ii. the interest that stakeholders have in particular issues. Influence over a strategy or action comes from a combination of power and interest

The Mendelow's framework is a 2 x 2 matrix with interest at the horizontal axis and power at the vertical axis. Interest and power are classified as either low or high as shown below:

		Interest: Low	Interest: High	
Power	Low	(1) Minimal Effort (LL)	(2) Keep Informed (LH)	Power
	High	(3) Keep Satisfied (HL)	(4) Key Players (HH)	

The framework is explained below:

i. In the first quadrant are stakeholders who have little power and low interest (LL) in a matter. They have minimal influence and the company can largely ignore them. Stakeholders in this group include small shareholders and the general public.

ii. In the fourth quadrant are key players/stakeholders. These are the stakeholders who have the highest amount of power and high interest (HH). Their influences will be of highest significance in making strategic decisions. In other words, the organisation's strategy must be acceptable to them. The situation may not be complicated if it has one major stakeholder, e.g., company's senior management. However, problems may arise when there are two or more stakeholder groups in the section with different interests and objectives.

iii. In the second quadrant are the stakeholders with high interest but low power (LH). These stakeholders may try to increase their power by entering into a coalition with one or more other stakeholders. An important issue here is that the company must continually keep them informed of whatever is happening in the company. The company's decision-making will not be affected by the group's objectives. In summary, they do not have great ability to influence strategy, but their views can become important in influencing decisions by entering into alliance with more powerful stakeholder groups through lobbying.

iv. In the third quadrant are the stakeholders with a lot of power but only limited interest in a matter (HL). This group should be satisfied so that they do not exercise their power to affect the company's strategic decision making. They should therefore be treated with care. They are capable of moving to quadrant 4, so they should be kept satisfied.

MARKING GUIDE

	HEADING	MARKS
(i)	Identification of the elements of Mendelow's Framework	1
(ii)	Explanation of Framework	2
(iii)	Diagramatic representation of framework	2
(iv)	Explanation of the 4 quadrants of the framework (2½ marks each x 4 points)	10
	TOTAL	**15**

EXAMINER'S REPORT

The question is testing candidates' ability to employ Mendelow's Framework to analyse stakeholders' influence over strategic actions or decisions.

About 90% of the candidates attempted the question but overall performance was below average. This was largely due to their inability to present Mendelows' Framework in a diagrammatic form and label it properly.

Candidates should ensure that they understand all the details of the frameworks discussed in the study text and that they are able to present them in diagrammatic forms where these may be required.

SOLUTION 7

(a)

i. Organisational structure can be defined as how job tasks are formally divided, grouped, and coordinated after the strategy for the organisation has been drafted.

ii. Organisational structure does not only assign responsibilities, it also gives authority and determines the pattern of relationships to achieve the strategy of the organization.

iii. Organisational structure provides the mechanism for the distribution of authority and responsibility within the organisation to achieve the strategy of the organisation.

iv. Organisational structure does not only stipulate what a group or an individual does but also whom to report to and meet when there is a problem to be solved to achieve the strategy of the organisation.

v. Organisational structure is an instrument for coordination and motivation of the employees to achieve the strategy of the organisation.

vi. Plans, programmes and projects have to be devised which would be separated into distinct job tasks for the strategy to accomplish the missions and objectives of an organisation.

(b) ***Types of Organisational Structure***

(i) ***Entrepreneurial organisation***

An entrepreneurial organisation is an entity that is managed by its entrepreneurial owner. The main features of an entrepreneurial organisation are usually that:

- the entrepreneur takes all the major decisions and does not delegate decision-making to anyone else.
- the entity is therefore organised around the entrepreneur and there is no formal management structure.
- operations and processes are likely to be simple and the entity will probably sell just a small number of products or services.

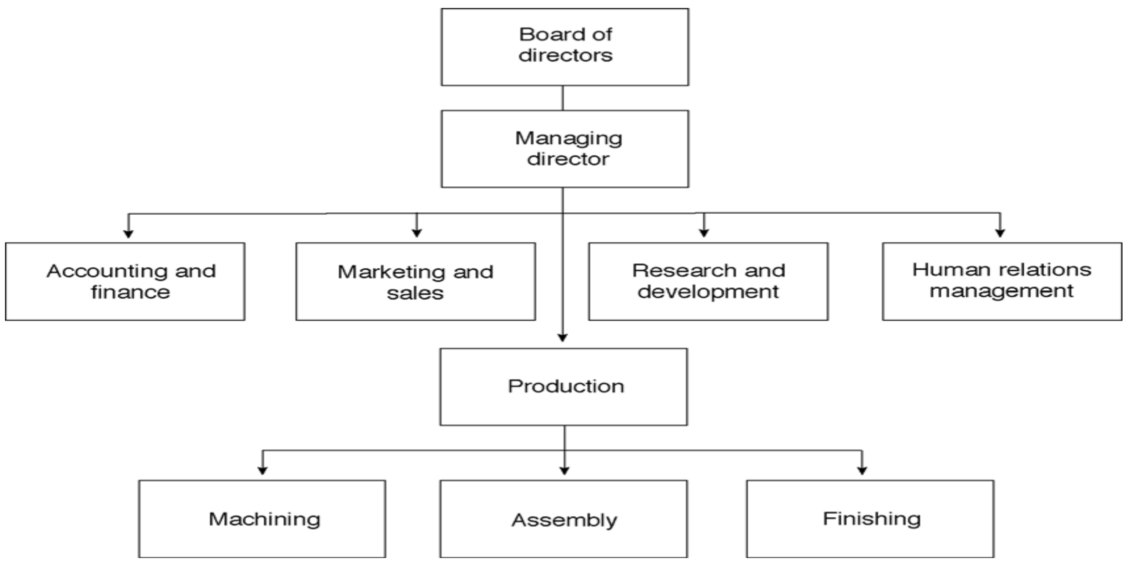
An entrepreneurial structure is appropriate when an entity is in the early phase of its life. As it grows larger, however, an entrepreneurial structure will become inefficient and a formal management structure would be required .

