THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PATHFINDER

NOVEMBER 2018 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.

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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA
SKILLS LEVEL EXAMINATION - NOVEMBER 2018

FINANCIAL REPORTING

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

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

The financial statements of OSHODI Nigeria Limited for the year ended May 13 2017 are as follows:

Statement of Profit or Loss for the year ended May, 31 2017

	₦'m
Revenue	3,820
Cost of sales	(2,620)
Gross profit	1,200
Operating expenses	(300)
	900
Interest	(30)
Profit before tax	870
Taxation expense	(270)
Net profit for the year	600

Statement of Financial Position as at May 31 2017 (including comparative figures)

	2017	**2016**
Non-Current Assets	**₦'m**	**₦'m**
Property, plant and equipment	1,890	1,830
Intangible assets	650	300
	2,540	2,130
Current Assets		
Inventory	1,420	940
Account receivables	990	680
Cash	70	nil
	2,480	1,620
Total Assets	5,020	3,750

Equity and Liabilities		
Ordinary shares of ₦1 each	750	500
Reserves:		
Share premium	300	100
Revaluation reserve	190	Nil
Retained earnings	1,610	1,400
Equity	**2,850**	**2,000**
Non-current liabilities	870	540
Current liabilities	1,300	1,210
Total equity and liabilities	5,020	3,750

OSHODI NIGERIA LIMITED

Statement of Changes in Equity for the year ended May 31 2017

	Share Capital ₦'m	**Share Premium ₦'m**	**Revaluation Reserve ₦'m**	**Retained Earnings ₦'m**	**Total ₦'m**
June 1 2016	500	100	Nil	1,400	2,000
Profit for the year	-	-	-	600	600
Transactions within Equity:					
Dividend				(400)	(400)
Bonus issue	50	(50)			
Issue of shares	200	250		-	450
Revaluation reserve	-	-	200	-	200
Transfer to retained earnings	-	-	(10)	10	-
May 31, 2017	**750**	**300**	**190**	**1,610**	**2,850**

Notes to the financial statements:

(1) **Cost of sales** includes depreciation of property, plant and equipment of ₦320 million and a loss on the sale of plant of ₦50 million. It also includes a credit for the amortisation of government grants. Operating expenses include a charge of ₦20 million for the amortisation of goodwill.

(2) **Intangible assets:**

	2017	2016
	₦'m	**₦'m**
Deferred development expenditure	470	100
Goodwill	180	200
	650	300

(3) **Non-current Liabilities:**

	2017	2016
	₦'m	**₦'m**
10% loan notes	300	100
Government grants	260	300
Deferred tax	310	140
	870	540

4) **Current Liabilities:**

Account payables	875	730
Bank overdraft	Nil	115
Accrued loan interest	15	5
Declared dividends unpaid	280	200
Taxation	130	160
	1,300	1,210

The following additional information is relevant:

(i) Intangible assets:
The company successfully completed the development of a new product during the current year, capitalising a further ₦500 million before amortisation charges for the period.

(ii) Property, plant and equipment/revaluation reserve:
The company revalued its buildings by ₦200 million on June 1 2016. The surplus was credited to revaluation reserve.

- New plant was acquired during the year at a cost of ₦250 million and a government grant of ₦50 million was received for the plant.
- On June 1, 2016 a bonus issue of 1 new share for every 10 held was made from the share premium.
- ₦10 million has been transferred from the revaluation reserve to realised profits as a year-end adjustment in respect of the additional depreciation created by the revaluation.
- The remaining movement on property, plant and equipment was due to the disposal of obsolete plant.

(iii) Share issue:
In addition to the bonus issue referred to above, Oshodi Nigeria Limited made a further issue of ordinary shares for cash.

Required:

a. Prepare statement of cash flows for Oshodi Nigeria Limited for the year ended May 31, 2017 in accordance with IAS 7 'Statements of Cash Flows' using the indirect method.
(25 Marks)

b. Compare the direct and indirect methods of preparing statement of cash flows.
(5 Marks)
(Total 30 Marks)

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

QUESTION 2

a. IAS 33 on earnings per share defined potential ordinary share as a financial instrument or other contract that may entitle its holder to ordinary shares at some time in the future. State the three examples of potential ordinary shares according to IAS 33.
(6 Marks)

b. Anambra Limited acquired 80% of Omambala Limited's ordinary shares for ₦210 million on January 1, 2013. On the acquisition date, the retained earnings of Omambala Limited were ₦105 million. The fair value of non-controlling interest in Omambala Limited at the date of acquisition was ₦56 million. The financial statements of the two companies for the year ended December, 31 2017 are stated below:

	Anambra Limited ₦'000	**Omambala Limited ₦'000**
ASSETS		
Non-Current Assets		
Property, plant and equipment	210,000	157,500
Investments	280,000	-
Current Assets		
Inventories	56,000	52,500
Trade and other receivables	42,000	98,000
Cash and cash equivalents	7,000	17,500
Total Assets	595,000	325,500

EQUITY AND LIABILITIES		
Equity		
Share capital	56,000	42,000
Share premium	14,000	7,000
Retained earnings	206,500	175,000
Non-Current Liabilities		
Loans notes	210,000	59,500
Current Liabilities		
Trade payables	108,500	42,000
Total equity and liabilities	595,000	325,500

The following additional information is relevant:

(i) Anambra Limited sold goods to Omambala Limited for ₦35 million with a gross profit margin of 25%. Included in the inventories of Omambala Limited is 40% of the goods as at December 31, 2017.

(ii) The fair values of net assets of Omambala are equal to their carrying amounts at acquisition date, this does not include land. The company has land which was included in the accounts at its cost amounting to ₦105 million and has a value of ₦126 million.

Required:

Prepare consolidated statement of financial position for the Anambra Limited group as at December 31, 2017. (14 Marks)

(Total 20 Marks)

QUESTION 3

Yemnike Nigeria Limited has an accounting profit before taxation of ₦225 million for the year ended December 31, 2017.

The following are extracts of the financial position of Yemnike Nigeria Limited as at December 31, 2017.

NON-CURRENT ASSETS	
	₦'000
Building	157,500
Plant and machinery	250,000
Assets held under finance lease	200,000
RECEIVABLES	
Trade receivables	182,500
Interest receivable	2,500
PAYABLES	
Fines	25,000
Finance lease obligation	216,000
Interest payable	8,250

The following information is relevant:

(i) The building was acquired by the company at the cost of ₦175million at the start of the year and it is the policy of the company to depreciate building at 10% p.a. on straight line basis.

The company tax consultants have stated that the company can claim ₦105million capital allowance this year on the building.

(ii) The balance in respect of plant and machinery is after providing for depreciation of ₦30million and the capital allowance claimable on it is ₦25million.

(iii) The asset held under finance lease was acquired during the year. The relevant tax law does not distinguish between finance lease and operating lease. Rental expense for lease is tax deductible. The annual lease rental is ₦72million and was paid on December 31, 2017. The depreciation policy for leased assets is 20% p.a. on straight line while annual finance charge amounted to ₦36,667million.

(iv) The receivables figure is shown net of an allowance for doubtful balances of ₦17.5million. This is the first year that such an allowance has been recognised. A deduction for debt is only allowed for tax purposes when the debtor enters liquidation.

(v) Interest income is taxed and interest expense is allowable both on cash bases. There were no opening balances on interest receivable and interest payable.

(vi) Provision for fines and penalties are not allowable deductions for tax purposes. The fines payable is a provision made during the year.

Required:

a. Calculate current tax expense for the period. (7 Marks)

b. Calculate the deferred tax liability as at December 31, 2017 (12 Marks)

c. Prepare notes showing the component of tax expense for the year. (1 Mark)

N.B: Income tax rate is 30%. **(Total 20 Marks)**

QUESTION 4

The following financial statements were extracted from the books of Adebayo Trading Company Plc for the relevant years.

Statement of Profit or Loss and Other Comprehensive Income for the year ended March 31:

	2018	2017
	₦'000	₦'000
Revenue	250,000	400,000
Cost of sales	(137,500)	(225,000)
Gross profit	112,500	175,000
Administrative expenses	(36,050)	(44,500)
Distribution expenses	(20,200)	(24,250)
Finance cost	(3,125)	(3,125)
Profit before tax	53,125	103,125
Taxation expense	(20,000)	(40,000)
Profit for the year	33,125	63,125

Statement of Financial Position as at March 31:

	2018	2017
Assets	**₦'000**	**₦'000**
Non-current assets at cost	136,500	196,000
Accumulated depreciation	(36,500)	(52,250)
	100,000	143,750
Current assets		
Inventory	79,250	20,750
Trade receivables	50,000	12,500
Bank balance	12,000	91,750
	141,250	125,000
Total Assets	241,250	268,750
Equity and Liabilities:		
Equity		
Ordinary shares of 50 kobo each	57,500	57,500
Retained earnings	43,000	25,000
	100,500	82,500
Non-current liabilities:		
10% Loan notes	31,250	31,250
12% Redeemable preference shares	-	5,000
	31,250	36,250

Current Liabilities:		
Trade payables	18,750	26,875
Taxation	60,000	40,000
Bank overdraft	30,750	83,125
	109,500	150,000
Total equity and liabilities:	241,250	268,750

Additional Information:

(i) Dividend paid to Equity holders are ₦15,125,000 for the year ended, March 31, 2018 and ₦21,375,000 in 2017.

(ii) There was a drop in the market price per share of the company's equity shares from 36 kobo in the year ended March 31, 2017 to 24 kobo in 2018.

(iii) The finance cost relates to the interest paid on the 10% loan notes.

Required:

a. Calculate in columnar form, for the two relevant years the following financial ratios:

- Return on capital employed
- Net profit margin (use profit after tax)
- Current ratio
- Quick ratio
- Debt ratio
- Fixed interest cover
- Dividend cover
- Dividend yield (12 Marks)

b. Comment on the profitability and short term liquidity of the company based on the ratios calculated. (4 Marks)

c. Management may use various forms of Creative Accounting to manipulate the view given by the financial statements. Identify and explain **fou**r creative accounting techniques.

(4 Marks)

(Total 20 Marks)

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

QUESTION 5

Akawo Limited is a building contracting firm based in Abuja. ABC Limited awarded a contract to Akawo Limited to construct a residential building in Lagos. The agreed contract price is ₦80 million and the completion date is December 31, 2017.

The following are details of transactions on the contract to March 31, 2016.
The contract commenced July, 1 2015.

Contract costs:	**₦'000**
Architects and surveyor's fees	1,000
Materials	6,200
Direct labour costs	7,000
Overhead is 40% of direct labour costs	
Estimated cost to completions (Excluding depreciation)	29,600
Plant and machinery used exclusively on the Contract	7,200

The value of the plant at the end of the contract would be ₦1.2m and the basis of depreciation is period of usage. Material on site as at March 31, 2016 is ₦600,000.

Progress payment made by ABC Limited to Akawo Limited amounted to ₦25.6m as at March 31, 2016.

The following information is also relevant to the contract as at March, 31 2017:

Cost incurred since the commencement of the contract to date-₦40.8m.
Estimated cost to completion (excluding depreciation)₦13.2m

ABC Limited paid additional ₦32.4m to Akawo Limited on March, 31 2017 Akawo Limited uses percentage of completion to determine profit on a contract.

Required:

Prepare in relation to the building contract, the statement of profit or loss extracts for the years ended March 31, 2016 and 2017 and the statement of financial position extracts as at the year ended on those dates. **(Total 15 Marks)**

QUESTION 6

Intangibles assets by their nature do not exist physically under IAS 38 Intangible assets. The following information on initial cost of intangibles asset were extracted from the Notes to the financial statements of Igbo-hood Limited, a film production company on January 1, 2017:

	₦'000
Books and literary works	800
Quick books and SAGE	950
Patents	1,200
Video and motion picture films	2,500
Franchise	3,200
Pictures and photographs	3,400
Order or production backlog	4,000
Plays	4,200
Customers' contract	4,400
Trade marks for customers	4,600
Broadcasting rights	5,000
Internet	5,400
Trade secrets	4,800

Additional Information:

(i)

	Date of Acquisition	**Assessed Useful life**
Quick books and SAGE	January 1, 2016	5
Trade marks	January 1, 2015	8
Plays	January 1, 2014	7
Franchise	January 1, 2013	8

(ii) Intangible assets are to be amortised on a straight line basis.

Required:

a. Calculate the costs of the following intangible assets:
   - i. Market based
   - ii. Customer related
   - i. Artistic related
   - iv. Contract based
   - v. Technology based

b. Calculate the carrying amounts of the following intangibles assets as at December 31, 2017
   - i. Quick books and SAGE
   - ii. Trade marks
   - iii. Plays
   - iv. Franchise (6 Marks)

c. Identify **four** internally generated intangible assets that are prohibited in IAS 38 (Intangibles Assets.) (4 Marks)

(Total 15 Marks)

QUESTION 7

Financial statements identify financial position, performance and changes in cash flows over a period of time. The main statements include statement of financial position, statement of comprehensive income and statement of cash flows. These statements are intended to show how well a company has performed and give indication of the value of the business. However, many accountants are of the opinion that the financial statements are limited in value to the users.

Required:

a. Identify and discuss the limitations of financial statements (8 Marks)

b. Identify potential users of financial statements and their likely Information needs. (5 Marks)

c. State the underlying assumptions of financial statements as enunciated by "The Conceptual Framework for Financial Reporting". (2 Marks)

(Total 15 Marks)

SOLUTION 1

(a)

OSHODI NIGERIA LIMITED
STATEMENT OF CASH FLOW FOR THE YEAR ENDED MAY 31, 2017

	Workings	₦'m	₦'m
Operating activities:			
Profit before tax			870
Add:			
Finance cost		30	
Depreciation		320	
Loss on sale of plant		50	
Amortization of goodwill		20	
Amortization of other intangible assets	1	130	550
Less:			
Government grant	2		(90)
Movement in working capital:			
Account payables		145	
Inventory		(480)	
Account receivables		(310)	(645)
Cash inflow from operations			685
Finance cost	3		(20)
Tax paid	4		(130)
Net Cash inflow from operating activities			535
Investing activities:			
Development of intangible assets		(500)	
Purchase of plant		(250)	
Disposal of PPE	6	20	
Government grant		50	
Net Cash outflow from investing activities			(680)
Financing activities			
10% loan notes		200	
Dividend paid	7	(320)	
Ordinary shares		200	
Share premium		250	
Net Cash inflow from financing activities			330
Net cash inflow for the period			185
Cash and cash equivalent at the beginning of year	8		(115)
Cash and cash equivalent at the year end			70

Workings

1.	**Intangible assets**	**₦'m**
	Opening balance	300
	New development cost	500
	Amortisation - goodwill	(20)
	Closing balance	(650)
	Amortisation - other intangible assets	130

2. **Government grant**

	₦'m
Opening balance	300
Addition for the period	50
Closing balance	(260)
Charge to profit or loss	90

3. **Finance cost**

	₦'m
Opening balance	5
Charge to profit or loss	30
Closing balance	(15)
Cash paid	(20)

4. **Tax paid**

	₦'m	**₦'m**
Opening balance:		
Current tax	160	
Deferred tax	140	300
Income tax for the period		270
Closing balance:		
Current tax	130	
Deferred tax	310	(440)
Tax paid		130

5. **Disposal of PPE**

	₦'m
Opening balance	1,830
Revaluation for the period	200
Purchase of plant	250
Depreciation	(320)
Closing balance	(1,890)
Disposed plant (w6)	70

6. **Proceed on disposal of plant**

	₦'m
Loss on disposal	(50)
Carrying amount (w5)	70
Proceeds	20

7. **Dividend paid**

Opening balance	200
Charged to SOCIE	400
Closing balance	(280)
Dividend paid	320

8. **Cash and cash equivalent**

	2017	**2016**
	₦'m	**₦'m**
Cash	70	-
Bank overdraft	-	(115)
	70	(115)

b.

COMPARISON BETWEEN THE DIRECT AND INDIRECT METHODS OF PREPARING STATEMENT OF CASH FLOWS

i. The Indirect method of Cash flow uses net income as a base and non-cash expenses like depreciation, non-cash incomes like profit on sale of scraps and net adjustments between current assets and liabilities to produce the overall cash flow statement. The Direct method uses only the cash transactions i.e. cash spent and cash received to produce the statement cash flow.

ii. Indirect method – The net income is adjusted to generate the cash flows.
Direct method – Reconciliation is done to separate the cash flow from other items.

iii. Indirect method – All the factors are taken into account.
Direct method - All non-cash transactions like depreciation are ignored.

iv. Direct method-discloses information not available elsewhere in the financial statements, whereas Indirect method involves adjusting the net profit or loss for changes in non-cash items and movement in working capital.

v. Indirect method - it is easier to prepare though difficult to understand. Direct method - it is a bit difficult to prepare but easier to understand.

EXAMINER'S REPORT

The question tests candidates' knowledge of IAS 7 on statement of cash flows. Candidates are required to prepare a statement of cash flow, and to compare the direct and the indirect methods of preparing the statement of cash flows

About 98% of the candidates attempted the question and the performance was average.

Candidates' commonest pitfalls were their inability to derive the amount for some cash flow items not given directly in the question, poor comparison of the direct and the indirect methods of presenting statement of cash flows and wrong classification of cash flows.

Candidates are advised to pay more attention to details bothering on the preparation of statement of cash flows when studying for future examination of the Institute.

Marking Guide		**Marks**	**Marks**
a.	Preparation of statement of cash flows:		
	- Cash flows from operating activities	14	
	- Cash flows from investing activities	6	
	- Cash flows from Financing activities	3	
	- Cash and Cash equivalent	2	25
b.	Comparison between the direct and indirect methods of presenting statement of cash flows Any 5 points from 3 comparison at 1 mark each		5
	Total		**30**

SOLUTION 2

a. IAS 33 gives the following examples of potential ordinary shares:

i. Financial liabilities or equity instruments that are convertible into new ordinary shares at some time in the future (convertible debentures, convertible preference shares).

ii. Share options and warrants: Options and warrants are financial instruments that give the holder the right (but not the obligation) to purchase new ordinary shares at some time in the future, at a fixed price.

iii. Shares that will be issued if certain contractual conditions are met, such as contractual conditions relating to the purchase of a business.

b.

ANAMBRA LIMITED GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION
AS AT DECEMBER 31 2017

Assets	**Note**	**₦'000**
Non-current assets		
Property, plant and equipment		
(₦210,000,000+₦157,500,000+₦21,000,000)		388,500
Goodwill	3	91,000
Investments (₦280,000,000 - ₦210,000,000)		70,000
Total non-current assets		549,500
Current assets		
Inventories (₦56,000,000+₦52,500,000 - ₦3,500,000)		105,000
Trade and other receivables (₦42,000,000 + ₦98,000,000)		140,000
Cash and cash equivalents (₦7,000,000 + ₦17,500,000		24,500
Total current assets		269,500
Total assets		**819,000**
Equity and liabilities		
Share capital		56,000
Share premium		14,000
Retained earnings	5	259,000
		329,000
Non-controlling interest	6	70,000
Non-current liabilities (₦210,000,000+₦59,500,000)		269,500
Current liabilities		
Trade payables (₦108,500,000 + ₦42,000,000)		150,500
Total equity and liabilities		819,000

Workings

1. **Group structure**

Anambra Limited	**80%**
Non-controlling interest	**20%**

2.

Net assets of Omambala Limited	**Date of Acquisition ₦'000**	**Date of Consolidation ₦'000**	**Post Acquisition ₦'000**
Share capital	42,000	42,000	-
Share premium	7,000	7,000	-
Retained earnings	105,000	175,000	70,000
Fair value of land	21,000	21,000	-
Total	175,000	245,000	70,000

3. **Determination of goodwill**

	₦'000
Purchase consideration	210,000
Non-controlling interest (at fair value)	56,000
Net assets at acquisition (wk 2)	(175,000)
Goodwill	91,000

4. **Unrealised profit**

	₦'000
Goods sold	35,000
Unsold goods (40% x N35,000,000)	14,000
Unrealized profit (25% x ₦14,000,000)	3,500

5. **Retained earnings of the group**

	₦'000
Retained earnings of Anambra Limited	206,500
Share of post acquisition profit of Omambala (80% x ₦70,000,000)	56,000
Unrealized profit (wk 4)	(3,500)
	259,000

6. **Non-controlling interests**

	₦'000
Fair value	56,000
Share of post acquisition profit of Omambala (20% x ₦70,000,000)	14,000
	70,000

EXAMINER'S REPORT

The question tests candidates' knowledge and understanding of IAS 33 on earnings per share and the preparation of group financial statements. Part (a) of the question required candidates to state three examples of potential ordinary shares stipulated in IAS 33 while Part (b) required them to prepare a consolidated statement of financial position of a group.

Candidates showed good understanding of the question as over 90% of them attempted the question and the performance was good.

Candidates' commonest pitfalls were their wrong calculations of the amounts for goodwill on consolidation, unrealised profit on inventory and consolidated retained earnings. Also some candidates could not give correct examples of potential ordinary shares.

Candidates are advised to endeavour to cover properly all aspects of the syllabus when preparing for future examinations of the Institute.

Marking Guide		**Marks**	**Marks**
a.	Examples of potential ordinary shares according to IAS 33 on EPS. Any 3 examples at 2 marks each		6
b.	Consolidated statement of financial position:		
	- Group structure	½	
	- Non-current assets	2½	
	- Goodwill on acquisition	2	
	- Current assets	4	
	- Equity	3	
	- Non-controlling interests	1	
	- Non-current assets	½	
	- Current liabilities	½	14
	Total		**20**

SOLUTION 3

a.

YEMNIKE NIGERIA LIMITED
TAX COMPUTATION FOR THE YEAR ENDED DECEMBER 31, 2017

	₦'000	**₦'000**
Accounting profit		225,000
Add:		
Disallowable expenses		
Depreciation on building	17,500	
Depreciation on plant & machinery	30,000	
Increase in allowance for doubtful debt	17,500	
Interest Payable (on accrual basis)	8,250	
Fines	25,000	
Depreciation of asset held under finance	40,000	
Lease		
Annual finance charge	36,667	
		174,917

Less:		
Allowable deductions		
Interests Income	2,500	
Capital allowance on building	105,000	
Capital allowance on plant & machinery	25,000	
Lease rentals	72,000	
		(204,500)
Taxable Profit		195,417

Current Tax Expenses at 30% = 58,625,100

b. **DEFERRED TAX LIABILITY AS AT DECEMBER 31, 2017**

	CARRYING AMOUNT	TAX BASE	TEMPORARY DIFFERENCE
Building	**₦'000**	**₦'000**	**₦'000**
Cost	175,000	175,000	
Dep/capital allowance	(17,500)	(105,000)	
CA/TWDV	157,500	70,000	87,500L
Plant & machinery			
Cost	230,000	280,000	
Dep/capital allowance	(30,00)	(25,000)	
CA/TWDV	250,000	255,000	5,000A
Asset held under Finance Lease			
Carrying amount	200,000	-	
Obligation	216,000	-	
	16,000	-	16,000A
Trade receivables			
C/A TWDV	182,500	200,000	17,500A
Interest receivables	2,500	-	2,500L
Fines	25,000	25,000	Nil
Interest payable	8,250	-	8,250A

	Temp. Diff. ₦'000	D/T (at 30%) ₦'000
Deferred Tax Liabilities		
(87,500 + 2,500)	90,000	27,000L
Deferred Tax Assets		
(5,000 + 16,000 + 17,500 + 8,250)	46,750	14,025A
Deferred tax liability as at December 31 2017		12,975L

c.