(ii) *Functional organisation structure*

A functional structure is usually the next stage in the development of the organisation structure of a growing entity. In a functional organisation structure, decision-making authority is delegated in a formal arrangement, and responsibilities are divided between the managers of different activities or functions. Typically, functions in a manufacturing entity include production (or operations); marketing and sales; and finance and accounting. There might also be a human relations function, an IT function and a research and development function.

Each function has its own management structure and staff.

An organisation chart showing a simple functional structure is shown below.



(iii) *Divisional organisation structure*

As entities grow and develop their business operations into different product-markets, a divisional structure might become appropriate. A division is an area of operations, defined by:

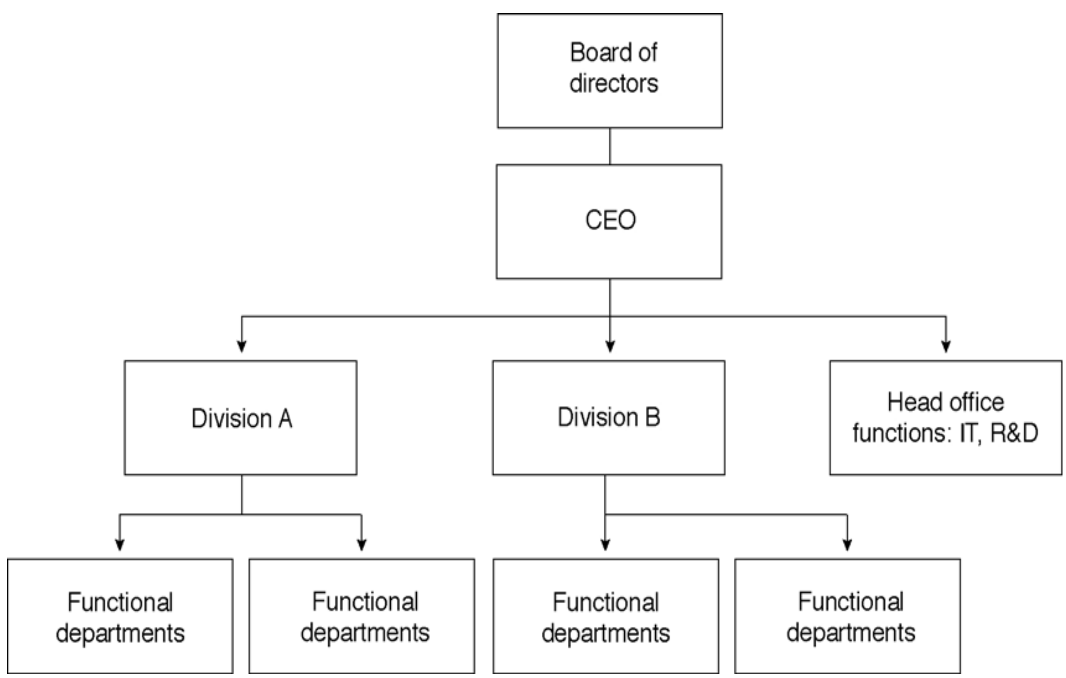
- markets in different geographical areas (for example, the African, the Asian, the European and the North American divisions).
- different products (for example the bus division and the rail division of a transport company).
- different customers (for example, industrial customers and consumer customers).

A division might be a strategic business unit of the entity (group). Each division has its own functional departments, such as marketing and sales, operations (production), and accounting and finance.

Authority is delegated from head office to the divisional management (led perhaps by a divisional managing director) and responsibility for the implementation of product-market strategy is mainly at divisional level.

Head office retains overall control, and there may be some head office functions providing support services to all the divisions, such as corporate strategy, IT and research and development.

The simple organisation chart below shows the organisation structure for a divisionalised organisation with two divisions, where IT and research and development are head office support functions.