TAX EXPENSE COMPONENT FOR THE YEAR

	₦'000
Current Tax Expense	58,625.10
Deferred Tax Expense	12,975.00
	71,600.10

EXAMINER'S REPORT

The question tests candidates' knowledge of tax computations involving calculation of current tax expense and deferred tax liability.

Candidates showed very poor understanding of the requirements of the question. About 6% of the candidates attempted the question and their performance was very poor.

Candidates commonest pitfalls were their mixing up of figures/amounts relating to current tax expense with those for deferred tax liability in their computations, poor calculation of the carrying amounts and tax bases of the relevant items and the inability to differentiate between allowable and disallowable expenses.

Candidates are advised to study properly the relevant accounting standards on taxation and the Institutes Financial Reporting study text when preparing for examinations in the future.

Marking Guide	**Marks**	**Marks**
a. Preparation of tax computations:		
- Disallowable expenses	3½	
- Allowable expenses	2½	
- Calculation of current tax expense	1	7
b. Deferred tax liability:		
- Carrying amount	3½	
- Tax base	3	
- Temporary difference	2½	
- Deferred tax liability	3	12
c. Components of tax expense:		
- Current tax expense	½	
- Deferred tax expense	½	1
Total		**20**

SOLUTION 4

a.

	RATIOS	**FORMULAE**	**2018**	**2017**
i.	Return on capital employed	PBIT / CE	53,123+3,125 / 131,750	103,125 + 3,123 / 118,750
			42,69%	89.47%
	OR	PAT / Equity	33,125 / 100,500	63,125 / 82,500
			32.96%	76.52%
ii.	Net profit margin	PAT / Revenue	33,125 / 250,000	63,125 / 400,000
			13.25%	15.78%
iii.	Current ratio	CA / CL	141,250 / 109,500	125,000 / 150,000
			1.29:1	0.83:1
iv.	Quick ratio	CA - Inv. / CL	62,000 / 109,500	104,250 / 150,000
			0.57:1	0.70:1
v.	Debt Ratio	Debt / Equity	5000 +31250 / 57500 + 43,000	31250 / 57500 + 25,000
			31.09%	43.94%
	OR	Debt / Total Asset	31,250 / 241,250 x 100 / 1	36,250 / 268,250 x 100 / 1
			12.95%	13.51%
vi.	Fixed Interest Covered	PBIT / Fixed interest	53125+3125 / 3,125	103125+3125 / 3,125
			18 times	34 times
vii.	Dividend Cover =	PAT / Dividend Paid	33,125 / 15,125	63,125 / 21,375
			2.19 times	2.95 times

viii. Dividend Yield = $\frac{DPS}{MPS}$

	13k	18.6k
	24k	36k
	54.8%	51.6%

Note:

CA	-	Current asset	CL	-	Current liability
INV	-	Inventory	PBIT	-	Profit before interest and tax
PAT	-	Profit after tax	DPS	-	Dividend per share
MPS	-	Market price per share	CE	-	Capital employed

b. **Comments on Performance and Short term Liquidity**

i. Two ratios which are relevant for measuring the company's profitability are the ROCE and the net profit margin. While the ROCE measures the efficiency or otherwise of management in the employing or utilizing the resources available, the Net Profit margin measures management control over operating expenses. The higher the ratios, the better the performance of the company. For Adebayo Trading Company Plc, the performance is on the decline as evidenced by the two ratios. The company recorded a decrease in ROCE from 89.47% in 2017 to 42.69% in 2018. Also the net profit margin declined from 15.78% in 2017 to 13.25% in 2018. Contributing factors are the significant reduction in revenue without a reduction in overheads.

ii. **Short term liquidity**

The current and quick ratios are normally used to measure short term liquidity. The ratios measure the ability of an entity to meet its short terms obligations as they fall due. A current ratio of 1.29:1 though below the benchmark is better in 2018 than in 2017 for the quick ratio, the position in 2017 of 0.70:1 declined to 0.57:1 in 2018.

This could be attributed to slow moving inventory resulting in lower sales revenue in 2018.

c. **Creative accounting techniques**

(i) Window dressing: An entity enters into a transaction just before the year end and reverses the transaction just after the year end. For example, goods are sold on the understanding that they will be returned immediately after the year end; this appears to improve profits and liquidity. The only reason for the transaction is to artificially improve the view shown by the financial statements.

(ii) "Off Balance Sheet" finance: Transactions are deliberately arranged so as to enable an entity to keep significant assets and liabilities out of the statement of financial position. This improves gearing and return on capital employed. Examples include sales and repurchase agreements and some forms of leasing.

(iii) Changes in accounting policies or accounting estimates: For example, an entity can revalue assets (change from the cost model to the relevant model) to improved gearing or change the way in which it depreciates assets to improve profits.

(iv) Profit smoothing: Manipulating reported profits by recognising (usually) artificial assets or liabilities and releasing them to statement profit or loss as required.

(v) Aggressive earnings management: Artificially improving earnings and profits by recognizing sales revenue before it is earned.

(vi) Capitalizing expenses: Recognising "assets" which do not meet the definition in the IASB conceptual framework for the recognition criteria. Examples include: human resources, advertising expenditure and internally generated brand names.

EXAMINER'S REPORT

The question, which is in three parts, tests the candidates' knowledge and understanding of financial ratios and the techniques of creative accounting.

Parts (a) and (b) require candidates to calculate some ratios and to comment on the performance and short term liquidity of an entity. Part(c) requires candidates to identify and give examples of creative accounting techniques.

Candidates' understanding of the question was good as over 95% of the candidates attempted the question and the performance was above average.

Candidates' commonest pitfalls were their wrong calculations of relevant ratios, inability to comment properly based on the ratios calculated. Some of them were unable to identify and explain creative accounting techniques.

Candidates are advised to also pay special attention to the interpretation of the results of the calculations when attempting question on financial ratio analysis in future examinations of the Institute.

Marking Guide	**Marks**	**Marks**
a. Calculation of financial ratios		
- Return on Capital employed	$1\frac{2}{3}$	
- Net profit margin	$1\frac{1}{3}$	
- Current ratio	$1\frac{1}{3}$	
- Quick ratio	$1\frac{1}{3}$	
- Debt ratio	$1\frac{1}{3}$	
- Fixed interest cover	$1\frac{1}{3}$	
- Dividend cover	$1\frac{1}{3}$	
- Dividend yield	$1\frac{1}{3}$	
- Columnar presentation	1	12
b. Comments on Performance and short-term liquidity		
- Comment on performance	2	

	- Comment on short term liquidity	2	4
c.	Creative Accounting Techniques		
	- Identification of 4 – techniques at ½ mark each	2	
	- Explanation of 4 techniques at ½ mark each	2	4
	Total		**20**

SOLUTION 5

AKAWO LIMITED

Statement of profit or loss (extract)	**Notes**	**2016**	**2017**
		₦'000	**₦'000**
Revenue	3	28,000	32,000
Cost of sales	3	(18,200)	(26,800)
Profit for the period		9,800	5,200

	Notes	**2016**	**2017**
Statement of financial position (extract)			
Non-current assets		**₦'000**	**₦'000**
PPE	5	5,400	3,000
Current assets			
Inventory - Material (WIP)		600	
Contract asset	4	2,400	2,000

Workings:

	2016		**2017**	
	₦'000	**₦'000**	**₦'000**	**₦'000**
1. Overall profit		80,000		80,000
Cost to date:			40,800	
Architect's and surveyor's fee	1,000			
Materials	5,600			
Direct labour costs	7,000			
Overheads (40% x ₦7000)	2,800			
Depreciation	1,800	(18,200)	4,200	(45,000)
Estimated cost to completion	29,600		13,200	
Depreciation	4,200	(33,800)	1,800	(15,000)
Total cost to completion		(52,000)		(60,000)
Profit		28,000		20,000

2. Percentage of completion

	2016	2017
	₦'000	**₦'000**
Cost to date	18,200	45,000
Total cost to completion	52,000	60,000
Percentage	**35%**	**75%**

3. Profit or loss

	2016	2017
	₦'000	**₦'000**
Revenue 2016 (35% x 80,000)	28,000	
2017 (75% x 80,000 - 28,000)		32,000
Cost of sales 2016 (35% x ₦52,000)	(18,200)	
2017 (75% x ₦60,000 –18,200)		(26,800)
Profit for the period	**9,800**	**5,200**

4. Statement of financial position

	2016	2017
	₦'000	**₦'000**
Cost to date	18,200	45,000
Profit to date	9,800	15,000
Bills received	(25,600)	(58,000)
Contract asset	2,400	(2,000)

5. Property, plant and equipment

	2016	2017
	₦'000	**₦'000**
Cost	7,200	7,200
Accumulated depreciation (w6)	(1,800)	(4,200)
Carrying amount	5,400	3,000

Depreciation

Monthly Depreciation $\frac{₦7,200 – ₦1,200)}{30 \text{ months}}$ = ₦200,000

2016 depreciation	₦ 200,000 x 9months	=	₦1,800,000
2017 depreciation	₦ 200,000 x 21months	=	₦4,200,000

EXAMINER'S REPORT

The question tests candidates' knowledge of construction contract account. Candidates were required to prepare in relation to a building contract, the statement of profit or loss extract for two years 2016 and 2017 and a statement of financial position extract as at the end of the two years.

Candidates appeared to have a poor understanding of the question as only about 40% of the candidates attempted the question and the performance was below average.

Candidates commonest pitfalls were their inability to determine the revenue and cost elements attributable to each of the relevant years. Candidates also exhibited poor presentation of the statements of profit or loss and statement of financial position extracts.

Candidates are advised not to ignore any aspect of the syllabus while preparing for the Institute's examinations in future.

Marking Guide	**Marks**
- Preparation of statement of profit or loss extract	8
- Preparation of statement of financial position extract	7
Total	**15**

SOLUTION 6

(a) (i)	**Market based intangible assets:**		**₦'000**
	Trade Marks		4,600
	Internets		5,400
		10,000	
	Customer's related		**₦'000**
(ii)	**Intangible assets**		
	Ordered or production backlog		4,000
	Customers' contract	4,400	
			8,400
(iii)	**Artistic related intangibles assets**		**₦'000**
	Books and literary works		800
	Video and motion film pictures		2,500
	Pictures and photographs		3,400
	Plays		4,200
			10,900

(iv)	**Contract based intangibles assets**	**₦'000**
	Franchise	3,200
	Broadcasting right	5,000
		8,200

(v)	**Technology based intangibles assets**		**₦'000**
	Quick books and SAGE		950
	Patents		1,200
	Trade Secrets	4,800	
			6,950

(b)	Carrying amount		**₦'000**
(i)	Quick book and SAGE cost		950
	Accumulated amortisation		
	₦950/5years x 2years	(380)	
			570

(ii)	Trade marks	**₦'000**
	Cost	4,600
	Accumulated amortization:	
	₦4600/8years x 3years	(1,725)
		2,875

(iii)	Plays	**₦'000**
	Cost	4,200
	Accumulated amortization:	
	₦4200/7years x 4years	(2,400)
		1,800

(iv)	Franchise	**₦'000**
	Cost	3,200
	Accumulated amortization:	
	₦3200/8years x 5years	(2,000)
		1,200

(c) IAS 38 prohibits the following internally generated intangibles assets:

Goodwill
Brands
Mastheads, Front page newspaper masthead
Publishing Titles
Customer's List

EXAMINER'S REPORT

The question tests candidates' knowledge and understanding of the provisions of IAS 38 Intangibles assets. The candidates are required to calculate the costs of the following intangibles classes; market based, customer related, artistic related, contract based and technology based intangible assets. They also determine the carrying amounts of some items of intangibles and to identify four internally generated intangibles prohibited by IAS 38.

Candidates had poor understanding of the question. About 50% of the candidates attempted the question and the performance was below average.

Candidates' commonest pitfalls were their inability to calculate the correct costs of the intangible assets due to wrong classifications and determination of the carrying amounts of some items.

Candidates' are advised to make effective use of the Institutes financial reporting study text while preparing for examination in the future.

Marking Guide		**Marks**	**Marks**
a.	Calculation of the costs of intangibles assets:		
	- Market based	1	
	- Customer related	1	
	- Artistic related	1	
	- Contract based	1	
	- Technology based	1	5
b.	Calculation of Carrying amounts of intangible assets:		
	- Quick Books and SAGE	1½	
	- Trade marks	1½	
	- Plays	1½	
	- Franchise	1½	6
c.	Identification of four Internally Generated Intangibles assets Prohibited in IAS38:		
	- Goodwill		
	- Brand		
	- Mastheads		
	- Publishing titles		
	- Customer's list		
	One mark each for any 4 points		4
	Total		**15**

SOLUTION 7

a. **LIMITATIONS OF FINANCIAL STATEMENTS**

- **Complex and detailed information:**

  Financial statements prepared under IFRS conditions are complex and detailed. Most users may not be able to fully understand what the financial statements are trying to communicate.

- **Timely information:**

  For decision making, timely information is required, therefore, for many users of financial statements, the information in it may not be received on time.

- **Historical cost:**

  The financial statements are mainly historical in nature and give a summary of past events and not what is going to happen in future.

- **Not all information is captured:**

  Much useful information is not captured in the financial statements. For example, internally generated intangible assets e.g. a brand name cannot be reflected in the statement of financial position of the reporting entity.

- **Creative accounting:**

  Management may manipulate the information in the financial statements so that it would not reflect the reality of the entity.

- **Financial market perception:**

  How the financial market perceives an entity cannot be recognised in the financial statement.

- **Revenue recognition:**

  The statement of comprehensive income may be inadequate on reflecting the amount of profit or loss made in a period because it is difficult to judge at what point revenue should be recognised.

- **Periodic financial statement:** are only drawn up at a specific period of time.

- **Events after financial year end**: A lot can happen between the end of financial period and when the statements are authorised for publication.

- **Related parties transaction:** Many transactions take place between related parties and these may not be fully reflected in the financial statements.

- **Mixed value:** The values used in financial statements are mixed in nature some transactions and balances are accounted for at historical cost while others are incorporate at fair values.

- **Inflationary effects:** If the inflation rate is relatively high, the amount associated with assets and liabilities in the statement of financial position will appear low, since they are not being adjusted for inflation. This mostly apply to non-current assets.

- **Incomparability across companies**: If users want to compare the results of different companies, their financial statements are not always comparable, because the entities may use different accounting policies. These issues can be located by examining the disclosures that accompany the financial statements.

- **No Predictive value:** The information in a set of financial statements provides information either historical results or the financial status of a business as of a specific date. The statements do not necessarily provide any value in predicting what will happen in the future. For examples a business could report excellent results in one month, and no sales at all in the following month, because a contract on which it was relying on has ended.

b. Potential users of financial statements and their likely information need.

- **Community** - For social responsibility

- **Suppliers and trade creditors -** are interested in information that will help them determine whether the amounts owing them will be paid on time.

- **Lenders -** wants information that will enable them to decide whether their loans will be paid when due, and whether or not to grant new loans to the entity.

- **Investors** - supply risk capital in the form of funding. This group is concerned with the risk inherent and the return provided by their investments.

- **Customers -** will be interested in the continuity of the entity, especially if they depend on it themselves.

- **Employees** - wish to know about the stability and profitability of the entity. This may give them confidence about their jobs and could be used to discuss salary and conditions of employment.

- **Government/Government Agencies** - They are interested in taxation and regulatory purposes.

- **General Public** - May be affected by an entity in a number of different ways especially how an entity may contribute to the local economy.

c. **Underlying assumptions of the Financial Statements** - The underlying assumption as enunciated by the conceptual framework for financial reporting is the going_concern basis of accounting. The going concern of basis of accounting is the assumption in preparing the financial statements that the entity will continue to operate for the foreseeable future and does not intend to go into liquidation and will not be forced to go into liquidation.

EXAMINER'S REPORT

The question tests candidates' knowledge of "The Conceptual Framework for Financial Reporting". The candidates are required to identify and discuss the limitations of financial statements, identify potential users of financial statement and their information need and also to state the underlying assumptions of financial statements.

Although over 80% of the candidates attempted the question, their understanding of it was limited as the performance was average.

Candidates' commonest pitfalls were their inability to explain the information need of the identified users and lack of knowledge of the conceptual framework.

Candidates are advised to cover all aspect of the Financial Reporting Syllabus while preparing for the examinations in future.

Marking Guide		**Marks**	**Marks**
a.	Limitations of financial statements		
	- Identification of any 8 limitations at $^1/_2$ mark each	4	
	- Explanation of any 8 limitations at $^1/_2$ mark each	$\underline{4}$	8
b.	Users of financial statements		
	- Identification of any 5 users at $^1/_2$ mark each	$2^1/_2$	
	- Explanation of any 5 information need of users at $^1/_2$ mark each	$\underline{2^1/_2}$	5
c.	Identification of the assumptions	1	
	- Explanation of the assumptions	$\underline{1}$	$\underline{2}$
	Total		$\underline{\underline{\mathbf{15}}}$

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION - NOVEMBER 2018

TAXATION

Time Allowed: $3^1/_4$ hours (including 15 minutes reading time)

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

(a) Dr Alade Ogungbemi retired from the service of Oyo State Government after attaining 60 years of age on July 31, 2017. He secured an employment with TUC Foods Limited as human resources manager, effective August 1, 2017.

(i) Salary: January 1 - July 31, 2017 ₦420,000 per month
(ii) New employment - ₦4,800,000 per annum
(iii) Pension income, effective August 1, 2017 - ₦840,000 per annum
(iv) Transport allowance, new employment - ₦120,000 per annum
(v) Rent allowance, new employment - ₦720,000 per annum
(vi) Contributions to national housing fund and contributory pension fund scheme at $2^1/_2$% and $7^1/_2$% of gross income, respectively
(vii) Rental income received (gross)

	₦
July 19, 2015	240,000
December 1, 2015	120,000
July 4, 2016	360,000
December 4, 2016	420,000

(viii) Dr. Ogungbemi is married and has four children. All except one aged 20 years are still in school.
(ix) Dr. Ogungbemi has a life assurance policy with a sum assured of ₦7,500,000 and annual premium of ₦460,000.
His aged parents live with him. None of them has an income.

Required:

Compute the personal income tax payable by Dr. Ogungbemi for the relevant year of assessment. (20 Marks)

(b) The board of public procurement recently organised a workshop for public enlightenment on the requirements for the registration of contractors and service providers to be eligible for public contract award.

In accordance with the Personal Income Tax Act CAP P8 LFN 2004 (as amended), **you are required to write short notes on:**

i.	National housing fund contribution	(3 Marks)
ii.	Contributory pension scheme	(4 Marks)
iii.	National health insurance scheme contribution	(3 Marks)
		(**Total 30 Marks**)

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

QUESTION 2

Adamu Musa Company Limited is a Nigerian telecommunications company which has been in business for several years. The company has been your client for so many years. Your partner has just had a meeting with Mr. Taragi, the company's managing director and came back with the company's annual report. The summary of the company's statement of profit or loss for the year ended October 31, 2017 is as follows:

	₦	₦
Gross profit		3,062,500
Add:		
Dividend received from other Nigerian companies (gross)	175,000	
Profit on sale of property, plant and equipment	160,000	
Rents received (gross)	140,000	475,000
		3,537,500
Less:		
Rent paid	250,000	
Wages and salaries	725,000	
Lighting and air conditioning	37,500	
Travelling expenses	50,000	
Rates	60,000	
Repairs to premises	150,000	
Depreciation	125,000	
Bad debts written off	50,000	
Income tax provision	175,000	
Stationery	75,000	
Postages and telephone	30,000	
Business name sign post	10,000	
Legal expenses	100,000	
General expenses	200,000	
Expansion of cold room	500,000	2,537,500
Net profit		**1,000,000**

Additional information:

(i) Bad debts include general provisions of ₦22,500 written off on sale of trade inventory.

(ii) Legal expenses include ₦25,000 for the acquisition of new lease and ₦12,500 for renewal of old lease.

(iii) General expenses include:

	₦
Repairs and maintenance of cold room	87,500
Chief Taragi's private use of official vehicle	25,000
Fine on Chief Taragi for traffic offence	12,500
Fine on employee for traffic offence (private journey)	7,500
Trade magazine	5,000
Other magazines (for private use)	3,750

(iv) Travelling expenses include Chief Taragi's (managing director) private hotel bill of ₦11,250.

(v) Capital allowances for the year as agreed with the tax office totalled ₦125,000.

(vi) Withholding tax at 10% was deducted at source from rental income.

Required:

(a) Compute the total profit and companies income tax payable (13 Marks)

(b) Calculate tertiary education tax (2 Marks)

(c) State five categories of companies that are liable to information technology tax. (5 Marks)

(Total 20 Marks)

QUESTION 3

J & P (Nigeria) Limited, a construction and civil engineering company, has been in business for many years. The harsh economic climate in the country resulted in a decline in the profits of the company which necessitated the decision of the board of directors to either cease operations on December 31, 2017 or March 31, 2018.

Recent accounts adjusted for tax purposes revealed the following adjusted profits:

	₦
Year ended July 31, 2013	5,460,000
Year ended July 31, 2014	4,970,000
Year ended July 31, 2015	4,320,000
Year ended July 31, 2016	3,450,000
Year ended July 31, 2017	1,875,000
8 Months ended March 31, 2018	750,000

You are required to:

Advise the board of directors on whether or not to cease operations on December 31, 2017 or March 31, 2018. (Show all workings) **(Total 20 Marks)**

QUESTION 4

Solomon, Musa and Chinnedu were classmates in their secondary school days. They are friends with passion for running a joint business because of their trust in one another.

They formed a partnership some years later, providing specialised agricultural engineering services to the agricultural sector. Accounts are made up to December 31, each year. The following are the adjusted profits for tax purposes:

	₦
Year ended December 31, 2014	3,240,000
Year ended December 31, 2015	3,712,500
Year ended December 31, 2016	5,400,000
Year ended December 31, 2017	4,950,000

Additional information is provided as follows:

(i) Solomon, Musa and Chinnedu are to share profits in the ratio of 3:6:3, respectively.