(iv) ***Matrix organisation structure***

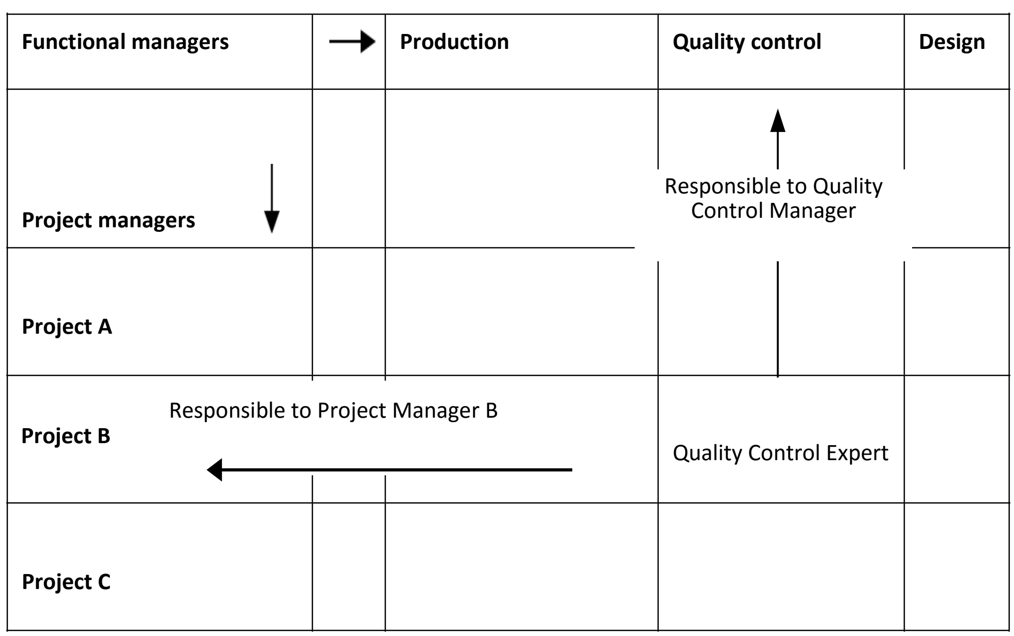
Some entities have developed a matrix organisation structure for some of their activities. The matrix organisational structure recognises that different functions within the entity need to work closely together. Horizontal relationships across different functions are as important as the 'traditional' reporting relationship within functions.

Matrix organisations and project organisation structures were both first used in the defence and aerospace industries, where companies were required to carry out major projects for customers, such as building a quantity of aircraft for a government customer.

The matrix organisation and project management structures were introduced to overcome the challenge of completing projects on time and within budget. By this structure, project managers were appointed with overall responsibility for individual projects and they have to organise the efforts of individuals from all the different functions. At the same time, functional managers, such as managers of engineering, production and sales and marketing, retained their decision-making authorities. In this way, a dual command structure was created. In a matrix organisation, the traditional vertical command structure has an overlay of horizontal authority or influence.

A matrix organisation has been defined as: 'any organisation that employs a multiple command system that includes not only a multiple command structure but also related support mechanisms and an associated organisational culture and behaviour pattern'.

The difference between a matrix organisation structure and a project organisation is that with a project organisation, the project management comes to an end when the project ends. With matrix organisation, the matrix structure of authority and command is permanent.



In the diagram above, the person indicated is a quality control expert and is responsible to the quality control manager for technical aspects of the job, maintaining quality systems and so on.

The person is also responsible to the manager of Project B. That manager will be concerned with completing the project on time, within the cost budget and to the proper standard.

Obviously conflicts can arise: the project manager might want to skip some tests to make up time, but the quality control department will not want to do that. Both can put the employee under some pressure. However the matrix structure should allow the employee to ask the two managers to discuss the problem, as it is plain that they are both involved.

Overall, matrix structures should:

- encourage communication; and
- place emphasis on 'getting the job done' rather than each manager defending his or her own position.

(v) Project-based and team-based structures

In addition to having a formal management structure, entities might also use project teams and other management teams to implement some activities.
Project teams are usually assembled to accomplish a specific task, such as introducing a new system or a new process. The project team should consist of members from different disciplines or functions, so that a wide range of skills is assembled to implement the project.
Project teams might be used for implementing planned strategic changes.

MARKING GUIDE

	HEADING		**MARKS**
(a)	Explanation of "structure follows strategy"		
	(1 mark each x 5 points)		5
(b)i	Identification of types of structure (1 mark each x 5 points)	5	
(b)ii.	Explanation of types of structure (1 mark each x 5 points)	5	
			10
	TOTAL		**15**

EXAMINER'S REPORT

The question is testing candidates' knowledge of the link between structure and strategy. It is also testing candidates' knowledge of the different types of structure and their ability to recognise the strategy that might necessitate the different types of structure.

Only about 50% of the candidates attempted the question and their performance was below average. Most of the candidates could not establish the link between structure and strategy. Neither could they identify the different types of structure nor explain the strategy that might induce the structure identified.

Candidates are advised to pay attention to the different parts of the syllabus.