(ii) Salaries are drawn in this order:

	₦
Solomon	810,000
Musa	540,000
Chinnedu	405,000

(iii) Interest on capital is 7½%

(iv) The capital account of each partner is

	₦
Solomon	337,500
Musa	675,000
Chinnedu	473,500

(v) On May 31, 2016, Solomon retired and Bakare, another old school mate was admitted on June 1, of the same year, on an annual salary of ₦405,000. He introduced a capital of ₦472,500 and was to have the same sharing ratio as that of Solomon.

Required:

(a) Calculate each partner's income from the partnership business for 2016 year of assessment and indicate the basis for which each partner will be assessed to tax. (16 Marks)

(b) Discuss the rules of commencement in respect of partnership business. (4 Marks)

(Total 20 Marks)

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

QUESTION 5

(a) Mandy Construction Nigeria Limited is an engineering company incorporated on January 1, 2009, and commenced business the same day. The company makes up its accounts to June 30, each year. The company had prepared its tax returns for 2017 assessment year and was of the opinion that it had no total profit and therefore not subject to companies income tax.

As a tax consultant, the chief executive officer has requested you to review the tax returns. This is to ascertain that there was no other provision of the tax laws that stipulates procedure to determine the tax payable in a situation where there is no taxable profit or the total profit results in no tax payable.

You have been provided with the following information relating to the company's records for the year ended June 30, 2016:

Statement of profit or loss for the year ended June 30, 2016, is as follows:

	₦'000
Revenue	5,656,000
Cost of sales	(4,404,211)
Gross profit	1,251,789
Other income	152,240
Administrative expenses	(907,906)
Operating profit	496,123
Investment income	50,934
Finance cost	(890,657)
Loss before tax	(343,600)
Income tax	-
Loss for the year	(343,600)

You are given the following additional information:

		₦
(i)	Included in administrative expenses are the following:	
	• Loss on disposal of property, plant and equipment	4,352,400
	• Depreciation	5,184,700
(ii)	Capital allowances as agreed with the tax office.	1,065,000

The company's authorised, issued and fully paid-up share capital of ₦1 each are provided as follows:

Name of shareholder	Nationality	No of shares @ ₦1.00 each
Musa Ahmed	Nigerian	6,250,000
White Harcourt	Nigerian	5,000,000
Okoro Bons	Nigerian	3,750,000
Lateef Kola	Nigerian	5,000,000
Jeans Brown	British	3,000,000
Cutty Fred	American	2,000,000
Total		**25,000,000**

The net assets of the company extracted from the statement of financial position as at June 30, 2016 was ₦3,441,041,000.

Required:

From the available information, compute companies income tax payable by Mandy Construction Nigeria Limited for the relevant assessment year. (12 Marks)

(b) The minimum tax regulation exempts certain companies.
Required:

State the categories of companies that are exempted from minimum tax liability.
(3 Marks)
(**Total 15 Marks**)

QUESTION 6

(a) Recently, the Federal Inland Revenue Service offices across the country embarked on nationwide sensitisation programme. At a forum organised for this purpose, in one of their offices in the South West zone, consultants were invited to present papers.

As one of the tax consultants, you are required to explain:

(i) **Three** main features of withholding tax. (3 Marks)

(ii) The relevant tax authorities in relation to withholding tax in Nigeria.
(3 Marks)

(b) The difficulty in determining what constitutes a trade has led to many litigations and the huge number of tax cases that exist on the issue.

The problem from decided cases is that of finding an absolute test for identifying a trade. The conclusion has always been that there are no fixed rules but that each case must be determined on its own fact.

Required:

State **six** considerations that influence the determination of when an activity constitutes a trade. (9 Marks)

(Total 15 Marks)

QUESTION 7

(a) As tax consultants to Aderibigbe and Associates Limited, the managing director of your client brought an assessment notice served on the company by the Federal Inland Revenue Service. He complained that the assessment was outrageous. You observed that the amount assessed was higher than that based on the documents submitted to the tax office.

You are required to:

Advise the managing director on the action to be taken to resolve the disputed assessment. (8 Marks)

(b) In a bid to bring more individuals and corporate organisations into the tax net, the submission of tax clearance certificates by taxpayers is a condition precedent before bidding for contracts.

You are required to:

State s**even** transactions which necessitate the submission of a tax clearance certificate. (7 Marks)

(Total 15 Marks)

Nigerian tax rates

1. Capital allowances

	Initial %	Annual %
Building expenditure	15	10
Industrial building expenditure	15	10
Mining expenditure	95	Nil
Plant expenditure (excluding furniture & fittings)	50	25
Manufacturing industrial plant expenditure	50	Nil
Construction plant expenditure (excluding furniture and fittings)	50	Nil
Public transportation motor vehicle	95	Nil
Ranching and plantation expenditure	30	50
Plantation equipment expenditure	95	Nil
Research and development expenditure	95	Nil
Housing estate expenditure	50	25
Motor vehicle expenditure	50	25
Agricultural plant expenditure	95	Nil
Furniture and fittings expenditure	25	20

2. Investment allowance 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%

SECTION A

SOLUTION 1

1(a) **Dr. Alade Ogungbemi**
Computation of personal income tax payable for 2017 tax year

	₦	₦
Earned income:		
Income from public service (Oyo State Government)		
1/1/2017-31/7/2017 (₦420,000x7)	2,940,000	
Income from TUC Foods Limited		
1/8/2017-31/12/2017 (₦4,800,000x$^5/_{12}$)	2,000,000	
Transport allowance (₦120,000x$^5/_{12}$)	50,000	
Rent allowance (₦720,000x$^5/_{12}$)	300,000	
Gross emoluments		5,290,000
Unearned income:		
Rental income:		
July 4, 2016	360,000	
December 4, 2016	420,000	780,000
Gross income		6,070,000
Consolidated relief allowance:		
(Higher of 1% x ₦6,070,000 or		
(₦200,000+20% x ₦6,070,000)		
₦200,000 +₦1,214,000		(1,414,000)
		4,656,000
Tax exempt items:		
Contribution to pension fund scheme		
($7^1/_2$% x ₦6,070,000)	455,250	
Contribution to national housing fund		
($2^1/_2$% x ₦6,070,000)	151,750	
Life assurance premium	460,000	(1,067,000)
Chargeable income		3,589,000

Computation of personal income tax	₦
Applying tax table rate	21,000
First ₦300,000 @ 7%	33,000
Next ₦300,000 @ 11%	75,000
Next ₦500,000 @ 15%	95,000
Next ₦500,000 @ 19%	336,000
Next ₦1,600,000 @ 21%	93,360
Next ₦389,000 @ 24%	653,360
₦3,589,000	

1(b)

(i) **National housing fund contribution**

The National Housing Fund Act Cap LFN 2004, provides that a Nigerian worker earning an income of ₦3,000 and above per annum in both public and the private sectors of the economy shall contribute 2.5% of his basic monthly salary to the fund.

Employers who fail to deduct or remit are liable to pay a penalty of ₦50,000 whilst self-employed persons are to pay N5,000 or one year imprisonment on conviction or both.

The employer is to deduct the contribution from the employee's monthly salary and remit to the Federal Mortgage Bank of Nigeria within one month of the deduction. The Act mandates the Federal Mortgage Bank to collect, manage and administer the fund. Contributions made to the fund are tax deductible.

(ii) **National pension scheme**

The Pension Reform Act 2014 (PRA), established a uniform contributory pension scheme for payment of retirement benefit of employees. The scheme applies to all employees in both the public and private sectors who are in employment in an organisation which has at least 15 employees.

The rate of contribution to the scheme shall be a minimum of 8% of employee's basic emoluments (i.e basic salary, housing allowance and transport allowance) as contribution for employees in the private and public sectors and 10% of the monthly emoluments as employers' contribution.

However, contributions made by an employee to the scheme shall be tax deductible.

Notwithstanding the foregoing mode of contribution to the scheme, an employer may agree or elect to bear the full burden of the scheme, provided that in such case, the employer's contribution shall not be less than 20% of the monthly emolument of the employee.

(iii) **National health insurance scheme**

The national health insurance scheme was set up by the National Health Insurance Act Cap N42 LFN 2004, for the purpose of providing health insurance which shall entitle persons under the scheme and their dependants to have the benefits of prescribed good quality and cost effective health services as set out in the Act.

The Act provides that an employer who has a minimum of ten employees may, together with every person in his employment, pay contribution under the scheme.

Contributions are earnings related for the public (federal) sector programme, the employer pays 3.25%, while the employee pays 1.75% representing 5% of the employee's consolidated salary. For the private sector programme and other tiers of government, the employer pays 10% while the employee pays 5%, representing 15% of the employee's basic salary. However, the employer may decide to pay the entire contribution. The employer may also undertake extra contributions for additional cover to the benefit package.

An employer under the scheme shall cause to be deducted from an employee's wages, any contribution which is payable by the employee.
The employer's contribution and the contributions in respect of its employees are to be paid into the account of a designated health maintenance organisation. Contributions to the scheme are tax deductible.

EXAMINER'S REPORT

The question tests candidates' knowledge of the computation of personal income tax liability and tax exempt items.

Candidates had a fair understanding of the question. The commonest pitfall was the inability of the candidates to understand applicable rates for the deduction of tax exempt items.

Candidates are advised to study the relevant laws and rules relating to tax exempt items as well as the Institute's Study Texts.

Marking Guide		**Marks**	**Marks**
(a)	Heading	1	
	Earned income:		
	Income from public service	1	
	Income from TUC Foods Limited	1	
	Transport allowance	1	
	Rent allowance	1	
	Gross emoluments	1	
	Rental income: July 4, 2016	1	
	December 4, 2016	1	
	Sub-total	1	
	Gross income	1	
	Consolidated Relief Allowance (CRA)	1	
	Sub-total after CRA	1	
	Contribution to national housing fund	1	
	Contribution to pension fund scheme	1	

Life assurance premium	1	
Sub-total of tax exempt items	1	
Chargeable income	1	
Computation of personal income tax payable ($^1/_2$ mark for each of the amounts)	3	**20**
	3	
(b)i Explanation of national housing fund contribution		
ii Explanation of pension scheme	4	
iii Explanation of national health insurance scheme Contribution	3	10
		30

SOLUTION 2

(a) **Adamu Musa Co. Ltd**

Computation of total profit and companies income tax liability

	₦	₦
Net profit as per accounts		1,000,000
Add:		
Depreciation	125,000	
Bad debts: general provision	22,500	
Income tax provision	175,000	
Business sign post	10,000	
Legal expenses disallowed	25,000	
Chief Taragi's private use of official vehicle	25,000	
Fine on Chief Taragi for traffic offence	12,500	
Fine on employee for traffic offence (private journey)	7,500	
Other magazines (for private use)	3,750	
Travelling expenses - Chief Taragi's private hotel bill	11,250	
Expansion of cold room	500,000	917,500
		1,917,500
Profit on sale of property, plant and equipment	160,000	
Dividend received	175,000	(335,000)
Adjusted or assessable profit		1,582,500
Capital allowances		(125,000)
Total profit		1,457,500

Companies income tax (30% of total profit)	437,250
WHT on rent (10% of ₦140,000)	(14,000)
Net companies income tax payable	423,250

(b) **Tertiary Education Tax (TET)**
TET @ 2% of assessable profit (2/100 x ₦1,582,500) ₦31,650

(c) **Companies liable to information technology tax**
The specified companies include:
(i) GSM service providers and all telecommunication companies;
(ii) Cyber companies and internet providers;
(iii) Pension managers and pension related companies;
(iv) Insurance companies; and
(v) Banks and other financial institutions.

EXAMINER'S REPORT

The question tests candidates' knowledge of the computation of companies income tax liability and the identification of companies liable to information technology tax.

Candidates displayed a fair understanding of the question but some were unable to identify the disallowable expenses and non-taxable incomes.

Candidates are advised to read widely to facilitate the identification of disallowable items and non-taxable incomes.

Marking Guide		**Marks**	**Marks**
(a)	Heading	½	
	Net profit per accounts	½	
	Expenses disallowed: ½ mark for each of the eleven points	5½	
	Subtotal of expenses disallowed	½	
	Subtotal before adjusting for incomes deducted from net profit	½	
	Profit on sale of property, plant and equipment	½	
	Dividend received	½	
	Subtotal of profit on sale of property, plant and equipment and dividend received	½	
	Adjusted profit	1	
	Capital allowances	½	
	Total profit	½	
	Companies income tax	½	
	Withholding tax on rent	1	
	Net companies income tax payable	½	13

(b)	Basis of computing tertiary education tax	1	
	Tertiary education tax payable	1	2
c)	1 mark for each of the five specified companies liable to pay information technology tax	5	5
			20

SOLUTION 3

J & P Nigeria Limited
Computation of assessable profits

Assuming business ceases on December 31, 2017

Assessment year	Basis period		Assessable profits
			₦
2017	1/1/2017- 31/12/2017	= (₦1,875,000x $^7/_{12}$)+($^5/_8$ x ₦750,000) = ₦1,093,750 + ₦468,750	1,562,500
2016	(Higher of)		
	1/1/2016 – 31/12/2016 (Actual)	($^7/_{12}$ x ₦3,450,000 + $^5/_{12}$ x ₦1,875,000) = ₦2,012,500 + ₦781,250 ₦2,973,750	
	or		
	Preceding year basis 1/8/2014 - 31/7/2015=	₦4,320,000	₦4,320,000
			₦5,882,500

Assuming business ceases on March 31, 2016

Assessment year	Basis period	Assessable profit
		₦
2018	1/1/2018 – 31/3/2018	281,250
2017	Higher of 1/1/2017 – 31/12/2017 (Actual) ($^7/_{12}$ x ₦1,875,000) +($^5/_8$ x ₦750,000) = ₦1,093,750 + ₦468,750 =	₦1,562,500

or			
Preceding year basis			
1/8/2015 – 31/7/2016	3,450,000	3,450,000	
			3,731,250

A comparison of the assessable profits for the two dates of cessation reveals the following:

	Date of Cessation	
	31/12/17	31/3/2018
	₦	₦
2018	-	281,250
2017	1,562,500	3,450.000
2016	4,320,000	4,320,000
	5,882,500	8,051,250

It is advisable that the company should cease business on December 31, 2017, because the assessable profits totalling ₦5,882,500, is lower than the assessable profits of ₦8,051,250, if the company ceases business on March 31, 2018 .

EXAMINER'S REPORT

The question tests candidates' knowledge of the principles of cessation of business.

Candidates had a poor understanding of the question. The commonest pitfall was the lack of understanding of how to compute the tax liabilities of the two option dates.

Candidates are advised to be familiar with computations in a situation whether to cease business on a particular date or later.

Marking Guide	**Marks**
Heading	1
1 mark for each of the correct 4 assessment years	4
1 mark for each of the correct basis periods	5
Cessation of business on 31/12/2017	
- Assessable profit for 2017 assessment year	1
- Options for 2016 assessment year - Actual	1
- Preceding year	1
Cessation of business on 31/3/2018	
- Assessable profit for 2018 assessment year	1
- Options for 2016 assessment year - Actual	1
- Preceding year	1
Comparison between the two dates of cessation	
- ½ mark for each of the 6 results	3
Recommendation on when to cease business	1
	20

SOLUTION 4

(a) **Solomon, Musa and Chinnedu in partnership**
Computation of partners' income for 2016 assessment year

	SOLOMON	**MUSA**	**CHINNEDU**	**BAKARE**
	₦	**₦**	**₦**	**₦**
Salary (5 months)	337,500			
Salary (7 months)				236,250
Salary (12 months)		540,000	405,000	
Interest on capital	10,547	50,625	35,513	20,672
Share of profit (see workings)	562,500	1,856,250	928,125	787,500
	910,547	2,446,875	1,368,638	1,044,422
	1/1/14 -	1/1/13 –	1/1/13 -	1/6/14 -
Basis period is	31/5/14	31/12/13	31/12/13	31/12/14
	Actual	PYB	PYB	Actual

Workings:

i. Solomon is deemed to have ceased business on 31/5/2016, having retired on same date. Accordingly, applying the cessation provisions, he is assessed in 2016 tax year on his income from the partnership for the period, 1/1/16 – 31/5/16, as follows:

	₦
Salary (5/12 x ₦810,000)	337,500
Interest on capital (₦337,500 x 7.5% x 5/12)	10,547
Share of profit - ₦5,400,000	
Year end 31/12/16 = ₦5,400,000 x 5/12 x 0.25	562,500

The Internal Revenue Service may revise Solomon's assessment for 2015 tax year to actual if this will produce higher assessable income than the preceding year basis on which he would have hitherto have been assessed.

ii. Bakare will be deemed to have commenced business on June 1, 2016, being the date of his admission into the partnership. Consequently, the commencement provision will apply for 2016 assessment year, and will therefore be assessed on actual basis, that is, income of the period 1/6/2016 – 31/12/2016, namely:

	₦
Salary (7/12 x ₦405,000)	236,250
Interest on capital (₦472,500 x 7.5% x 7/12)	20,672
Share of profit ₦5,400,000 (Y/E 31/12/2016)	
₦5,400,000 x 7/12 x 0.25 (profit share)	787,500

iii. Both Musa and Chinnedu, the continuing partners, will continue to be assessed on preceding year basis. Consequently, for 2016 assessment year, their assessable income is the share of each of them from the partnership income for the year ended 31/12/2015 namely:

		₦	₦
Adjusted profit	31/12/2015		3,712,500
Solomon	(₦3,712,500 x 0.25)	928,125	
Musa	(₦3,712,500 x0.5)	1,856,250	
Chinnedu	(₦3,712,500 x0.25)	928,125	3,712,500

4b. It is true that partnership income is subject to commencement rules. The commencement rules are as follows:

(i) The assessable income of the year of commencement shall be the profit from date of commencement to the end of the year of assessment;

(ii) The assessable income for the second year of assessment, that is, the succeeding year of commencement shall be the profit from the day of commencement to a period of 12 months thereafter, that is; the profit of the first twelve months from commencement;

(iii) The assessable income for the third year of assessment after commencement shall be profit of the business for the year ended in the preceding year of assessment; and

(iv) A retiring partner's income will be determined by preference to cessation rules while new partner joining the partnership will have his case determined by the reference to commencement rules. Continuing partners will be assessed on preceding year basis.

EXAMINER'S REPORT

The question tests candidates' knowledge of the computation of partnership tax liability.

Candidates had a good understanding of the question though some candidates were unable to differentiate between partnership agreement and commencement rule.

Candidates are advised to pay attention to the computations of tax liabilities when there are abnormal basis periods.

Marking Guide		**Marks**	**Marks**
(a)	Computation of salary for each of the 4 partners – 1 mark for each partner	4	
	Computation of interest on capital for each of the 4 partners -	4	
	1 mark for each partner	4	
	Computation of share of profit for each of the 4 partners at 1 mark each	4	
	Computation of total income for each of the 4 partners at 1 mark each	4	16
(b)	1 mark for each of the 4 commencement rules	4	4
			20

SOLUTION 5

(a) **Mandy Construction Limited**
Computation of companies income tax liability for 2017 assessment year

		₦	₦
Net Loss as per accounts			(343,600,000)
Add:			
Loss on disposal of property, plant and equipment	4,352,400		
Depreciation		5,184,700	9,537,100
Adjusted/(Assessable loss)			(334,062,900)
Capital allowances		1,065,000	
Relieved		0	
Unrelieved capital allowance c/f		1,065,000	
Total profits			Nil
Companies income tax payable			Nil
Tertiary education tax payable (2% of assessable profit)		Nil	

Minimum tax computation

(i) Highest of:

		₦	₦
❖	0.5% of gross profit 0.005 x ₦1,251,789,000		6,258,945
❖	0.5% of net assets 0.005 x ₦3,441,041,000		17,205,205
❖	0.25% of paid-up share capital 0.0025 x ₦25,000,000		62,500
❖	0.25% of Revenue .0025 x ₦500,000	1,250	
(ii)	0.125% of revenue in excess of ₦500,000 Actual revenue = ₦5,656,000,000 Revenue in excess of ₦500,000 = ₦5,655,500,000 (0.00125 x ₦5,655,500,000)	7,069,375	
	Add: The highest of (1) – (3) above	17,205,205	24,274,580

The minimum tax liability is ₦24,274,580.

(b) According to CITA, the minimum tax provision shall not apply to :

(i) A company carrying on agricultural trade or business;

(ii) A company with at least 25% imported equity capital;

(iii) A company that has not been in operation for more than four calendar years (that is, for the first 4 calendar years of its commencement of business)

EXAMINER'S REPORT

The question tests candidates' knowledge of the computations of companies income tax, tertiary tax and minimum tax liability.

Candidates had a fair knowledge of the question. The commonest pitfall was the inability of the candidates to compute minimum tax liability and identify companies that are exempted from minimum tax regulation.

Candidates are advised to pay attention to the computation of minimum tax liability and be familiar with minimum tax regulation.

Marking Guide		**Marks**	**Marks**
(a)	Heading	½	
	Net loss per accounts	½	
	Loss on disposal of property, plant and equipment	½	
	Depreciation	½	
	Subtotal	½	
	Adjusted profit	½	
	Capital allowances	½	
	Total profit	½	
	Companies income tax payable	1	
	Tertiary education tax payable	½	
	Minimum tax computations:	½	
	Gross profit basis	1	
	Net assets basis	1	
	Paid up share capital basis	1	
	0.25% on ₦500,000 revenue	1	
	0.125% on excess of revenue over ₦500,000	1	
	Identification of which of the bases is the highest	1	12
(b)	1 mark for each of the three companies that are exempt from minimum tax regulation	3	3
			15

SOLUTION 6

(a)(i) **Main features of withholding tax include:**

- Rate applicable is a function of the type of transaction and whether it is carried out by an individual or a company;

- Payment of withholding tax is statutory on a person making the payment;

- It is an advance payment of income tax which is utilised as tax credit against income tax liability of the year to which the income relates. It is not a separate tax;

- Withholding tax represents the final tax on franked investment income in the hands of the recipients; and

- Withholding tax being an advance payment of income tax cannot be used later as credit for any other tax such as tertiary education tax and value added tax.

(ii) **The relevant tax authorities in relation to withholding tax in Nigeria are:**

- Federal Inland Revenue Service for corporate entities;
- State Internal Revenue Service for individuals; and
- Federal Inland Revenue Service for residents of the Federal Capital Territory, Abuja, members of the Nigeria Armed Forces and Police, and officers of the Nigerian Foreign Service.

6(b) The Royal Commission on the taxation of profit and income gave a summary of considerations that influence the identification of the badges of trade and they include:

(i) The subject matter of the realisation;
(ii) The length of period of ownership;
(iii) The frequency or number of similar transactions;
(iv) Supplementary work on or in connection with the property realised;
(v) The circumstances that were responsible for the realisation; and
(vi) The motive.

EXAMINER'S REPORT

The question tests candidates' knowledge of the rules relating to withholding tax and the determination of trade for tax purposes.

Candidates displayed a good understanding of the question, but some candidates were unable to enumerate the considerations of what constitute a trade and identify the features of withholding tax.

Candidates are advised to study withholding tax rules and the determination of what constitutes a trade for tax purposes.

Marking Guide		**Marks**	**Marks**
(a)i.	1 mark for each of any 3 features of withholding tax	3	3
ii.	1 mark for each of the 3 tax authorities in relation to withholding tax	3	3
			6
(b)	1½ marks for each of the 6 considerations that influence the determination of when an activity constitutes a trade	9	9
			15

SOLUTION 7

(a) The following actions would be taken as remedy to the disputed tax assessment:

(i) The consultant will review the accounts and documents which were earlier sent to the tax office to determine whether there was a genuine reason for the increase in the assessment. If there is any genuine reason for the increase in the assessment, the taxpayer will be advised not to pursue the disputed assessment, but to make payment without further delay;

(ii) However, if there is no ground or basis for the variation in the assessment, then a valid notice of objection will be written to FIRS within 30 days of the receipt of the notice of assessment. The notice of objection will contain the grounds of objection;

(iii) The tax consultant will expect the FIRS to see reasons and amend the assessment, which if satisfactory, would be amended. On the other hand, where the FIRS refuses to amend the assessment, a notice of refusal to amend should be written and sent to the taxpayer; and

(iv) Within 30 days upon the receipt of the notice of refusal to amend from the tax authority, a notice of appeal would be filed with the Tax Appeal Tribunal.

(b) The transactions in respect of which a tax clearance certificate must be produced are as follows:

(i) Application for government loan for industry or business;
(ii) Application for contract awards;
(iii) Application for certificate of occupancy;
(iv) Application for trade license;
(v) Appointment or election into public offices;
(vi) Application for transfer of real property;
(vii) Application for registration as a contractor:
(viii) Application for foreign exchange or exchange control permission to remit funds outside Nigeria;
(ix) Application for firearms license;
(x) Application for import and export license;
(xi) Application for government distributorship;
(xii) Application for allocation of market stall;
(xiii) Application for plot of land;
(xiv) Stamping of guarantor's form for Nigerian passport;
(xv) Application for the approval of building plan;
(xvi) Registration of motor vehicle;
(xvii) Change of ownership of vehicle by vendor;
(xviii) Application for agent license; and
(xix) Application for pool and gaming and license.

EXAMINER'S REPORT

The question tests candidates' knowledge of the process of objections, appeals in tax dispute resolutions and transactions which necessitate the submission of tax a clearance certificate. Candidates displayed a good knowledge of the question but some candidates were unable to explain how to register an objection to a tax assessment and file an appeal.

Candidates are advised to pay attention to objections to tax assessments and appeal process.

Marking Guide		**Marks**
(a)	2 marks for each of the 4 steps to be taken to resolve a disputed assessment	8
(b)	1 mark for each of the 7 transactions which will necessitate the submission of tax clearance certificates	7
		15

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – NOVEMBER 2018

PERFORMANCE MANAGEMENT

Time Allowed: $3^{1}/_{4}$ hours (including 15 minutes reading time)

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

JJ Company specialises in the manufacture and distribution of accessories for cars and motorcycles across central Lagos and the suburbs. The board and management of the company have decided to expand their potential market by capitalising on the recent demand for pedal cycles caused by congestion and concerns for global warming. They intend to start manufacturing pedal cycles from 2019.

The design team has developed four models A, B, C and D for the initial launch of the pedal cycle.

The manufacturing process involves frame manufacturing and assembly/accessory fitting.

Year 1

At present, there are 40 employees who are available to undertake frame manufacturing and 20 who are available to undertake assembly and accessory fitting. Each employee works a 37-hour week. At present, no overtime is permitted, so all of the output has to be completed within the normal working week. Employees working on the frame manufacturing cost ₦1,100 per hour. Those working on the assembly/accessory fitting cost ₦1,500 per hour. All the employees can be fully utilised elsewhere in the company if not working on this venture.

The anticipated time in hours that each process will take is as follows:

Model	**A**	**B**	**C**	**D**
Frame manufacturing	2.25	2.20	2.20	2.60
Assembly/accessory fitting	1.25	1.80	1.40	3.00

The direct materials are expected to cost ₦5,500 for model A, ₦6,000 for model B, ₦6,000 for model C and ₦10,000 for model D. There is no limit on the availability of materials.

Variable overheads of ₦2,700 per pedal cycle are incurred for both A and C models and ₦3,000 per pedal cycle for both B and D models.

Fixed overheads allocated to the pedal cycle workshop are ₦666,000 per annum. The organisation uses labour hours upon which to base its overhead absorption rates.

The company has done some initial market research and this indicates that demand and selling prices are likely to be as follows:

Model	**Number of pedal cycles**	**Selling price per unit**
		₦
A	200	14,550
B	75	16,500
C	220	17,000
D	80	24,000

Year 2

In Year 2, all other factors are assumed to be as in Year 1. However, two further options are available in order to meet demand.

The first is to lift the overtime ban and pay overtime at a rate of time and a half. If this happens however, it would be necessary to raise the selling price of all units of the specific model being completed outside normal working hours by ₦2,500 per pedal cycle. The selling price of the other models would remain as in Year 1.

The second option is to buy-in the completed pedal cycle necessary to meet the demand from another supplier. This would cost the company ₦27,000 per pedal cycle. The selling price of all units of the model in question would be increased by ₦5,500, if this option were to be pursued. The board and management are reluctant to pursue this option as they are concerned it may lower demand.

Required:

a. Determine the production plan that would maximise the profit available to JJ Company in Year 1 assuming that no overtime is worked. State the profit that would be earned as a result of this plan. (14 Marks)

b. Advise JJ Company of its most profitable course of action in Year 2, assuming that all of the demand is to be satisfied. (8 Marks)

c. Explain in detail, how the relationship between the company and the chosen supplier should be controlled on the assumption that the directors of the company are giving consideration to outsourcing their key inputs. (8 Marks)

(Total 30 Marks)

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

QUESTION 2

X and Y Divisions are two arms of the XY group of companies. X Division manufactures one type of component which it sells to external customers and also to Y Division.

The following information relates to X Division:

Market price per component	₦200
Variable cost per component	₦105
Fixed costs	₦1,375,000 per period
Demand from Y Division	20,000 components per period
Capacity	35,000 components per period

Y Division assembles another type of product which it sells to external customers. Each unit of that product requires two of the components that are manufactured by X Division.

The following information relates to Y Division:

Selling price per unit	₦800
Variable cost per unit:	
Two components from X	2 @ transfer price
Other variable costs	₦250
Fixed costs	₦900,000 per period
Demand	10,000 units per period
Capacity	10,000 units per period

Group Transfer Pricing Policy

- Transfers must be at opportunity cost.
- Y must buy the components from X.

Required:

a. Calculate the profit for each division if the external demand per period for the components that are made by X Division is:

    i. 15,000 components

    ii. 19,000 components

    iii. 35,000 components (13 Marks)

b. Calculate the financial impact on the Group if Y Division ignored the transfer pricing policy and purchased the 20,000 components that it needs from an external supplier for ₦170 each. Your answer must consider the impact at each of the three levels of demand (15,000, 19,000 and 35,000 components) from external customers for the components manufactured by X Division. (3 Marks)

c. Explain **TWO** attributes of a good transfer pricing policy. (4 Marks)

(Total 20 Marks)

QUESTION 3

Omegboeji Nigeria Limited is a trading company that specialises in buying and selling of bulk oil.

The company is financed by a capital base of ₦24 million inclusive of reserves in a mix of 30% and 70% of debt and equity respectively. The company has been in trading business for the past six years and has consistently adhered to its corporate policy on sales, purchases and inventory management.

The company's policy on sales is to ensure that sales proceeds are collected as follows:

(i) Cash Sales is 30% of the monthly sales.

(ii) The balance of the month's sales is to be collected in the month following sales.

The policy on monthly purchases which is in agreement with the supplier's policy is to pay for all supplies in the month following the month of purchase. The general policy of the company is that purchase cost for bulk oil represents 60% of the corresponding annual sales value while its inventory policy is to reserve 30% of the month's purchases as closing inventory.

The following information is available for the five years 2013 to 2017:

	Actual		**Estimates**		
	2013	**2014**	**2015**	**2016**	**2017**
	₦'000	**₦'000**	**₦'000**	**₦'000**	**₦'000**
Monthly Sales	12,000	15,000	16,800	18,000	24,000
Monthly Salaries	800	800	960	960	1,080
Monthly Rent	400	400	400	400	400
Monthly Expenses	350	370	390	390	380

Additional information:

(i) The company will purchase a motor vehicle in July 2016 which will be paid for in two instalments as follow:

First Payment will be 60% of cost in September 2016 while the balance will be paid in November 2016. The cost of the motor vehicle is expected to be ₦7,500,000.

(ii) Annual depreciation for the motor vehicle will be 20% on a straight-line basis. Monthly expenses include annual depreciation for the motor vehicle.

(iii) The cash balance as at December 31, 2014 was ₦2,500,000.

(iv) The company's salaries, rent and expenses will be paid in the month during which they are due.

Required:

a. Prepare a cash forecast for 2015, 2016 and 2017, showing closing cash balance at each year end. (10 Marks)

b. Prepare a forecast profitability statement for 2015, 2016 and 2017. (7 Marks)

d. Determine and comment on the forecast liquidity ratio (current ratio) for 2017. (3 Marks)

(Total 20 Marks)

QUESTION 4

Julmat Limited, a manufacturing company, has developed a new product. This requires an initial capital investment of ₦5m. At the end of the product's life, the capital equipment is expected to have a value of ₦3m. Julmat Limited requires an Annual Rate of Return (ARR) of 20% on its average investment on products of this type. The new product has an expected life of one year before it will be replaced by a more advanced product.

Production

The new product will be manufactured in batches of 1,000 units using a just-in-time production system.

The first batch is expected to incur a direct labour cost of ₦100,000 but a 75% learning curve is expected until the cumulative production equals 30 batches.

Thereafter, each batch is expected to incur the same direct labour cost as that of the 30th batch.

The expected direct materials cost for the first batch is ₦50,000. However, an experience curve is expected to apply to the first ten batches produced; thereafter no further savings in material costs per batch are expected.

Other production costs are expected to be ₦10,000 per batch.

Sales

Sales of the new product are expected as follows for each of the four stages of the product life cycle:

Stage	**Units sold**	**Selling Price per unit**
		₦
Introduction	10,000	120
Growth	30,000	100
Maturity	60,000	80
Decline	30,000	50

Note: The learning index for a 75% learning curve is - 0.4150.

Required:

a. Prepare calculations to show the total direct labour cost of the product for each of the four stages of the product life cycle. (6 Marks)

b. Assuming that there is no experience curve in relation to the product's direct material cost, prepare a statement that shows the profitability of the new product for each of the four stages of the product life cycle individually and in total for the product's life. (5 Marks)

c. Assuming that the direct material experience curve applies, calculate the average direct material cost per batch that must be incurred in order for the company to meet its ARR target over the life cycle of the product. (4 Marks)

d. Discuss the concept of life cycle costing and its effect on product pricing strategies at different stages of the product life cycle. Use the Julmat Limited scenario to illustrate your answer. (5 Marks)

(Total 20 Marks)

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

QUESTION 5

a. During the system analysis phase, the analyst uses different methods to obtain information. You are required to discuss these methods, including their advantages and disadvantages. (7 Marks)

b. Discuss **SIX** challenges likely to be encountered in the development of an organisation's Management Information System. (8 Marks)

(Total 15 Marks)

QUESTION 6

DDD Limited is a relatively small, specialist manufacturer of chemicals that are used in the pharmaceutical industry. It does not manufacture any pharmaceutical products itself since these are made by different processes and under different conditions. DDD obtains its raw materials, which are quite simple, from large chemical companies, and modifies them by a number of patented processes before selling them to a few pharmaceutical companies. DDD makes significantly higher margins than its suppliers, which manufacture in bulk. Several patents are due to expire in the next three years. The large pharmaceutical companies, which are DDD's customers, are suffering reduced profits as governments reduce the price they are prepared to pay for drugs. As a result, the pharmaceutical companies are pressuring DDD to reduce its prices. Majority of the shares in the company are owned by members of the family which started the business some years ago and who still take active part both as managers of the business and as development chemists. There is a share option scheme for the employees and this is well supported.

Required:

a. Advise the Board of Directors of the possible threats related to the patent expiring. (7 Marks)

b. Appraise suitable courses of action that DDD might take to maintain its profits in the face of the threats identified in (a) above. (8 Marks)

(Total 15 Marks)

QUESTION 7

Information within an organisation can be analysed into the following three levels:

- Strategic information;
- Tactical information; and
- Operational information.

Required:

Give detailed characteristics of each type of the above information.

(Total 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:

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

where

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

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

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

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

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

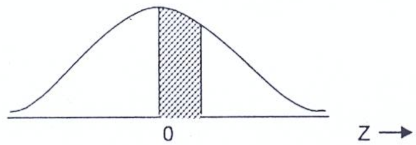
Discount rate (r)

Periods

(n)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%	
1	0·990	0·980	0·971	0·962	0·952	0·943	0·935	0·926	0·917	0·909	1
2	1·970	1·942	1·913	1·886	1·859	1·833	1·808	1·783	1·759	1·736	2
3	2·941	2·884	2·829	2·775	2·723	2·673	2·624	2·577	2·531	2.487	3
4	3·902	3·808	3.717	3·630	3.546	3.465	3·387	3·312	3·240	3·170	4
5	4·853	4·713	4·580	4·452	4·329	4·212	4·100	3·993	3.890	3·791	5
6	5·795	5·601	5·417	5·242	5·076	4·917	4·767	4·623	4.486	4·355	6
7	6·728	6.472	6·230	6·002	5·786	5·582	5·389	5·206	5·033	4·868	7
8	7·652	7·325	7·020	6·733	6·463	6·210	5·971	5·747	5·535	5·335	8
9	8·566	8·162	7·786	7.435	7·108	6·802	6·515	6·247	5·995	5·759	9
10	9·471	8·983	8·530	8·111	7·722	7·360	7·024	6·710	6.418	6·145	10
11	10·368	9·787	9·253	8·760	8·306	7·887	7.499	7·139	6·805	6.495	11
12	11·255	10·575	9·954	9·385	8·863	8·384	7·943	7·536	7'161	6·814	12
13	12·134	11·348	10·635	9·986	9·394	8·853	8·358	7·904	7·487	7·103	13
14	13·004	12·106	11·296	10·563	9·899	9·295	8·745	8·244	7·786	7·367	14
15	13·865	12·849	11·938	11·118	10·380	9·712	9·108	8·559	8·061	7·606	15
(n)	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%	
1	0·901	0·893	0·885	0·877	0·870	0·862	0·855	0·847	0·840	0·833	1
2	1·713	1·690	1·668	1·647	1·626	1·605	1·585	1·566	1·547	1·528	2
3	2.444	2.402	2·361	2·322	2·283	2·246	2·210	2·174	2·140	2·106	3
4	3·102	3·037	2·974	2·914	2·855	2·798	2·743	2.690	2·639	2.589	4
5	3·696	3·605	3·517	3·433	3·352	3·274	3·199	3·127	3·058	2·991	5
6	4·231	4·111	3·998	3·889	3·784	3·685	3·589	3.498	3.410	3·326	6
7	4·712	4·564	4.423	4·288	4·160	4·039	3·922	3·812	3·706	3·605	7
8	5·146	4·968	4.799	4·639	4.487	4·344	4·207	4·078	3·954	3·837	8
9	5·537	5·328	5·132	4·946	4·772	4·607	4.451	4·303	4·163	4·031	9
10	5·889	5·650	5.426	5·216	5·019	4·833	4·659	4.494	4·339	4·192	10
11	6·207	5·938	5·687	5.453	5·234	5·029	4·836	4·656	4.486	4·327	11
12	6·492	6·194	5·918	5·660	5·421	5·197	4·988	4·793	4·611	4.439	12
13	6·750	6.424	6·122	5·842	5·583	5·342	5·118	4·910	4·715	4·533	13
14	6·982	6·628	6·302	6·002	5·724	5.468	5·229	5·008	4·802	4·611	14
15	7·191	6·811	6.462	6·142	5·847	5·575	5·324	5·092	4·876	4·675	15

NORMAL DISTRIBUTION

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



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

SOLUTION 1

a) **Available Hours**

i) Frame manufacturers: 37 hours × 40 employees = 1,480

ii) Assembly/Fitting: 37 hours × 20 employees = 740

Hours needed to meet production requirements

	A	B	C	D	Total
Demand (quantity)	200	75	220	80	
Frame manufacture time per pedal cycle (hrs.)	2.25	2.20	2.20	2.6	
Frame manufacture time (hrs.)	450	165	484	208	1,307
Assembly/fitting time per pedal cycle (hrs.)	1.25	1.80	1.40	3.00	
Assembly/fitting time (hrs.)	250	135	308	240	933

Therefore, labour for the assembly and accessory fitting is a limiting factor, since the available time is less than required time.

Contribution per hour of limiting factor

	A	**B**	**C**	**D**
Materials	5,500	6,000	6,000	10,000
Labour: Frame	2,475	2,420	2,420	2,860
Assembly/Fitting	1,875	2,700	2,100	4,500
Variable overheads	2,700	3,000	2,700	3,000
Total Variable cost per pedal cycle	12,550	14,120	13,220	20360
Selling price per pedal cycle	14,550	16,500	17,000	24,000
Contribution per pedal cycle	2,000	2,380	3,780	3,640
No. of assembly hours	1.25	1.80	1.40	3.00
Contribution per hour	1,600	1,322	2,700	1,213
Ranking	2	3	1	4

ALTERNATIVE WORKINGS

Contribution per unit of limiting factor (using total value approach)

	A	**B**	**C**	**D**
No of Units of Pedal Cycle	200	75	220	80
	₦	₦	₦	₦
Total sales	2,910,000	1,237,500	3,740,000	1,920,000
Less variable costs:				
Materials	1,100,000	450,000	1,320,000	800,000
Labour frame	495,000	181,500	532,400	228,800
Assembly	375,000	202,500	462,000	360,000
Variable overhead	540,000	225,000	594,000	240,000
Total variable cost	2,510,000	1,059,000	2,908,400	1,628,800
Total contribution	₦400,000	₦178,500	₦831,600	₦291,200
Contribution/pedal cycle	₦2,000	₦ 2,380	₦3,780	₦3,640

No. of assembly hours	1.25	1.80	1.40	3.00
Contribution/hour	₦1,600	₦1,322	₦2,700	₦1,213
Ranking	2	3	1	4

Production plan	
Available assembly hours	740
Model C (full demand) 220 x 1.4 hours	308
Remaining hours	432
Model A (full demand) 200 × 1.25 hours	250
Remaining hours	182
Model B (full demand) 75 x 1.8 hours	135
Remaining hours	47

This means that 47/3 = 15 Model D pedal cycles can be produced within the time available. This leaves a shortfall of 80 -15 = 65 pedal cycles.

Resulting Profit

	A	**B**	**C**	**D**	**Total**
Production	200	75	220	15	
Contribution per pedal cycle (₦)	2,000	2,380	3,780	3,640	
Total contribution (₦)	400,000	178,500	831,600	54,600	1,464,700
Less fixed costs (₦)					666,000
Maximum possible profit (₦)					798,700

b) **Option 1:** Pay overtime to meet demand for Model D pedal cycles:

65 pedal cycles require 65 x 3 hours = 195 hours of assembly time.

	Normal Time	**Overtime**	
Quantity	15	65	
	₦	₦	**Total**
Current variable cost per unit	20,360	20,360	
Overtime premium (3 hours × ₦1,500 × 0.5)	-	2,250	
	20,360	22,610	
Selling price (revised)	24,000	26,500	
Contribution/unit	3,640	3,890	
Total contribution	54,600	252,850	=₦307,450

Option 2: Outsourcing

	In-house	**Outsource**	**Total**
Quantity	15	65	
	₦	₦	
Selling price (revised)	29,500	29,500	
Variable cost/unit	(20,360)	(27,000)	
Revised unit contribution	9,140	2,500	
Total contribution	137,100	162,500	=₦299,600

It would therefore be more profitable for the company to pay overtime.

c) In simple term, the relationship should be controlled through an enforceable contract. This should include the following terms:

Specification: The precise specification of the service or product should be clearly set out and agreed. This is essentially to ensure that there is total clarity and to avoid disputes. The specification should therefore be based on measurable dimensions of performance.

Quality: A key dimension of performance is the level of quality which must be achieved. This must be specified to ensure that the final product meets customer expectations.

Lead time: Even if the product or service conforms with the required quality standard, it will be of little value unless it is delivered within the required timescale.

Agreed cost: While a cost will have been agreed before the arrangement is put into operation, this should be recorded to avoid misunderstanding.
It is also possible that costs will not be constant. For example, there may be a reduction if the volume is above a specified level. The term of such a reduction should be agreed and set out in advance.

Basis of cost increase: Equally, it is possible that if the volume of product or service rises above a certain level, the supplier will incur additional costs. The grounds on which such cost may be passed on should be clearly set out. The arrangement should also be subjected to regular review, and part of such a review should include cost.

Cost reduction if standard is not met: While it would be hoped that any relationship would be mutually beneficial, the contract should set out the basis on which any reduction in cost due to standards not being met will be calculated.

Penalty clause: It is important to ensure that, in the event that the supplier's performance does not meet the specified standard, there is an agreed mechanism to provide for compensation.

Notice period for termination: It is possible that a situation could arise where either part will wish to withdraw from the arrangement. If this is done in an arbitrary fashion, it is likely to be detrimental to the other party. Therefore, any withdrawal or termination should be under an agreed procedure. This will allow the other party to make alternative arrangements.

Confidentiality: Outsourcing could lead to competitors obtaining information that are confidential to the company. One way of minimising this risk is a contractual requirement to maintain confidentiality.

EXAMINER'S REPORT

The question tests candidates' understanding of the concept of limiting factors and their application in determining production plan, associated profit and the impact when such challenges are resolved by overtime work and outsourcing strategies. This is particularly true when the limiting factor is labour hours.

Candidates are expected to consider the determination of constraint factor, computation of contribution per limiting factor, impact of satisfying all the demands, when overtime ban is lifted and when products are outsourced.

Understanding of the concept was generally poor.

Candidates' commonest pitfall was poor understanding of the various concepts in the question and determination of the limiting factor.

Candidates are encouraged to use ICAN study text when preparing for the Institute's future examinations.

Marking Guide			**Marks**		**Marks**
a)	Calculation of available hours and Calculation of hours needed	3			
	Identification of limiting factor, calculation Of contribution per limiting factor and ranking of models.	4			
	Calculation of optimal production		3		
	Calculation of profit		4		14
b)	* Evaluation of option 1	4			
	* Evaluation of option 2	4		8	
c)	1 mark per well explained point, maximum of 8			8	
					30

SOLUTION 2

a) **Working Notes**
Analysis of demand

	(i)	(ii)	(iii)
External demand ('000 units)	15	19	35
Internal demand	20	20	20
Capacity at Division X	(35)	(35)	(35)
Excess demand ('000 units)	0	4	20

Since the demand of Y Division must be met according to the group policy, the supply to the external market must be reduced by the excess demand.
Opportunity cost will be involved in transferring these units to Y. They will be transferred at market price of ₦200.

Thus:

i) When external demand is 15,000 units, the entire 20,000 units demanded by Y will be transferred at variable cost of ₦105 per unit.

ii) When external demand is 19,000 units, internal demand remains 20,000 units of which 16,000 units (35,000 – 19,000) will be transferred internally at ₦105 per unit, while the balance of 4,000 units (20,000 – 16,000) would be transferred at full market price of ₦200 per unit.

iii) When external demand is 35,000 units, every unit transferred to Y will be priced at full market price since units produced by X can be sold externally.

Computation of profit of Division X

External demand for components	15,000	19,000	35,000
	₦'000	₦'000	₦'000
Internal transfer - @ ₦105	2,100	1,680	
- @ ₦200	0	800	4,000
Total internal transfer	2,100	2,480	4,000
External sales (15,000 × ₦200)	3,000	3,800	3,000
Total revenue	5,100	5,480	7,000
Total costs (see below)	(5,050)	(5,050)	(5,050)
Profit	50	430	1,950
Total cost computation:			₦'000
Variable cost = 35,000 units × ₦105			3,675
Fixed cost			1,375
			5,050

Computation of profit of Division Y

External demand of components	15,000	19,000	35,000
	₦'000	₦'000	₦'000
Sales (10,000 units × ₦800)	8,000	8,000	8,000

Own costs - Variable (10,000 × ₦250)	(2,500)	(2,500)	(2,500)
- Fixed	(900)	(900)	(900)
Profit before cost of components	4,600	4,600	4,600
Cost of components transferred	(2,100)	(2,480)	(4,000)
Profit	2,500	2,120	600

b) **Impact Analysis**

External demand of components	15,000	19,000	35,000
	₦'000	₦'000	₦'000
New cost of components (20,000 × ₦170)	(3,400)	(3,400)	(3,400)
Cost of components transferred	2,100	2,480	4,000
Incremental profit/(loss)	(1,300)	(920)	600

ALTERNATIVE SOLUTION TO 2 (b)

Financial impact on group profit

	15,000 units	**19,000 units**	**35,000 units**
	₦	**₦**	**₦**
Loss of contribution from internal transfer:			
(₦95/unit x 20,000units)	(1,900,000)	-	-
(₦95/unit x 16,000units)	-	(1,520,000)	-
(₦95/unit x 0units)	-	-	0
Savings from external purchases (₦200 – ₦170) x 20,000)	600,000	600,000	600,000
Incremental profit/(Loss) =	(1,300,000)	(920,000)	600,000

c) **Desirable Attributes of a good transfer pricing policy**

i) **Goal congruence:** The prices should be set so that the divisional management's desire to maximise divisional profit is consistent with the objectives of the company as a whole. The transfer prices should not encourage suboptimality in decision making.

ii) **Performance evaluation:** The transfer prices should be such that would enable central management to effectively determine the contribution of each of the divisions towards corporate profit. The transfer pricing method therefore should not lead to distortion of the level of efficiency and effectiveness of the divisional managers.

iii) **Divisional autonomy:** The prices should seek to maintain the maximum divisional autonomy so that the benefits of decentralisation (motivation, better decision making, initiative, etc.) are maintained. The profit of one division should not be dependent on the action of other divisions.

iv) **Tax minimisation:** In multinational companies, the prices should lead to the minimisation of tariffs and income taxes and observance of legal restrictions.

v) **Motivation:** The transfer price should be such that will encourage the divisions to transact business with one another.

vi) **Fairness:** A good transfer pricing policy must also be fair to the divisions and the divisions must perceive it to be fair, since it will affect their performance.

vii) **Bookkeeping:** The transfer pricing policy should ensure proper recording of movement of goods or services between divisions.

EXAMINER'S REPORT

The question tests candidates' understanding of transfer pricing policy and its application.

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

Candidates' commonest pitfall was their inability to discern when to use market price or variable cost as transfer price.

Candidates are encouraged to ensure that they study ICAN study text and other relevant materials, when preparing for future examinations.

Marking Guide		**Marks**	**Marks**
a)	• Analysis of demand • Analysis of the results	1	
	• Computation of X profit	8	
	• Computation of Y profit	4	13
b)	Impact analysis		3
c)	2 marks per point		4
	Total		20

SOLUTION 3

(a) Cash Flow Statement

S/N	Description	2015	2016	2017
		₦'000	**₦'000**	**₦'000**
	Cash inflow:			
1.	Cash sales	60,480	64,800	86,400
2.	Receipts from debtors	139,860	150,360	197,400
	Total Cash Inflow	200,340	215,160	283,800

	Cash outflow:			
1.	Payments to suppliers	119,880	128,880	169,200
2.	Salaries	11,520	11,520	12,960
3.	Rent	4,800	4,800	4,800
4.	Expenses	4680	3930	3060
5.	Motor Vehicle	-	7,500	-
	Total cash outflow	(140,880)	(156,630)	(190,020)
	Net cash flow	59,460	58,530	93,780
	Opening cash Balance	2,500	61,960	120,490
	Closing cash balance	61,960	120,490	214,270

(b) Profitability Statements for 2015, 2016, and 2017

S/N	Description	**2015**	**2016**	**2017**
		₦'000	**₦'000**	**₦'000**
	Revenue:			
	Sales	201,600	216,000	288,000
	Less cost of sales:			
	Opening inventory	2,700	3,024	3,240
	Purchases	120,960	129,600	172,800
	Goods available for sales	123,660	132,624	176,040
	Less closing inventory	3,024	3,240	4320
	Cost of sale	120,636	129,384	171,720
	Gross profit	80,964	86,616	116,280
	Salaries	11,520	11,520	12,960
	Rent	4,800	4,800	4,800
	Expenses –cash	4,680	3,930	3060
	Expenses – depreciation	-	750	1500
	Total operating costs	21,000	21,000	22,320
	Net profit	59,964	65,616	93,960

(c) Liquidity profile for 2017:

Current asset	₦
Closing inventory	4,320,000
Trade receivables	16,800,000
Cash balance	214,270,000
Total current asset	235,390,000

Current Liabilities

Trade payables = ₦14,400,000

The current ratio = ₦235,390,000/14,400,000 = 16.35 : 1

Comment: The normal ratio for current ratio is 2: 1 meaning that the standard current asset cover for the current liability should be twice. In the current case, the coverage is more than 16 times.

Workings

S/N	Items	2013	2014	2015	2016	2017
		₦'000	**₦'000**	**₦'000**	**₦'000**	**₦'000**
1	Monthly sales	12,000	15,000	16,800	18,000	24,000
2	Annual sales	144,000	180,000	201,600	216,000	288,000
3	Purchase value (0.6)	86,400	108,000	120,960	129,600	172,800
4	Closing inventory = .3 of monthly Purchases	2,160	2,700	3,024	3,240	4,320
5.	Payment to suppliers = 11 months plus opening payables	79,200	106,200	119,880	128,880	169,200
6.	Closing payables purchases in Dec.	7,200	9,000	10,080	10,800	14,400
7	Analysis of sales	144,000	180,000	201,600	216,000	288,000
	Cash sales -30%	43,200	56,400	60,480	64,800	86,400
	Opening receivables received	-	8400	10,500	11,760	12,600
	Receipt from receivables	92,400	115,500	129,360	138,600	184,800
	Closing receivables - 70% of Monthly sales	8,400	10,500	11,760	12,600	16,800
	Total receipts from receivables	92,400	123,900	139,860	150,360	197,400
	Monthly expenses= Less monthly depreciation = Cash motor expenses	350 - 350	370 - 370	390 - 390	390 - 390	380 125 255
	Annual cash expenses	4,200	4,440	4,680	4,680	3,060
	Less 6months dep.(₦125x6)	-	-	-	750	-
	Annual cash expenses	4,200	4,440	4,680	3,930	3,060
	Depreciation charge	-	-	-	750	1500

EXAMINER'S REPORT

The question tests candidates' understanding of cash forecast, profitability statement and determination of current ratio.

Over 90% of the candidates attempted the question and performance was generally poor.

Candidates' commonest pitfall was the computation of monthly cash flow items rather than the annual cash flow items required by the question and their inability to determine the closing inventory.

Candidates are advised to carry out extensive study of the ICAN study text with other relevant materials when preparing for future examinations.

Marking Guide

		Marks	Marks
(a)	Cash forecast		
	Heading – 1 tick at $^1/_3$	$^1/_3$	

	Income – 6 ticks at $^1/_3$	2	
	Payments – 13 ticks at $^1/_3$	$4^1/_3$	
	Cash balances – 10 ticks at $^1/_3$	$\underline{3^1/_3}$	10
(b)	Profitability statement		
	Sales – 3 ticks at $^1/_5$ mark	$^3/_5$	
	Cash of sale – 12 ticks at $^1/_5$	$2^2/_5$	
	Gross profit – 3 ticks at $^1/_5$	$^3/_5$	
	Expenses during		
	Salaries, Rent, & Depreciation – 11 ticks at $^1/_5$	$2^1/_5$	
	Total operating cost – 3 ticks at $^1/_5$	$^3/_5$	
	Net profit – 3 ticks at $^1/_5$	$\underline{\underline{^3/_5}}$	7
(c)	Calculation of liquid assets – 4 ticks at ¼ mark	1	
	Ratio calculation	1	
	Stating comment on liquidity status	$\underline{1}$	$\underline{3}$
			$\underline{\underline{20}}$

SOLUTION 4

a) **Calculation of direct labour cost**

❖ **Introduction stage**

The learning curve applies throughout this stage

∴ $Y = ax^b =$ ₦$100,000 \times 10^{-0.4150}$ = ₦38,459

Giving total direct labour cost as 10 × ₦38,459 or ₦384,590

❖ **Growth stage**

The learning curve continues for another 20 batches, bringing cumulative output up to 30 batches.

$Y = ax^b =$ ₦$100,000 \times 30^{-0.4150}$ = ₦24,378

Total cost for 30 batches:

$TC_{30} = 30 \times 24,378$	= ₦731,340
Less TC_{10}	= <u>384,590</u>
Therefore, total cost for these 20 batches	= <u>₦346,750</u>

The direct labour cost of each of the other 10 batches in this stage is the same as that of the 30th batch:

Average cost for the first 29 batches

$= Y_{29} =$ ₦$100,000 \times 29^{-0.4150}$ = ₦24,723

TC_{30}, as computed above = ₦731,340

TC_{29} = ₦24,723 × 29 = ₦716,967

Direct labour cost for the 30th batch = ₦14,373

Therefore, the total direct labour cost for these 10 batches

= 10 × ₦14,373 = ₦143,730

Thus, the total direct labour cost for this stage of the product life cycle is (₦346,750 + ₦143,730) = ₦490,480

- **Maturity stage**

  The learning curve effect has now ended so the direct labour cost of these 60 batches will be:

  60 batches × ₦14,373 = ₦862,380

- **Decline stage**

  The learning curve effect has now ended so the direct labour cost of these 30 batches will be: 30 batches × ₦14,373 = ₦431,190

b)

	Introduction	Growth	Maturity	Decline
Sales units	10,000	30,000	60,000	30,000
Selling price	₦120	₦100	₦80	₦50
	₦	₦	₦	₦
Sales revenue	1,200,000	3,000,000	4,800,000	1,500,000
Direct labour	384,590	490,480	862,380	431,190
Direct materials	500,000	1,500,000	3,000,000	1,500,000
Others	100,000	300,000	600,000	300,000
Profit	215,410	709,520	337,620	(731,190)
Total profit = ₦531,360				

c) Julmat Limited requires a 20% return on its average investment.
Average investment = (₦5m + ₦3m)/2 = ₦4m
Profit target is therefore 20% of ₦4m = ₦800,000
As shown in the answer to (b) above, the profit predicted without the experience curve is ₦268,640 less than that required (₦800,000 – ₦531,360).
Total production throughout the products life cycle = 130 batches, (10+30+60+30).
Currently, the total direct material cost throughout the product life cycle = ₦6.5m.

This ₦6.5m needs to be reduced by ₦268,640 to ₦6,231,360 which is an average direct material cost per batch of ₦47.934. Therefore, average direct material cost per batch $= \frac{₦6,231,360}{130} = ₦47.934$

d) The concept of life cycle costing is that the costs and revenues of a product are accumulated over its life cycle and its overall profitability is measured, rather than separating costs and revenues into accounting periods. In this scenario, the length of the product life cycle is 12 months but this may not coincide with the company's accounting year.

The statement shown in solution (b) above shows the products profitability over its life cycle.

As illustrated in the scenario to this question there are four recognized stages in the life cycle of a product. In this scenario, it appears that Julmat Limited is using a market skimming approach to the initial launch pricing of its product because it is starting with a high price in the introduction stage. This is then being gradually reduced over the life cycle of the product.

The company will not only be reducing the price of the product in order to make it harder for competitors to enter market but also to increase the demand for its product through the growth stage. At this time, the cost of the product will also be lower than that at the launch stage due to the effect of learning and experience curves on its labour and material costs.

In the maturity stage, the company will reduce the selling price further to consolidate its sales and would hope that there may be further cost savings due to economies of scale though, these are not evident from the data in this scenario.

Finally, in the decline stage, the company will have to reduce its price to sustain sales, while under more competition from other similar products in the market, prior to launching a new product of its own.

EXAMINER'S REPORT

The question tests candidates' understanding of learning curve theory and its application in a life cycle costing situation.

About 40% of the Candidates attempted the question and the performance was poor.

Candidates' commonest pitfalls were their inability to interprete and apply the concept in a life cycle costing situation and their lack of understanding of its concept.

Candidates are advised to study the ICAN study text and other relevant text books, when preparing for the Institute's examination.

Marking Guide

		Marks
a)	Calculation of labour cost: 12 ticks at ½ each	6
b)	Calculation of direct material cost when there is no experience curve 25 ticks at $^1/_5$ each	5
c)	Calculation of average direct material cost to meet ARR target 8 ticks at ½ each	4
d)	Explain life cycle cost concept 5 ticks at 1 each	5
	Total	**20**

SOLUTION 5

(a) **The Methods of data collection**

(i) **Observation Method:** Observation method is a method during which data from the field are collected through monitoring or systematic viewing. It could be either participatory or not.

Advantages: Subjectivity and bias are eliminated; method is reliable and dependable; system analyst gets current data and observation results are independent of respondent's variable.

Disadvantage

- It is an expensive method (more time is required).
- Limited data.
- Unforeseen factors may interfere with observational task.
- Respondents' opinion cannot be recorded on certain subjects.
- Consciousness of being monitored may affect respondents and this performance may be susceptible to observers' bias.

(ii) **Interview Method**

This is a method of collecting data which involves presentation or oral /verbal stimuli and reply in terms of oral/verbal responses. Most times, it is regarded as a face-to-face survey process. It could also be personal, group or telephone interviews.

Advantage

- o Data are gathered in greater depth.
- o Flexibility in restructuring the questionnaire.
- o Interviewer, by his skill, can overcome resistance.
- o Interviewer can collect supplementary information about

respondent's personal characteristics and environment which has value in interpreting results.

- Fast to obtain information.
- Eliminates ambiguity.

Disadvantages

- Little time is given to respondents.
- Survey is restricted to respondents who have telephones.
- Not suitable for intensive survey where comprehensive responses are required.
- Biased data may be obtained.
- Time consuming.
- Can be costly.
- Very difficult to develop interview questionnaire because it should be short, simple, less ambiguous, relevant, non-offensive or non-irritating, and concise.

(iii) **Questionnaire Method**

This method of data collection is quite popular, particularly in the case of big enquiries. The questionnaire is mailed to respondents who are expected to read and understand the questions and write down the reply in the space meant for the purpose in the questionnaire itself. It could be structured or unstructured questionnaire type.

Advantages

- It can be achieved at lower costs even when the geographical area covered is large.
- Respondent's claims are free from bias.
- Adequate time to think of responses.
- Non-reachable respondents may be conveniently contacted.
- Large samples can be used, so results are more reliable.
- Reduces chance of evaluation bias because same questions are asked of all respondents.
- Popular method.
- Can be subjected to mathematical or statistical analysis to make the results scientific.

Disadvantages

- Low rate of return of duly filled questionnaire.
- Can be used only when respondents are educated and cooperative.
- It is inflexible.
- Omission of some questions.
- Difficult to know if the expected respondents have filled the form or it is filled by someone else.
- Slowest method of data collection and therefore may not be timely.
- Items may not have same meaning to all respondents.
- Good survey questions are difficult to develop.

iv) **Case Study Method**

It is essentially an intensive investigation of the particular phenomenon/event under consideration. Important characteristics are as follows:

- The researcher can study one single variable or more of such variables for his purpose; and
- The selected variable is studied intensively.

Advantages of Case Study Method

- An opportunity for an in-depth and detailed examination of the entity.
- More relevant and reliable data is gathered.

Disadvantages of Case Study Method

- Data gathered is restricted to the situation under study and at that particular time, and this may not be relevant to future applications.
- Usually, it is time consuming to collect, organise and analyse data.

(v) **Panel Method**

In this method, data are collected from the same sample respondents at the same interval either by mail or by personal interview. This is used for studies on:

- Expenditure Pattern;
- Consumer Behaviour;
- Effectiveness of Advertising; and
- Voting Behaviour and so on.

Advantages

- Useful in aerodynamics and highly technical cases.
- Extremely versatile tool for creative modeling.

Disadvantages

- Too technical.
- Costly.
- Limited application.

(vi) **Experiment Method**

An experiment is a controlled study in which the researcher attempts to understand cause-and-effect relationships. The study is "controlled" in the sense that the researcher controls:

- How subjects are assigned to groups; and
- Which treatments each group receives.

Advantages

- It is scientific.
- Reliable.
- Eliminates bias.

Disadvantages

- Expensive.
- Time consuming.

(vii) **Focus Group**: Gathering information through a small demographically diverse group of people in guided or open discussion about a subject matter with a view to determining reactions that can be expected from a larger population.

Advantages

Information is obtained from a diverse group of people and therefore could be more reliable and real to life.

Disadvantages

Result can be influenced by the researcher based on his/her reading of the group discussions. So, it could be biased.

(viii) **Tally/Counting**: This involves gathering data by recording actual performance through physical counting.

Advantages

- Scientific.
- Accurate.
- Reliable.

Disadvantages

- Could be cumbersome.
- Time- Consuming.
- Useful only for small population.

(ix) **Literature Review Documentations and Records:** This involves searching for available written data from past records, documents, statistical details and other records.

Advantages

Involves the use of verifiable empirical documented data sources which can be referred to subsequently.

Disadvantages

- o Because it is historical, it therefore may not be suitable for current or future situation.
- o Basis of compilation may be flawed.

b. **Challenges in the development of Management Information System (MIS)**

- ▪ The MIS development team is faced with various challenges from the requirement gathering phase to the implementation phase due to technological and human challenges and the type of data and information required.

- ▪ Lack of internet connectivity is also a challenge. The lack of understanding about passwords and security policies caused situations where passwords were even written on sticky notes and pasted on monitors, etc.

- ▪ A major problem of introducing an MIS in an organization is the nature of the company, structure, product, personnel, etc. These will always pose a challenge.

- ▪ When the system is introduced to the staff, some of them may be reluctant to use the system because of lack of trust in computer systems. In addition to that, the infrastructure and security policy implementation are difficult tasks.

- ▪ Another challenge is the shortage of human resources within the MIS team. The problem associated with data gathering, analysis, training, and documentation activities, are all human resource problems.

- **Bad Communication**: Lack of understanding/planning for customer, organization and other stakeholders' requirements/needs for the project.

- **Unclear Requirements**: Unclear requirements will lead to changes in the course of the project, which will increase delivery time and bring about customers' resentments.

- **Increasing Cost**: This will lead to added labour and project cost. Thus making the project less profitable and takes away interest from stakeholders.

- **Delayed Project Delivery**: The impact of operational challenges and the introduction of software with less functionality will result in delayed project delivery.

- **Market Pressure**: Another important aspect is the rapid development of software to meet the ever-changing market demands.

- **Knowing the Technical needs**: This is about understanding programming languages, the frameworks, the systems and the algorithms needed for a particular information system to be successful.

- **Design Patterns**: Identifying the right design patterns for your information system software and establishing an actual design review, quality evaluation criteria and design management is something highly neglected today because of the time and effort it takes.

- **Quality Control**: Building quality and maintaining same to serve multitude of customers.

- **Security**: Security of data/information is highly important especially with today's cyber warfare and attacks. Use of Password, Physical security and limited access to a system is imperative.

- **Debugging challenges**: Dealing with bugs through debugging as a process of locating and fixing a software or hardware-related error or problem is critical to the successful Management of an information system.

EXAMINER'S REPORT

The question requires candidates to discuss methods of data collection and the challenges that face the system analysts when developing an organisation's management information system.

Candidates' understanding of the requirements of the question was high. Over 75% attempted the question, while performance was adjudged to be over 50%.

Candidates' commonest pitfall was their inability to correctly discuss some of the listed methods.

Candidates are therefore, advised to carry out extensive study of the ICAN Study Text alongside other relevant texts when preparing for future examination.

Marking guide			**Marks**	**Marks**
a.	Explanation/Definition	- Any 3 methods = 3 x $1^1/_3$	4	
	Advantage	- Advantages for the 3 = 3 x ½	1½	
	Disadvantage	- Disadvantages for the 3 = 3 x ½	1½	7
b.	Challenges - 6 points at $1^1/_3$ each			8
	Total			**15**

SOLUTION 6

a) DDD is exposed to the following threats due to the imminent expiry of patents:

i. **Increased competitive rivalry**

Without patent protection to stop them, existing rivals will be able to produce cheaper copies of DDD chemicals. This will reduce the price which DDD can charge for its products and reduce margins.

Also, since the patents are attached to processes rather than specific chemicals, there is the threat that competitors will be able to use the processes to develop new chemicals before DDD produces its own.

ii. **Increased threat of entry**

Existing patents also act as barriers deterring new entrants into DDD's markets. Without this barrier, there is a greater threat that new firms will enter the market, increasing competition and driving down prices and margins.

iii. **Increased power of customers**

At present, DDD exerts considerable power over customers as they have limited ability to switch suppliers. This is reflected by DDD's current high margins. Once patent protection is removed, competitors will be able to make similar chemicals giving customers more choice.

The pharmaceutical companies will thus be able to exert more influence over DDD in areas such as price, credit terms, delivery terms and so on.

iv. **Increased power of suppliers**

Any fall in volume will reduce DDD's power over suppliers and bulk discounts may be lost.

v. **Staffing issues**

The expected fall in profits will affect the value of share options, which in turn, will affect employee’s motivation. Also, the likely fall in volumes could require DDD to consider redundancies.

vi. **Fall in profit**

There may be decrease in profit from operations as a result of fall in the value of the patent.

vii. **Fall in share prices**

The expiration of patent may actually affect the prices of DDD’s shares in the market.

viii. **Employee’s share option**

Employee may not want to exercise the option as the expiration of patent becomes imminent.

ix. **Staff turnover**
The knowledge of expiry date of the patent may raise staff rate of turnover as this may affect staff motivation.

x. **Rate of debts to turnover**
Since the customers are asking for reduction of sales prices, if they are not obliged, there may be serious increase in receivables.

xi. **Litigation threat**
The company may start spending huge amount on litigation as a result of flouting of the patent right, resulting from impatience of some users of the products or other manufacturers.

xii. **Customer loyalty**
The loyalty of customers may be threatened, realising that the patent right will be expiring soon.

b) **Possible courses of action include the following:**

i. **Try to establish new patents for existing processes**
By changing various aspects of existing processes, it may be possible to establish new patents for them, eliminating the threats outlined above. This option should be pursued first by discussing with patent experts to assess the likelihood of success.

ii. **Develop new processes / products as part of product portfolio management.**
Presumably, part of DDD's long-term planning process is such that it anticipates patent expiry as a normal part of its business and has already developed new patent-protected processes and chemicals to replace the ones concerned. If not, then resources need to be allocated to such portfolio development.

iii. **Cut prices to retain customers**
DDD could seek to retain customers by cutting prices and relying on its existing good relationships with them. Low prices may also act as a deterrent to new entrants.

Volume economies of scale may still enable DDD to produce the chemicals concerned at a lower cost than competitors, allowing it to make a reasonable margin even with lower prices. However, if larger manufacturers enter the market, then this advantage would quickly become eroded.

iv. **Long-term contracts**
An alternative way of retaining customers could be to offer them lower prices in exchange for signing long-term contracts. Particularly where patents are not due to expire immediately, customers could be tempted by lower prices now and the guarantee of no price rises in the future.

This would also be a way of responding to current pressure from customers to reduce prices.

v. **Buy major threats**
If DDD can identify specific threats from competitors, then one option would be to buy them. This is unfeasible given DDD's small size.

vi. **Challenge of government policy**
The company may need to file an appeal to enable the customer to charge prices that will stop the agitation of reduction in prices.

vii. **Extension of patent right**
The company may, if possible, ask for the extension of the patent right on the existing product.

viii. **Cost reduction technique**
There may be need for the reduction of prices since there are costs incurred on the product e.g. suppliers prices may be negotiated lower.

ix. **Staff welfare package**
In order to reduce staff turnover rate, some welfare packages may be introduced.

x. **Incentive to customer**
To reduce debtors' figures, incentives such as cash and trade discounts may be introduced.

EXAMINER'S REPORT

The question tests candidates' understanding of the threats that can result from expiring patent and suitable courses of action to maintain profitability when such threats are identified.

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

Candidates' commonest pitfall was their inability to identify threats associated with the expiring patent.

Candidates are advised to study the ICAN study text when they are preparing for future examinations.

Marking Guide		**Marks**
a)	Possible threats resulting from expiring Patents	
	Any 7 points @ 1 mark	7
b)	Suitable courses of action to maintain profit	
	Any 4 points @ 2 marks	
		8
	Total	15

SOLUTION 7

Types of Information

Information within an organisation can be divided into three levels, thus:

a. Strategic Information;
b. Tactical Information; and
c. Operational information.

a. **Strategic information:** This is used by senior managers to plan the objectives of their organisations, and to assess whether the objectives are being met in practice. Such information includes overall profitability, the profitability of different segments of the business, capital equipment needs and so on.

Strategic information therefore has the following features:

i. It is derived from both internal and external sources;
ii. It is summarised at a high level;
iii. It is relevant to the long term objectives of the organisation;
iv. It deals with the whole organisation (although it might go into some details);
v. It is often prepared on an 'ad hoc' basis;
vi. It is both quantitative and qualitative;
vii. It cannot provide complete certainty, given that the future cannot be predicted;
viii. It is information about the organisation as a whole or a large part of it;
ix. It is peculiar to top management team;
x. It offers tools for helping organisations to apply metrics and analytical tools to their information repositories;
xi. It is often forward-looking;
xii. There is often a high degree of uncertainty in the information;
xiii. Incoming and outgoing data can be stored and cross referenced according to a wide range of individually specified controls and parameters; and
xiv. It typically includes built-in controls that filter, sort, categorise and store information in easy to manage categories.

b. **Tactical information:** This is used by middle level management to decide how the resources of the business should be employed, and to monitor how they are being and have been employed.

Such information includes productivity measurements (output per man-hour or per machine hour), budgetary control or variance analysis reports, and cash flow forecasts and so on.

Tactical information therefore has the following features:

i. It is primarily generated internally;
ii. It is summarised at a lower level;
iii. It is relevant to the short and medium term;
iv. It describes or analyses activities or departments;
v. It is prepared routinely and regularly;
vi. It focuses on divisional investment;
vii. It controls information based on historical performance and may be forward- looking
viii. It is based on quantitative measures;
ix. It is at a greater level of detail than strategic information;
x. It is often concerned with performance measurement;
xi. The level of uncertainty is much less than that of strategic information;
xii. It is usually associated with budgets and budgetary control and similar annual plans; and
xiii. It is about individual departments and operations.

c. **Operational information:** This is used by 'front-line' managers such as foremen or head clerks to ensure that specific tasks are planned and carried out properly within a factory or office and so on. In the payroll office, for example, information at this level will relate to day-rate labour and will include the hours worked each week by each employee, his rate of pay per hour, details of his deductions, and for the purpose of wages analysis, details of the time each man spent on individual jobs during the week. In this example, the information is required weekly, but more urgent operational information, such as the amount of raw materials being input to a production process, may be required daily, hourly, or in the case of automated production, second by second.

Operational information has the following features:

i. It is derived almost entirely from internal sources;
ii. It is highly detailed, being the processing of raw data;

iii. It relates to the immediate term;

iv. It is task-specific;

v. It is prepared constantly or very frequently;

vi. It is largely quantitative;

vii. It is peculiar to junior level management;

viii. It may be summarised at a work group or section level, but is in a more detailed form than tactical information;

ix. It is often concerned with transactions, procedures and performance measurement on a daily level; and

x. It includes scheduling of operations and monitoring output, such as daily efficiency levels.

EXAMINER'S REPORT

The question requires candidates to give detailed characteristics of the three levels of information within an organisation.

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

Candidates' commonest pitfall was their inability to identify the characteristics of the three levels of information within an organisation.

Candidates are advised to study the ICAN study text when preparing for future examinations.

Marking Guide	**Marks**
Strategic information	
1 mark per point, maximum of 5 points	5
Tactical information	
1 mark per point, maximum of 5 points	5
Operational information	
1 mark per point, maximum of 5 points	<u>5</u>
Total	**15**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – NOVEMBER 2018

AUDIT AND ASSURANCE

Time Allowed: $3^1/_4$ hours (including 15 minutes reading time)

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

SECTION A: COMPULSORY QUESTION (30 MARKS)

QUESTION 1

a. Auditors are required by International Standards on Auditing (ISA) to understand and assess a client's system of internal control. Consequently, auditors must use their judgment to determine whether to test all or part of the Internal control system as part of their response to the assessed risk of material misstatement in the financial statements to be audited.

Required:

i. Explain the following terms:
- Control environment
- Control procedures (5 Marks)

ii. State and explain the **five** elements of internal control as identified by ISA 315. (5 Marks)

b. ACB Limited is a transport and logistics company which commenced business on January 1, 2012 and has over 250 trucks in its fleet. The operations of the company cover all the six geo-political zones in the country. The company operates an in-house workshop as a separate business unit under the supervision of a Workshop Manager and it handles repairs of the company's trucks and other third party vehicles as well. All the spare parts needed for the repairs of trucks are supplied directly from the company's central store located very close to the workshop. The company purchases spare parts mostly in bulk and keeps them in a central store for supply to the workshop when the need arises. The following procedures are followed from the purchase stage to the consumption of spare parts for repairs of trucks.
Request for the spare parts to be purchased is sent by the storekeeper to the procurement department on monthly basis for approval. The storekeeper then collects an IOU and goes to open market together with a mechanic to purchase the items. Cash invoices collected for the spare parts purchased are attached with the IOU retirement form which is submitted to the Accountant at the end of each month. The Accountant makes entries of the spare parts purchased into the ledger on monthly basis.

The mechanic in charge of the repair of a damaged truck sends to the storekeeper a memo requesting for supply of spare parts. The mechanic collects the spare parts from the store on the basis of the memo he sent to the storekeeper. He prepares a list of items supplied on monthly basis and sends it to the Accountant for posting into the ledger. The spare parts supplied are posted by the Accountant into the spare parts consumption ledger at the end of each month. The storekeeper takes inventory of the spare parts in the store at the end of each year jointly with some mechanics that provide technical advice during the exercise.

The spare parts collected are used by the mechanic in charge of the damaged truck brought for repairs. The mechanics in the workshop prepare a list of spare parts collected and used for the various trucks repaired by each of them for submission to the Workshop Manager. The Workshop Manager prepares and sends his monthly report which contains list of trucks repaired and the spare parts consumed to the Managing Director.

Your firm was appointed to carry out audit of the company's accounts for the last four years of operation. From the preliminary discussion the Managing Director had with you, you were informed that the operations of the workshop in the last four years resulted into loss which he said was as a result of lack of controls in the handling of the purchase, storage and consumption of spare parts in the workshop.

Required:

i. Identify **three** internal control weaknesses in the above scenario with respect to procurement of spare parts, storage and supply of spare parts in the store and consumption of spare parts in the workshop. (9 Marks)

ii. Recommend appropriate internal controls that would address the identified weaknesses. (6 Marks)

iii. Explain the audit tests to be carried out to assess if the recommended controls would work effectively to prevent or correct errors and to detect occurrence of frauds in the system. (5 Marks)

(Total 30 Marks)

SECTION B: YOU ARE REQUIRED TO ANSWER TWO OUT OF THREE QUESTIONS IN THIS SECTION

(40 MARKS)

QUESTION 2

Your firm has been the financial consultants to West Africa Dairies Company Plc (WADCO) for three years. A competitor within the industry, has now approached your firm to become their financial consultant.

Required:

a. Identify and explain the conflict of interest that may arise if your firm takes up the competitor's engagement. (6 Marks)

b. Explain the specific safeguards that your firm could apply if you are to accept the offer. (14 Marks)

(Total 20 Marks)

QUESTION 3

Holy Family Limited is a trading company that deals in furniture. The company is a major distributor to Happy Couples Limited that manufactures the furniture. The turnover of the company as at December 31, 2017 was ₦120,000,000. Also, in the statement of financial position is a figure of ₦2,500,000 that represents trade receivables. The auditor informs the Managing Director of the need to circularise the debtors. The Managing Director feels indifferent to circularisation saying that the figure of ₦2,500,000 is not material with a turnover of ₦120,000,000.

Required:

a. As an auditor, explain to the Managing Director the concept of materiality in accordance to ISA 320. (5 Marks)

b. State the steps you are expected to take as regards materiality when planning and performing an audit. (5 Marks)

c. Explain to him why you should confirm receivable balances through circularisation. (3 Marks)

d. If you decide to circularise only sample of receivables, list the type of accounts that should not be overlooked in selecting the sample. (7 Marks)

(Total 20 Marks)

QUESTION 4

The independent auditor identifies and assesses risk of material misstatements through understanding of the entity and its environment.

a. Describe the factors the auditor should consider while obtaining information on the entity and its environment. (10 Marks)

b. Explain why the auditor needs to perform risk assessment and the procedures. (5 Marks)

c. International Standards on Auditing, ISA 300 requires the Independent auditor to plan the audit of the financial statements so that the engagement will be performed in an effective manner.

Required:

State the benefits of audit planning to the independent auditor. (5 Marks)

(Total 20 Marks)

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

QUESTION 5

The intangible assets that can be recognised in the statement of financial position are purchased goodwill, intangibles having a readily ascertainable market value and development costs.

Required:

a. State **five** audit tests required to obtain audit evidence on purchased goodwill. (5 Marks)

b. Identify **five** audit tests relevant to obtaining evidence on development projects. (5 Marks)

c. Itemise **five** conditions that must be fulfilled before development projects can be recognised in the financial statements. (5 Marks)

(Total 15 Marks)

QUESTION 6

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

Required:

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

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

c. What steps must the auditor take if he discovers that the evidence obtained is insufficient to form an opinion? (5 Marks)

(Total 15 Marks)

QUESTION 7

Good Weather Nigeria Plc is a company engaged in the business of manufacturing detergents with annual turnover of ₦7 billion. It carries out its operations from six locations, Abuja, Enugu, Benin, Port-Harcourt and Jos with head office in Lagos. The company has an internal audit function with three staff. The Chief Internal Auditor was recruited by the Executive Finance Director to facilitate good working relationship between the finance and audit functions. All the staff in the unit are graduates and members of the Institute of Chartered Accountants of Nigeria (ICAN). The staff of internal audit have been in the unit for over eight years. The Chief Internal Auditor reports to the Executive Finance Director.

Required:

a. Explain the term "internal audit". (2 Marks)

b. Identify and explain the weaknesses in the above scenario. (8 Marks)

c. Enumerate the differences between the roles of an internal auditor and external auditor. (5 Marks)

(Total 15 Marks)

SOLUTION 1

A (i) Explanation of control environment and control procedures

Control environment comprises the management style, the corporate culture and values shared by the company employees and it provides the background against which the various other controls operate. The control environment includes the views, awareness and actions of management regarding an entity's internal control and it is the foundation on which an effective system of internal **control** is built and operated in an organization that strives to:

- Achieve its strategic objectives;
- Provide reliable financial reporting to internal and external Stakeholders;
- Operate its business efficiently and effectively;
- Comply with all applicable laws and regulations; and
- Safeguard its assets;

Part of the blame for the financial crisis and other prominent failures of the 21st century can be appropriately attributed to failures in the control environment. Factors reflected in the control environment include;

- The philosophy and operating style of the directors and management;
- The entity's organization structure;
- Human resource policies and practices;
- Communication and enforcement of integrity & ethical principles;
- Methods of assigning authority and responsibility which includes segregation of duties and supervisory controls; and
- Participation of managers through the directors' methods of imposing controls through internal audit function, function of the board of directors and personnel policies and procedures.

Control procedures These are those policies and procedures which are established to achieve the entity's specific objectives. They include procedures designed to prevent, to detect and or, correct errors. Control procedures are the use of standard and consistent procedures in giving directions in the entity's operations in order to achieve a set target.

The control procedures include:

- Performance reviews or management controls. These include review and analysis of actual performance against budgets or forecasts;
- Information processing. These are the variety of controls to check the accuracy, completeness and authorisation of transactions;
- Physical controls – physical security over assets and records; and
- Segregation of duties

(ii) The ISA 315 requires the auditor to gain an understanding of each of the elements of internal control as part of his evaluation of the control systems operating within an entity. He must also document the relevant features of the control systems together with his evaluation of their effectiveness.

The elements of internal control include the following:

Control Environment: This includes views, awareness and actions of management regarding an entity's internal control. It also includes the governance and functions of management and asserts the premise of an organization. It is a basis for good internal control, providing guidance and structure. Control environment includes communication and enforcement of integrity and ethical values, commitment to competence, participation of management, management philosophy and operating style, organization structure, assignment of authority and responsibility and human resource policies and practices.

Risk assessment process: Management should strive to identify, assess and manage business risks on a continual basis. ISA 315 requires auditors to gain understanding of the client's company management to the extent that those risk assessment processes may affect the financial reporting process. Risks can arise or change due to changes in entity's operating environment, new personnel, new or revamped information systems, rapid growth, new technology, new business models, products or activities, corporate restructurings, expanded foreign operations and new accounting pronouncements.

Information System: Information System consists of infrastructure (physical and hardware components), software, people, procedures and data. 315 ISA requires auditors to have understanding of the business information systems including the accounting systems used by the management to the extent that they may affect the financial reporting process. Auditors must identify and understand the entity's principal business transactions, how the transactions and other relevant events are captured, the processing methods applied to those transactions, the accounting records to support the figures in the financial statements and the processes used in the preparation of the financial statements.

Control activities (internal controls): These are policies and procedures other than control environment used to ensure that the entity's objectives are achieved. They are specific controls designed to prevent errors that may arise in processing information, or to detect and correct errors that may arise in processing information. Control activities are categorized into performance reviews and information processing which include application and general information technology controls, physical controls and segregation of duties.

Monitoring of controls: It is important within an internal control system that management should review and monitor the operation of the controls, on a systematic basis, to satisfy themselves that the controls remain adequate and effective and that they are being applied properly by the various arms of the entity. The monitoring process includes internal audit reviews of the internal controls which enable the department to identify areas of non-compliance by the operators and weaknesses in the internal controls and the recommended controls to block any identified loopholes in the system.

(b)i. The following are the weaknesses identified in the operations of ACB Limited:

Procurement of spare parts

❖ The company does not have registered suppliers and all spare parts are purchased from open market and this can give room for malpractices in the procurement process.

- Procurement of spare parts solely through cash exposes the company to risk of fraud in the cash handling process.

- No quotations are received from more than one supplier to give room for price comparison and no price survey was carried out before purchases to ensure fair prices on purchases.

- No checks and balances system is involved in the purchase of spare parts to ensure that other party such as internal audit department witnessed the receipt of the items into the store.

- Lack of control in the spare parts received as there is no Goods Received Note (GRN) raised for the spare part items received into the store.

- IOUs collected by the storekeeper are retired on monthly basis instead of retiring same at the conclusion of each transaction.

- Audit department is not involved in the process of payment for the spare parts purchased.

- The storekeeper purchases and also keeps the spare parts in his store. There is no segregation of duties.

Storage and supply of spare parts:-

- Request memo for spare parts is not authorized by the Workshop Manager before it is sent to the store.

- Supply of spare parts is based on the memo and no separate document such as Issue Note is raised for the spare parts supplied.
- No evidence that the mechanic acknowledged receipt of spare parts collected.
- The use of bin card is not in place and no record of spare parts received and supplied is maintained by the storekeeper.
- No periodic inventory count is done except the one that is carried out at the end of the year by the storekeeper himself.
- The storekeeper sends summary of the spare parts supplied to the Accountant at the end of each month for posting into the ledger.
- Internal audit department is not involved in the supply of spare parts to the workshop.

Workshop operations:

- Lack of control over spare parts collected as there is no record maintained for the items before they are used for repairs.

- There is no job card opened for trucks brought into the workshop for repairs.

- There is no authorization and approval system in the workshop to ensure that trucks are repaired only on the basis of the Workshop Manager's approval.

- There is no separate method of documenting third party trucks that were brought into the workshop for repairs.

- Spare parts used for repairs of trucks are not documented into the account of each truck repaired to enable management know the cost of spare parts used for each truck.

(ii) Recommended controls to address the identified weaknesses

– The company should have registered suppliers that will be used whenever spare parts are to be purchased.

– Request for purchase of spare parts should be approved by the Managing Director.

– Quotations for the items to be purchased should be received from more than one registered supplier.

– The use of local purchase order should be put in place and every purchase to be made must be supported with an LPO which must be addressed to the supplier with the most competitive price.

– Bulk purchases made should not be paid by cash but by cheque only.

– Receipt of spare parts purchased and brought into the store should be physically witnessed by the auditor and the storekeeper.

– All spare parts received into store should be entered into goods received note which must be signed by both the storekeeper and the auditor.

– The management should introduce the use of inventory records such as bin card, issue note and others which will ensure proper documentation of stock transactions that occur in the store.

– There should be authorization controls that will ensure that the request for spare parts by mechanics is authorized and approved by a senior officer.

– Issuance and collection from the store should be acknowledged on the store issue note.

– Stock/inventory of spare parts in the store should be counted at least once in a quarter by the storekeeper, the auditor, the accountant and the mechanics working jointly.

- Bin card should be maintained for each type of spare parts issued to the workshop and this must be updated each time an item is issued out for use in the repair of trucks.

- Job card should be opened for each truck brought into the workshop for repairs and details of spare parts used for the repair work must be recorded in the card.

- Job cards should be signed off by the Workshop Manager as an approval for the release of the truck from the workshop.

- Details in each Job Card should be used by the accountant to do the billing for the repair work done on each truck.

- There should be separate document to be maintained for the record of third party trucks brought into the workshop for repairs.

- The unused portion of the spare parts in the workshop should be returned to the central store with relevant documentation.

(iii) The audit tests to be carried out to assess if the above controls are working effectively include:

- Examine the process of procurement of spare parts and ascertain if purchase is made from the approved suppliers. Ascertain if quotations are obtained from more than one supplier to give room for price comparison and that the supplier with the most competitive price is selected;

- Ascertain that items brought in by suppliers are checked to ensure that the quantity, quality and specification of the spare parts received agree with what is contained in the Local Purchase Order (LPO);

- Ascertain that goods received note (GRN) is issued for all the spare parts received into the store and that all the parties involved in the receipt of the items sign the GRN;

- Review the payment procedures to ensure that suppliers' invoices are checked by the internal audit department and other relevant officer. It must be ensured that the quantities in the invoice agree with the quantities in the GRN;

- Examine the system of authorization and approval of the mechanics' request for spare parts and that receipt of spare parts collected by them from the store is acknowledged on the issue note raised for the supply;

- Tests should be carried out to ensure that inventory control procedures documented are working properly;

- Check the bin cards randomly selected to ensure that all spare parts received and issued from the store are entered therein correctly;

- Check job cards randomly selected and carry out tests on them to ensure that all the trucks received into workshop were duly authorized and approved for repairs;

- Review the billing system operated in the workshop to ensure that all the trucks repaired were properly booked and appropriate bills were generated for the correct amounts; and

- Review the operation of the internal audit department, if it is in existence, to ensure that it is working effectively and efficiently.

EXAMINER'S REPORT

The question, a compulsory one, is in two parts. Part (a) tests candidates on the elements of internal control. Part (b) tests candidates to interprete a given scenario and draw out control weaknesses, therefrom. The attempt on the question by the candidates was 100%.

The understanding of the question was good in part (a), but generally poor in part (b). Performance was therefore poor in part (b). The candidates' undoing in part (b) was poor interpretation of the need of the question, especially inability to properly analyse, a given scenario occasioning mix-up of solutions to the constituent parts of part (b). Candidates should apply their skill to analyse and interprete given scenarios properly to enable them satisfy the need of examiners, at this level, since this is required of them.

<u>Marking Guide</u>		**Marks**	**Marks**
Question 1a			
i)	½ mark each for element of control environment explained (Maximum of 5)	2½	
	½ mark each for any control procedure explained subject to a maximum of 5	$2^1/_2$	
ii)	1 marks each for any 5 element of internal control	<u>5</u>	10

Question 1b

i)	1 mark each for any one of the three weaknesses explained Maximum of 3 points for each on procurement, storage/supply and consumption of spare parts.	9	
ii)	2 marks each for any one of the recommended three internal controls	6	
iii)	1 mark each for any five audit tests described.	<u>5</u>	<u>20</u>
	Total		**<u>30</u>**

SECTION B
SOLUTION 2

(a) The Conflict of interest that may arise

The firm of Financial Consultants whose members are chartered accountants are not prevented from acting as financial consultants to two competing entities according to the professional code of ethics. There may not be any conflict of interest, if the financial consultants act as consultants to the two competing entities in this case, subject to the firm observing the professional duty of not disclosing confidential information of one client to another. Nevertheless, if there is any perceived conflict of interest, the test is whether a "reasonable and informed third party" armed with facts of the particular case would consider the conflict of interest as likely to affect the judgement of the financial consultants.

(b) Specific Safeguards the firm could apply if the firm of financial consultants are to accept the offer from the competing company

The possible safeguards might include the following:

i. Considering whether it is appropriate to accept an assurance engagement from a new client that is in direct competition with an existing client, it may be appropriate to decline the offer from the potential new client. Thus, if it is perceived that the acceptance of the competitor's engagement would materially prejudice the interests of West Africa Dairies Company Plc., the appointment should not be accepted;

ii. Careful management of the clients, for example by ensuring that different members of staff are used on the two engagements;

iii. Full and frank disclosure to the clients of any potential conflict, together with suitable steps by the firm to manage the potential conflict of interest;

iv. Procedures to prevent access to information such as physical separation of the teams and confidential and secure data filing. Such an approach is known as creating "Chinese walls";

v. Establishing clear guidelines on security and confidentiality and the use of confidentiality agreements;

vi. Regular review of safeguards in place;

vii. Advising one or both clients to seek additional independent advice; and

viii. Use of different engagement consultants for the different assignments in the competing entities.

The approach that the consulting firm should take will be a matter of judgement and should reflect the circumstances of the case.

EXAMINER'S REPORT

This question tests candidates' knowledge of professional ethics.

Part (a) is on conflicts of interest, while part (b) is on safeguards applicable to conflicts of interest. About 90% of the candidates attempted the question.

Candidates did not understand part (a) of the question well, but their understanding of part (b) was good.

Performance of the candidates in part (a) was poor, while the attempt at part (b) was generally above average. The commonest pitfall of the candidates was not relating their general knowledge to specified requirement of the question, thereby interpreting question out of context.

Candidates should use the Institute's Study Text adequately and be able to apply their knowledge to specific situations.

Marking Guide		**Marks**	**Marks**
(a)	**Identification of conflict of interest**	**2**	
	Explanation 2 points x 2 marks each	**4**	**6**
(b)	**2 marks x any 7 points**		**14**
	Total		**20**

SOLUTION 3

(a) **HOLY FAMILY LTD**

Concept of materiality

The auditor gives an opinion on whether the financial statements present fairly in all material respects, the financial position and performance of the entity. Information is material if on the basis of the financial statements, could influence the economic decision of users should it be omitted or misstated. Applying the concept of materiality means that the auditor will not aim to examine every figure in the financial statements. He will concentrate his efforts on the more significant items in the financial statement either;

(i) because of their high value or
(ii) because there is a greater risk that they could be stated incorrectly.

(b) **Steps to be taken as regards materiality when planning and performing an audit**

In assessing what is or is not material, auditors are entitled to assume that users:

(i) have reasonable knowledge of the business and will be willing to study the information in the financial statements;

(ii) understand that financial statements are prepared and audited to levels of materiality;

(iii) recognise uncertainties inherent in certain amounts in the financial statements (such as provisions);

(iv) make reasonable economic decisions based on the information in the financial statements; and

(v) ISA 320 requires the auditor to apply the concept of materiality, when evaluating the effect of misstatement in the financial statements and therefore on his audit opinion.

(c) **Why auditors must confirm receivable balances by circularisation**

The auditor must circularise customers with receivables balances because this provides external evidence as to the existence and values of a company's assets at the year end or statement of financial position date. It may also be said to provide confirmation as to the effectiveness of the company's internal control and cut-off procedures. Provided that there is no suggestion that a customer is a related party, the evidence from the direct confirmation of receivable balances from customers is more reliable than that obtained from the client's own records, because it has greater degree of independence. It also confirms that the client has the legal right to the amount receivable.

(d) **T**he types of accounts balances that should not be overlooked when selecting samples for circularisation of customers with receivables balances are:

(i) Nil balances;
(ii) Credit balances or negative balances;
(iii) Overdue balances;

(iv) Balances known to be in dispute;
(v) Balances which are not made up of specific invoices because the customer has been paying round sums on account;
(vi) Very large and/or balances considered material;
(vii) Balances with known related parties; and
(vii) Accounts written off during the period.

EXAMINER'S REPORT

The question is in four parts.

Part (a) tests on concept of materiality.
(b) tests the candidates on materiality in relation to an audit
(c) requires candidates to explain the reason for circularisation of receivables balances
(a)requests candidates to list the type of accounts that should not be overlooked in the circularisation process.

About 65% of the candidates attempted the question and performance was good in part (a), poor in part (b) and fair in parts (c) and (d).

Their commonest pitfall was their inability to answer questions properly thus resulting in avoidable mistakes of repetition of same solutions to different parts of the question. Candidates should ensure that they know the requirements of a question before attempting it and cultivate the habit and technique of answering questions properly.

MARKING GUIDE		**Marks**
(a)	Explanation of concept	5
(b)	1 mark for each step listed (Max 5 points)	5
(c)	Explanation of reasons for circularisation	3
(d)	1 mark for each point (maximum of 7 points)	7
		20

SOLUTION 4

(a) **Understanding of the entity and its environment**

The auditor's understanding of the entity and its environment involves the consideration of the following factors:

(i) **Industry, regulatory, and other external factors, including the applicable financial reporting framework.**

The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation. For example, long-term contracts may involve significant estimates of revenues and costs that give rise to risks of material misstatement. In such cases, the auditor considers whether the engagement team includes members with sufficient relevant knowledge and experience.

Legislative and regulatory requirements, on the other hand, often determine the applicable financial reporting framework to be used by management in preparing the entity's financial statements.

(ii) **Nature of the entity, including the entity's selection and application of accounting policies.**

The auditor should understand the nature of the entity, including its operations, ownership and management structures and also the entity's selection and application of accounting policies and their relevance with the requirements of applicable financial reporting framework. The auditor also identifies financial reporting standards and regulations that are new to the entity and considers when and how the entity will adopt such requirements. Where the entity has changed its selection of or method of applying a significant accounting policy, the auditor considers the reasons for the change and whether it is appropriate and consistent with the requirements of the applicable financial reporting framework.

(iii) **Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements.**

The entity conducts its business in the context of industry, regulatory and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the operational approaches by which management intends to achieve its objectives. Business risks result from significant conditions, events, circumstances, actions or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity's business is also dynamic and the entity's strategies and objectives change over time.

(iv) **Measurement and review of the entity's financial performance**

Performance measures and their review indicate to the auditor aspects of the entity's performance that management and others consider to be of importance. Performance measures, whether external or internal, create pressures on the entity that, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Obtaining an understanding of the entity's performance measures assists the auditor in considering whether such pressures result in management actions that may have increased the risks of material misstatement.

(v) **Internal control**

The auditor uses the understanding of internal control to identify types of potential misstatements, consider factors that affect the risks of material misstatement, and design the nature, timing, and extent of further audit procedures.

The auditor's primary consideration is whether, and how, a specific control prevents, or detects and corrects, material misstatements in classes of transactions, account balances, or disclosures, and their related assertions, rather than its classification into any particular component.

(vi) **Nature and competence of its management**

The auditor must study the nature and competence of the entity's management. With a strong system in place, management should identify, assess and manage business risks, on a continual basis. ISA 315 requires the auditor to gain an understanding of the risk assessment process used by the client company's management, to the extent that those risk assessment processes may affect the financial reporting process.

The quality of the risk assessment and management process within the client company can be used by the auditor to assess the overall level of audit risk. If the management has no such process in place, the auditor will need to do more work.

(b) **Risk assessment**

Management should identify, assess and manage business risks on a continual basis especially significant business risks that may prevent the entity from achieving its corporate objectives.

International Standards on Auditing ISA 315 requires an auditor to perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statements and assertion levels. The risk assessment procedures shall include the following:

i) Inquiries of management and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error;

ii) Analytical procedures. This involves the study of ratios and trends to identify the existence of unusual transactions or events or amounts that might have implications on the audit; and

(iii) Observation and inspection.
This includes inspection of internal control manuals, business plans, observation of operations and procedures.

(c) Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan, in order to reduce audit risk to an acceptably low level. The benefits of audit planning are as follows:

(i) Adequate planning helps to ensure that appropriate attention is devoted to important areas of the audit;

(ii) It ensures that potential problems are identified and resolved on a timely basis;

(iii) Adequate planning ensures that the audit engagement is properly organized and managed in order to be performed in an effective and efficient manner;

(iv) Adequate planning assists in the proper assignment of work to engagement team members;

(v) It facilitates the direction and supervision of engagement team members and the review of their work;

(vi) It also assists, where applicable, in coordination of work done by other auditors and experts; and

(vii) It also assists in the establishment of strong base for future audits.

EXAMINER'S REPORT

The question is in three parts:

Part a: tests candidates understanding on the factors the auditor would consider while obtaining information on an entity and the environment.

Part b: tests candidates understanding on the reasons for risk assessment and procedures thereon.

Part c: tests candidates understanding on the benefits of audit planning to the Independent Auditor.

About 85% of the candidates attempted the question, but their understanding of the question and performance was generally below average. The commonest pitfall was candidates giving solution out of context thus reflecting their poor understanding. Candidates should use the appropriate study materials for future examinations.

Marking Guide		**Marks**	**Marks**
a	1 mark for each factor stated (Maximum of 5)	5	
	1 mark for each factor described	5	
	(maximum of 5)		10

b	Description of the reason for risk assessment	2	
	1 mark for each of the ways auditor can perform risk assessment(max of 3)	3	5
c	1 mark for each of the benefits for audit planning. (maximum of 5 benefits)		5
		Total	20

SOLUTION 5

(a) **Tests of detail for purchased goodwill**

The tests listed below relate mainly to the valuation of purchased goodwill.

i. Confirm that a business was acquired and confirm the consideration paid for the business acquired. This is a measure required to check the existence of purchased goodwill as well as to confirm its valuation.
ii. Review the reasonableness of the valuation placed on the net assets acquired.
iii. Check the calculation of the purchased goodwill as the difference between the consideration paid and the fair value of the net assets acquired.
iv. Review for the possibility of an impairment having arisen thereafter.
v. Ensure that any impairment loss has been correctly calculated and recorded in the financial records.

(b) **Tests of detail for development projects**

Audit tests might include the following:

i. Discuss the development project with management, other relevant senior personnel and other key stakeholders to assess the feasibility of the project and product;
ii. Discuss management's intention to complete the asset and either use or sell it;
iii. Review projections and forecasts for using resources and generating future economic benefits;
iv. Assess production and marketing plans and whether a market (or use) actually exists;
v. Consider funding requirements to completion; and
vi. Assess whether the entity will actually be able to use or sell the asset.

(c) **Conditions to be met before development projects are recognised**

IAS 38 states that an intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

i. The technical feasibility of completing the intangible asset so that it will be available for use or sale;
ii. Its intention to complete the intangible asset and use or sell it;
iii. Its ability to use or sell the intangible asset;
iv. How the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;
v. The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and

vi. Its ability to measure reliably, the expenditure attributable to the intangible asset during its development.

EXAMINER'S REPORT

The question is in three parts. It tests candidates' knowledge of IAS 38 – intangible assets and its related audit procedures.

About 30% of the candidates attempted the question. Even with the low percentage of attempt, the understanding of the question displayed was low. Performance consequently was poor.

Their greatest undoing is lack of proper coverage of this area of the syllabus and non-utilisation of the Institute's Study Text. It is recommended that candidates should make use of the Institute's Study Text for future examination.

Marking Guide		**Marks**
(a)	1 Mark each for any 5 points	5
(b)	1 Mark each for any 5 points	5
(c)	1 Mark each for any 5 points	5
		Total 15

SOLUTION 6

(a) **SUFFICIENCY OF AUDIT EVIDENCE**

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

i. The quality of that evidence. The quality will depend on the source of the evidence and its reliability;
ii. The seriousness of the risk that the financial statements might not give a true and fair view: when the risk is high, more audit evidence will be required;
iii. The materiality of the item;
iv. The strength of the internal controls in the client's accounting systems; and
v. The sampling method that the auditor will use to obtain the audit evidence: the chosen method will affect the size of the audit sample that the auditor requires.

(b) **RELIABILITY OF AUDIT EVIDENCE**

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

i. Audit evidence is more reliable when it is obtained from independent sources outside the entity under audit;
ii. Internally generated audit evidence is more reliable when the related controls are effective;

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

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

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

(c) If the auditor discovers that the evidence obtained is insufficient to form his opinion, he may take any of the following actions, depending on the circumstances.

i. Obtain more evidence.

ii. Carry out more tests of control, further tests may indicate that the controls are not as weak as the auditor initially suspected.

iii. Carry out more substantive procedures where he has concluded that the internal control system is not functioning well.

iv. Discuss the problem with the client's senior management or the audit committee, so that they are aware of the problem.

v. Indicate the findings from audit evidence obtained this should be included in the management letter prepared by the auditor to the client.

vi. Qualify the audit report or modify his audit opinion. This should only be used as an extreme measure if other methods fail to resolve the problem.

EXAMINER'S REPORT

The question is in three parts. It tests candidates' knowledge on audit evidence. Almost all of the candidates attempted the question.

Candidates generally exhibited fair understanding of the question, but their performance especially in parts (a) and (c) was not encouraging. Their commonest pitfall was mix-up in their understanding of the requirements of the question especially in parts (a) and (c).

Candidate should make use of the Institute's Study Text for future examinations

Marking Guide		**Marks**
(a)	1 mark for each of the 5 factors identified.	5
(b)	1 mark for each of the 5 principles explained.	5
(c)	1 mark each for any 5 points stated	5
	Total	**15**

SOLUTION 7

a. Internal audit consists of audit, investigation or review work carried out on a voluntary basis by an entity, for its own control purposes.

The role of internal audit is to provide independent assurance that an organisation's risk management, governance and internal control processes are operating effectively. The internal audit work may be carried out by the entity's own full-time internal audit staff, or by an external accountancy firm.
To be effective, the internal audit activity must have qualified, skilled and experienced people who can work in accordance with the requirements of the Code of Ethics and the International Standards.

There is no regulatory or statutory requirement for internal audit, though a reference was made in Section 359 (6) of the Companies and Allied Matters Act CAP C20 LFN 2004 in respect of the audit committee authorising the internal auditor to carry out investigations into any company activity of interest or concern to the audit committee. An entity, therefore, will only carry out internal audit work if it considers the benefits sufficient to justify the cost.

b. The following weaknesses exist in the structure of Good Weather Nigeria Plc.:

Inadequate staffing
The staff strength of 3 is considered inadequate for the size of the entity. The internal audit function is expected to plan its work in other to cover the operations of the entity which includes periodic visits to all the locations. This may not be achieved with only 3 staff.

Appointment of Chief Internal Auditor
The appointment of the Chief Internal Auditor by the Executive Finance Director is not appropriate as this will create independence issues. To guarantee the independence of the internal audit function, the Chief Internal Auditor should not be appointed by a senior executive who may have some self interest in wishing to appoint somebody who may compromise. Instead, the audit committee should be responsible for appointing the Chief Internal Auditor, subject to approval by the board of directors.

Rotation of internal audit staff
Internal auditors should not be allowed to become too familiar with the operator they audit or the management responsible for them. To reduce the familiarity threat, internal auditors should be rotated regularly, say every three to five years, and at the end of this time they should be assigned to other jobs within the entity. From the above scenario, the staff of internal audit have remained in the unit for over 8 years without any form of rotation which is considered inappropriate.

Line of reporting
The Chief Internal Auditor may report to the audit committee and not to the Finance Director or Chief Accountant. This is to guarantee objectivity of his report.

c. The differences between the roles of internal and external auditor are:

Appointment
External auditors are appointed by the shareholders, while the internal auditors are employees of the company;

Role and Work
The role of the external auditor is to express an opinion on the truth and fairness of the annual financial statements. The external auditor will therefore carry out whatever work he deems necessary to reach that opinion

The internal auditor examines systems and controls and assess risks in order to make recommendations to management for improvement;

Qualification
The qualification of the external auditor is set out by statute. This ensures that the external auditor is independent of the entity and suitably qualified;

There is no statutory requirements, as the audit committee is expected to select a suitably competent person to act as internal auditor. It is therefore possible that the internal auditor may not be as competent as the external auditor, depending on management's recruitment criteria.

Scope of work
The scope of the work of external auditor is determined by the result of his risk assessment, regulatory and statutory requirements as approved by the Audit Committee. The scope of the work of internal auditor is determined by management or those charged with governance.

Report
The external auditor is statutorily required to report to the members of the entity, while the internal auditor reports to the audit committee.

EXAMINER'S REPORT

The question tests candidates understanding of internal audit.

Part (a) – requests candidates to explain internal audit.

Part (b) – requires candidates to identify weaknesses in a given scenario.

Part (c) – tests candidates on differences between the roles of internal auditor and external auditor.

About 98% of the candidates attempted the question. The candidates showed generally very fair understanding of the requirements of the question. Performance was generally above average.

Candidates' major undoing was non-application of their requisite skills to analyse the given scenario and interpret the requirements of the question.

Candidates are advised to improve on their analytical skills when preparing for future examinations.

	Marking Guide	**Marks**	**Marks**
a.	**2 marks for good explanation of internal audit**		**2**
b.	**1 mark for each weakness listed(Maximum 4)**	**4**	
	1 mark for each weakness described(maximum 4)	**<u>4</u>**	**8**
c.	**½ mark for each point listed (maximum of 5 points)**		
	½ mark for each point described (maximum of 5 points)	**2½**	
		<u>2½</u>	**<u>5</u>**
	Total		**<u>15</u>**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – NOVEMBER 2018

PUBLIC SECTOR ACCOUNTING & FINANCE

Time Allowed: $3^{1}/_{4}$ hours (including 15 minutes reading time)

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

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

QUESTION 1

The Federal Government of Nigeria is committed to the principle of transparency and accountability in all its financial activities. The country has diverse sources of revenue which include natural resources, ranging from iron-ore, crude oil, zinc, tin-ore and coal.

In order to enhance its agenda of “zero tolerance for corruption”, the country established, among others, the Nigeria Extractive Industry Transparency Initiative Commission (NEITI) with the sole aim of reducing corruption in the extractive industry. The establishment of the commission was backed by an Act of National Assembly in 2007.

The commission normally carries out annual audit of accounts of companies in the extractive industry having obtained their statements of accounts on a regular basis. Records available to NEITI revealed that five out of fifty-two companies in the industry failed to render their statements of accounts for the year 2016; another eight companies rendered falsified statements of accounts, while thirty-nine companies rendered accurate statements of accounts.

The records of receipts and expenditures of NEITI revealed a total receipts of ₦2,396,581,900 in 2016, out of which ₦1,998,500,770 was expended on the commission’s activities up to December 31, 2016.

Further scrutiny of the accounts revealed receipts of gratification by some government officials in the eight companies that presented falsified statements of accounts. There were also expenses on frivolous overseas tours allegedly for attending seminars and workshops.

In line with the Act that established the commission, the audit reports on the financial activities of the companies in the extractive industry have been sent to the President and the National Assembly.

Required:

a. Discuss five actions that should be taken against the companies that failed to render their statements of accounts and those that rendered falsified statements of accounts.
(7½ Marks)

b. Calculate the unspent amount by the commission as at December 31, 2016 and the treatment of the unspent amount. (4 Marks)

c. Outline **five** functions of NEITI as contained in the Act that established it and indicate the members of the National Stakeholder Working Group (NSWG) as contained in the NEITI Act, 2007. (12½ Marks)

d. Explain **six** procedures for the appointment of auditors and publication of reports as contained in Section 4 of NEITI Act, 2007. (6 Marks)

(Total 30 Marks)

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

QUESTION 2

In line with the Government's efforts at promoting accountability and transparency, the Federal Government of Nigeria has adopted and is implementing the International Public Sector Accounting Standards (IPSAS). The IPSAS 16 specifically deals with Investment Property which could be land, building or both. A public sector entity may be established to manage such property portfolio on commercial basis. An example of such entity could be a University or Local Government.

Required:

a. Discuss **two** reasons for holding investment property and the **two** methods of measurement as contained in IPSAS 16. (8 Marks)

b. Illustrate with **four** examples each of investment property and non-investment property. (12 Marks)

(Total 20 Marks)

QUESTION 3

In order to ameliorate the transportation challenges being encountered by civil servants, Welfare State of Nigeria gave motor vehicle, tri-cycle and motorcycle loans and advances for its workers. The workers were granted loans and advances equivalent to their annual basic salary. The total fund available for the loan was ₦1billion. The officers that applied for the loans and their grade levels are as follows:

250 officers - GL 01 - 05 at an average annual basic salary of ₦258,000;

100 officers - GL 06 - 07 at an average annual basic salary of ₦450,000;

50 officers - GL 08 and above at an average annual basic salary of ₦650,000.

The interest rate payable on the loans and advances is 12.5% p.a. to take care of time value of money.

(a) **You are required to calculate**:

i. The total loans and advances that were given to the workers, showing the balance of the fund not yet accessed. (10 Marks)

ii. The aggregate interest paid on the loans and advances. (2 Marks)

(b) **Discuss**:

i. **Four** conditions which have to be fulfilled for the grant of correspondence advance. (4 Marks)

ii. **Two** requirements for granting and repaying correspondence advance. (4 Marks)

(**Total 20 Marks**)

QUESTION 4

Sampolopolo Local Government has identified a vacant land beside its marriage registry building. The director of administration proposed that the land be used either for a cybercafé where the general public can browse, make phone calls, photocopy and carry out other computer services or for construction of an entertainment event-hall that can be rented out on commercial basis.

This idea was tabled at the council's management meeting and unanimously accepted. However, the Finance and General Purposes Committee recommended five years for the project since the council secretariat building will be extended in future to accommodate more offices for the increased staff strength and this was approved.

The cost of building the cybercafé and the event-hall with necessary facilities and fittings as well as the expected cash inflows/profits as prepared by the director of administration are as follows:

	Cybercafé	**Event hall**
	₦'000	**₦'000**
Initial cash outlay	225,000	300,000
Residual value	20,000	20,000
Cash inflows:		
Year 2012	90,000	150,000
Year 2013	105,000	150,000
Year 2014	120,000	30,000
Year 2015	135,000	30,000
Year 2016	150,000	30,000

Required:

As the consultant engaged by Sampolopolo Local Government, advise the Local Government on the more viable project using:

i. Pay Back Period (PBP) (7 Marks)

ii. Accounting Rate of Return (ARR) (13 Marks)

(Total 20 Marks)

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

QUESTION 5

For some years, the level of Nigeria's public debt has maintained an upward trend.

You are required to discuss:

a. **Four** major causes for the increase in public debt. (7 Marks)

b. Explain **three** major benefits and **two** adverse effects of public debt to the country.
(8 Marks)
(**Total 15 Marks**)

QUESTION 6

The need for government intervention in the economy is justified on the basis of market failure. In particular, the intervention has become inevitable in view of some practical situations for which the market is rather unhelpful.

Required:

a. Discuss the notion of "market failure" as a basis for government intervention.
(5 Marks)

b. Provide four illustrative cases to justify government intervention in the Nigerian economy.
(10 Marks)
(**Total 15 Marks**)

QUESTION 7

"There are critical issues and problems with decentralisation of government and intergovernmental fiscal relations in Nigeria".

You are required to discuss:

a. The main objectives of an ideal system of fiscal relations among sub-national units in a federation. (6 Marks)

b. **Three** problems of intergovernmental fiscal relations in Nigeria.
(9 Marks)
(Total 15 Marks)

SOLUTION 1

a) **Actions to be taken against companies that fail to render or falsify statement of accounts**

i. An extractive industry company which gives false information or reports to the Federal Government or its agencies regarding its production, sales and income; or renders false statement of accounts or fails to render a statement of accounts required under this Act to the Federal government or its agencies, resulting in the under payment or non-payment of revenue accruable to the Federal government or statutory recipients, commits an offence and is liable on conviction to a fine of not less than ₦30m.

ii. Where the extractive industry company has been convicted of an offence under (i) above, the court shall, in addition to the penalty prescribed there under, order the company to pay the actual amount of revenue due to the Federal Government.

iii. An extractive industry company which delays or refuses to give information or report under this Act, or willfully or negligently fails to perform its obligations under this Act, commits an offence and is liable on conviction to a fine of not less than ₦30m.

iv. The President may, on the recommendation of the National Stakeholders Working Group (NSWG), suspend or revoke the operational license of any extractive industry company which fails to perform its obligations under this Act.

v. If any extractive industry company commits an offence against the Act, every director or other person concerned in the management of the company commits the offence and is liable on conviction to not less than 2 years imprisonment or a fine of not less than ₦5m unless that person proves that:

- The offence was committed without his consent or connivance; or
- The person exercised all such diligence to prevent the commission of the offence as ought to have been exercised by that person, having regard to the nature of his functions in that company and to all the circumstances.

vi. A government official who renders false statement of accounts or fails to render statement of accounts required under this Act to the Federal Government or its agencies, resulting in the underpayment or non-payment of revenue accruable to the Federal Government or statutory recipients, commits an offence and is liable on conviction to not less than 2 years imprisonment or a fine of not less than ₦5m, unless that person proves that:

- The offence was committed without his consent or connivance; or
- The person exercised all such diligence to prevent the commission of the offence as ought to have been exercised by that person, having regard to the nature of his functions in that company and to all the circumstances.

b) **Calculation of unspent amount as at December 31, 2016**

	₦
Total receipts	2,396,581,900.00
Total expended	1,998,500,770.00
Unspent balance as at December 31, 2016	**398,081,130.00**

The unspent amount of ₦398,081,130.00 should be paid back to the treasury.

c) **Functions of Nigeria Extractive Industries Transparency Initiative (NEITI) as contained in the Act that established it are to:**

i. Develop a framework for transparency and accountability in the reporting and disclosure by all extractive industry companies of revenue due to or paid to the Federal Government;

ii. Evaluate without prejudice to any relevant contractual obligations and sovereign obligations the practices of all extractive industry companies and government respectively regarding acquisition of acreages, budgeting, contracting, materials procurement and production cost profile in order to ensure due process, transparency and accountability;

iii. Ensure transparency and accountability in the management of the investment of the Federal Government in all extractive industry companies;

iv. Obtain, as may be deemed necessary, from any extractive industry company an accurate record of the cost of production and volume of sale of oil, gas or other minerals extracted by the company at any period, provided that such information shall not be used in any manner prejudicial to the contractual obligations or proprietary interests of the extractive industry company;

v. Request from any company in the extractive industry, or from any relevant organ of the Federal, State or Local Government, an accurate account of money paid by and received from the company at any period, as revenue accruing to the Federal Government from such company for that period; provided that such information shall not be used in a manner prejudicial to the contractual obligations or proprietary interest of the extractive industry company or sovereign obligations of government;

vi. Monitor and ensure that all payments due to the Federal Government from all extractive industry companies, including taxes, royalties, dividends, bonuses, penalties, levies and such like are duly made;

vii. Identify lapses and undertake measures that shall enhance the capacity of any relevant organ of the Federal, State or Local Government having statutory responsibility to monitor revenue payments by all extractive industry companies to the Federal Government;

viii. Disseminate by way of publication of records, reports or otherwise any information concerning the revenues received by the Federal Government from all extractive industry companies as it may consider necessary;

ix. Promote or undertake any other activity related to its functions and which in its opinion, is calculated to help achieve its overall objectives as enumerated in section 2 of this Act; and

x. Ensure that all fiscal allocations and statutory disbursements due from the Federal Government to statutory recipients are duly made.

Membership of National Stakeholders Working Group (NSWG)

The NSWG shall be constituted by the President and shall consist of a Chairman and not more than 14 other members, one of whom shall be an Executive Secretary.

In making appointment into the NSWG, the President shall include:

(i) Representative of extractive industry companies;

(ii) Representative of Civil Society;

(iii) Representative of Labour Unions in the extractive industries;

(iv) Experts in the extractive industry; and

(v) One member from each of the six geopolitical zones.

d) **Procedures for the appointment of independent auditors and publication of reports in accordance with Section 4 (1) of NEITI Act 2007.**

i. NEITI shall, in each financial year, appoint independent auditors to audit the total revenue which accrued to the Federal Government for that year from extractive industry companies, in order to determine the accuracy of payments and receipts.

ii. The independent auditors appointed under (i) above shall undertake a physical process and financial audit on such terms and conditions as may be approved by the National Stakeholders Working Group (NSWG).

iii. Upon the completion of an audit, the independent auditors shall submit the reports together with comments of the extractive industry companies to the NEITI, which shall cause same to be disseminated to the National Assembly and the Auditor-General for the Federation and also ensure their publication.

iv. NEITI shall submit a bi-annual report of its activities to the President and National Assembly.

v. An auditor or auditing firm that has audited any extractive industry company in any given year shall not be appointed in the same year for the purposes of (ii) above in another extractive industry in the same year.

vi. An auditor or auditing firm shall not be engaged for more than two years consecutively for the purposes of (ii) above.

vii. The Auditor-General for the Federation shall, not later than 3 months after the submission of the audit report to the National Assembly, publish any comment made or action taken by the government on the audit reports.

EXAMINER'S REPORT

The question tests candidates' knowledge of the principles of transparency and accountability through the Nigeria Extractive Industry Transparency Initiative Commission (NEITI) relating to actions to be taken against relevant companies that render falsified statements of accounts; calculation and treatment of the unspent amount of receipts; NEITI functions; membership of the National Stakeholder Working Group (NSWG); and the procedures for the appointment of auditors with the publication of reports as prescribed by Section 4, NEITI Act 2007.

All the candidates attempted the question and their performance was good in part (b) but average in the other parts of the question.

Candidates' major pitfall was their inability to comprehend the question's requirements.

Candidates are advised to prepare very well for the Institute's future examinations.

Marking guide		**Marks**	**Marks**
a.	Any five actions to be taken against companies that failed to render or falsified statement of accounts @ 1½ marks each		7½
b.	Stating of the correct total receipts	1	
	Stating of the correct total expended	1	
	Correct **c**alculation of unspent amount as at December 31, 2016	1	
	Treatment of unspent amount	<u>1</u>	4
c.	Any five functions of NEITI @ 1½ marks each	7½	
	Stating the Chairman and no more than 14 other members one of whom shall be an Executive Secretary @ 1 mark each	3	
	Stating of any other four representatives to be included among the 14 members @ ½ mark each	<u>2</u>	12½
d.	Any six procedures for the appointment of independent auditors and publication of reports@ 1 mark each		<u>6</u>
	Total		**<u>30</u>**

SOLUTION 2

(a) **Reasons for holding investment property and methods of measurement**

Reasons

Investment property is an asset (land or building, or part of a building, or both) held to earn rentals or for capital appreciation or both, rather than for:

i. Use in the production of supply of goods or services or for administrative purposes; and
ii. Sale in the ordinary course of operations

Methods of measurement

Measurement of recognized assets could be by using any of these two applicable methods:

i. Fair Value Model - Investment property is measured at fair value unless there is clear evidence when the entity first acquires an item of investment property that the fair value of the asset is not reliably determined; and
ii. Cost Model – Investment property is measured at its cost less any accumulated depreciation and any accumulated impairment losses.

Chosen method shall be applied to all of an entity's investment property.

(b) **Examples of investment and non- investment property**
Examples of investment property will include:

i. Land held for capital appreciation which may be sold at a beneficial time in future;
ii. Land held for a currently undetermined future use;
iii. A building owned by the reporting entity (or held by the reporting entity under a finance lease); and
iv. A building that is vacant but is held to be leased out under one or more operating leases on a commercial basis to external parties.

Examples of Non-investment property will include:

i. Properties held for sale in the ordinary course of operations or in the process of construction or development for such sale;

ii. Properties being constructed or developed on behalf of third parties e.g. where a service department of a ministry enters into construction contracts with entities external to its government;

iii. Owner-occupied properties including property held for future use as owner-occupied property held for future development as subsequent use as owner-occupied property, property occupied by employees such as housing for military or police personnel;

iv. Properties that are being constructed or developed for future use as investment property. Until construction or development is complete, at which time the property becomes investment property, such a property does not acquire investment property status;

v. Properties held to provide a social service and which also generates cash flows; and

vi. Properties held for strategic purpose which could be accounted for in accordance with IPSAS 17 (on Property, Plant and Equipment)

EXAMINER'S REPORT

The question tests candidates' knowledge of the provisions of IPSAS 16 as they relate to reasons for holding investment property and the methods of measurement with examples of both investment property and non investment property.

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

Candidates' major pitfall was their poor understanding of the contents of IPSAS 16.

Candidates are advised to prepare adequately for the Institute future examinations by using the Institute's Study Text.

Marking guide		**Marks**	**Marks**
a.	Any two reasons for holding investment property and methods of measurement @ 2 marks each	4	
	Any two methods of measurement @ 2 marks each	4	8
b.	Any four examples of investment property @ 1½ marks	6	
	Any four examples of non- investment property @ 1½ marks each	6	12
	Total		**20**

SOLUTION 3

a) i. **Computation of loans and advances granted and the balance of fund not yet accessed**

S/N	**Grade Level**	**No. of officers**	**Average Basic Salary**	**Total loans granted**
			₦	**₦**
i.	01-05	250	258,000.00	64,500,000.00
ii.	06-07	100	450,000.00	45,000,000.00
iii.	08 and above	50	650,000.00	32,500,000.00
	Total			**142,000,000.00**
	Available fund			1,000,000,000.00
	Fund not accessed			**858,000,000.00**

ii. **Calculation of aggregate interest paid on loans and advances**

12.5% of ₦142,000,000.00 = ₦17,750,000.00

b)i. **Conditions for granting of correspondence advance**

The conditions to be fulfilled to access correspondence advance are:

- That the ability and efficiency of the officer warrant his taking the course;
- That the subjects in the course to be pursued are related to his work;
- That the study is likely to increase his efficiency;
- That the course is with a reputable college or establishment;
- That its completion does not itself constitute grounds for advancement;
- That the officer will enter into agreement for repayment;
- That the advance shall be granted free of interest; and
- That the officer produces receipts to show that the whole advance has been appropriately utilized.

ii. **Requirements for granting and repaying correspondence advance are:**

- That the advance does not include an element for postage, stationery, examination or other fees, etc;
- That the advance shall be recovered in twenty-four consecutive installments;
- The outstanding balance of any advance shall be recovered in full from the last payment of salary and/or retirement gratuity of an officer who leaves the service on retirement, resignation, termination of appointment or dismissal;
- The lack of any advice regarding repayment of any installments of an advance does not absolve an officer from repaying an advance in accordance with the terms of these regulations. Any installment not recovered shall be deducted enbloc on receipt of appropriate documents; and
- In the event of an officer being transferred from one pay station to another before an advance granted him is fully recovered, details of the advances granted him and recoveries made up to the date of transfer shall be stated in his last pay certificate forwarded to the new pay station along with a certified true copy of his personal emolument record.

EXAMINER'S REPORT

The question tests candidates' knowledge of the financial and accounting treatment of loans and advances for public/civil servants for motor vehicles, tricycles and motorcycles. The question requires candidates to ascertain how much of the loans and advances accessed and those not yet accessed with

the aggregate interest paid on the advances. In addition, candidates are expected to discuss conditions and requirements for granting and repayment of correspondence advance.

Majority of the candidates attempted the question and they performed above average in part (a) but poorly in part (b) of the question.

Candidates' major pitfall was their poor understanding of the part (b) of the question's requirements.

They are advised to prepare adequately for the Institute future examinations.

Marking guide		**Marks**	**Marks**
a.i.	Computation of loans and advances granted to each grade @ 1½ marks each	4½	
	Computation of total loans and advances granted to all grades @ 2 marks	2	
	Stating of correct available fund	1	
	Calculation of fund not accessed	2½	10
a.ii	Multiplication of interest rate with total loans granted	1	
	Correct aggregate interest paid on loans and advances	1	2
b.i.	Any four conditions for granting of correspondence advance @ 1 mark each	4	
b.ii.	Any two requirements for granting and repaying correspondence advance @ 2 marks each	4	8
	Total		**20**

SOLUTION 4

i. **Pay Back Period**

Year	**Cybercafé**		**Event hall**	
	Cash outflow/inflows	**Cumulative cash flows**	**Cash outflow/inflows**	**Cumulative cash flows**
	₦	**₦**	**₦**	**₦**
2011	(225,000.00)	(225,000.00)	(300,000.00)	(300,000.00)
2012	90,000.00	(135,000.00)	150,000.00	(150,000.00)
2013	105,000.00	(30,000.00)	150,000.00	00.00
2014	120,000.00	90,000.00	30,000.00	30,000.00
2015	135,000.00	225,000.00	30,000.00	60,000.00
2016	150,000.00	375,000.00	30,000.00	90,000.00
Residual	20,000.00	395,000.00	20,000.00	110,000.00

The payback period for cybercafé is 2 years + (30/120 X 12) =2 years and 3 months while the payback period for event hall is exactly 2 years.

Decision: Event hall project is more viable based on payback period.

ii. **Accounting Rate of Return (ARR)**

Calculation of accounting profit

Year	**Cybercafé Cash inflows**	**Depreciation**	**Accounting Profit**	**Event hall Cash inflows**	**Depreciation**	**Accounting Profit**
	₦	**₦**	**₦**	**₦**	**₦**	**₦**
1	90,000	41,000	49,000	150,000	56,000	94,000
2	105,000	41,000	64,000	150,000	56,000	94,000
3	120,000	41,000	79,000	30,000	56,000	(26,000)
4	135,000	41,000	94,000	30,000	56,000	(26,000)
5	150,000	41,000	109,000	30,000	56,000	(26,000)
Total			**395,000**			**110,000**

	Cybercafé	Event hall
Depreciation	225,000-20,000 / 5 **=₦41,000**	300,000-20,000 / 5 **= ₦56,000**
Average Accounting profit (AAP)	395,000 / 5 **= ₦79,000**	110,000 / 5 **= ₦22,000**
Average Investment (AI)	225,000+20,000 / 2 **= 122,500.00**	300,000+20000 / 2 **= N 160,000**
ARR= AAP/AI	79,000 / 122,500 **=0.6449 or 64.49%**	22,000 / 160,000 **= 0.1375 or 13.75%**

The accounting rate of return for cybercafé is 64.49% while the accounting rate of return for event hall is 13.75%

Decision Cybercafé project is more viable based on Accounting Rate of Return(ARR)

EXAMINER'S REPORT

The question tests candidate's knowledge of investment appraisal in the public sector. It requires candidates to evaluate two projects using the Pay-Back-Period (PBP) and the Accounting Rate of Return (ARR).

Majority of the candidates attempted the question and their performance was above average. However their major pitfall was poor presentation of their solutions.

Candidates are advised to practice very well before writing the Institute future examinations.

Marking guide		Marks	Marks
i.	Computation of cumulative cash flows up till year 2014for the two project @ ½ mark each tick	4	
	Determination of viable project based on pay back period	3	7
ii.	Calculation of total 5 years profits for each project @ 1/3 mark each tick for 12 ticks	4	
	Calculation of average accounting profit for the two project @1½ marks per project	3	
	Calculation of average investment for the two project @ 1½ marks per project	3	
	Calculation of Accounting Rate of Return for the two project @ 1 mark per project	2	
	Decision	1	13
	Total		**20**

SOLUTION 5

a) The reasons why the level of Nigeria's public debt has maintained upward trend for some years now include the following:

(i) **Rapidly increasing population**: With an annual population growth rate of about 3%, Nigeria has one of the fastest growing populations in the world. The need arises for government borrowing to expand public infrastructure and utilities to cater for the welfare of the teeming population;

(ii) **Huge and persistent budget deficit**: The government has been adopting deficit budgets to stimulate the economy, especially after its taxing capacity has been stretched to the limit;

(iii) **Balance of Payments (BOP) disequilibrium**: Excessive reliance on foreign resources to maintain domestic production activities and on foreign goods and services beyond the nation's foreign exchange earning capacity also explains the increase in Nigeria's public debt;

(iv) **Implementation of development programmes**: The promotion of sustainable economic growth and development usually requires provision of new and upgrading of existing social and economic infrastructure like roads, railways, electricity, schools and hospitals. The tax revenue of government has never been sufficient to execute such projects and this often necessacitates government borrowing;

(v) **Economic instability**: Public debt of the internal type is usually contracted to control inflation. For example, the sale of treasury bills to mop up excess liquidity is a strategy to promote price stability. A stable economy naturally provides an enabling environment for economic growth and development;

(vi) **Natural disasters**: Government has the responsibility to provide relief to the victims of flood and fire disasters as well as victims of sectarian violence and terrorist attacks. For example, Internally Displaced Persons (IDPs) camps created for victims of Boko-Haram insurgents are not normally adequately provided for in the national budgets. Hence government usually contracts public debt to take care of un-anticipated disasters;

(vii) **Fall in government revenue**: Nigeria operates a mono-cultural economy, depending largely on revenue from crude oil exports. Poor performance of crude oil in the international market usually triggers public borrowing to bridge the financial resources gap; and

(viii) **Debt - servicing**: New debt with favourable terms and conditions are usually incurred to service old debts with a view to reducing the burden of debt on the economy.

b) The following are some of the benefits associated with public debt:

i. **Economic growth and welfare improvement:** This is achieved by the government if the borrowed funds are utilized to finance economically and socially viable projects such as infrastructural upgrade and poverty alleviation programmes;

ii. **Increased investment and employment opportunities:** The confidence of local and foreign investors in the economy would be boosted if public debt is used to control inflation. There would be more investment, creation of new jobs and greater output of welfare – enhancing goods and services;

iii. **Improvement of standard of living:** This occurs when borrowed funds are used to create public works and transformation of the environment;

iv. **Reduction of income inequalities:** This occurs if borrowed fund is spent on social securities and projects that are of more benefits to the lower income group such as expansion of primary healthcare centres, free feeding to pupils in public schools; and

v. **Investors in government securities become richer:** Those who purchase government securities become richer as they acquire additional assets to boost their wealth portfolio.

On the other hand, the adverse consequences of public debt include the following:

i. **Crowding–out of private investments:** Government competes with private companies in the money market thereby depriving them of loanable funds they need to grow their activities;

ii. **Future obligations on tax payers:** Future generations are made to bear excessive tax burden especially when borrowed funds are diverted to white – elephant projects which are not relevant to economic growth and development;

iii. **Welfare–worsening conditionalities:** Stiff conditions that carry grave repercussions on living standards such as trade liberalisation, withdrawal of subsidies on essential products, expenditure reduction that are attach to some foreign loans, especially IMF loans.

iv. **Inflationary effect:** Specifically, the servicing of domestic debt usually causes aggregate demand to increase when creditors bring the income they generate through their investment in government securities into circulation; and

v. **Debt-servicing problem affects budget implementation:** This occurs when short and medium – term loans are committed to long-term projects with amortisation becoming due before completion of projects.

EXAMINER'S REPORT

Candidates are expected to demonstrate and discuss fully the causes, benefits and adverse effects of public debt in Nigeria.

Virtually all the candidates attempted the question and the pass rate was above average. Majority of the candidates discussed well the causes and benefits of increased public debt in Nigeria. Most of them, however, had problems explaining copiously, the adverse effects of public debt.

Candidates are advised to make good use of the Institute's Study Text in order to be familiar with and have better understanding of this aspect of the syllabus.

Marking guide	**Marks**	**Marks**
a. For each of the first **four (4)** points:		
-Mentioning @½mark per point	2	
- Explanation @1 ¼ marks per point	5	7

b. For each of the first **three (3)** benefits

- Mentioning @1 mark per point	3	
- Explanation @1 mark per point	3	
For each of the **two (2)** adverse consequences		
- Mentioning @½ mark per point	1	
- Explanation @ ½ mark per point	1	8
Total		**15**

SOLUTION 6

(a) Notion of **"market failure"** as a basis for government intervention.
Market failure is a label for the view that the market does not provide a panacea for all economic problems as implied in the classical/neo-classical prescription.

The main sources of market failure are "monopoly", externalities and uneven income distribution. These and many market imperfections give rise to under-provision and over-charging for goods; under-provided public goods and a socially unacceptable distribution of incomes.

The various sources of market failure together with its adverse consequences provide a prima facie case for considering public regulation of some goods, public provision of others and redistribution of income

(b) Justifications for government intervention in the Nigerian economy are:

(i) **Provision of public goods**: Some goods and services like defence, street lights are non-rival in consumption and not subject to the exclusion principle. Such goods are rarely provided by private individuals and firms;

(ii) **Merits goods**: These are goods which may not be consumed in sufficient quantities unless people are compelled to consume them. Examples are education and health care services which are essential to human existence and well being;

(iii) **Desire for economic stability**: Government intervention is justified where there is a need to reduce fluctuations in output, employment, income and prices which may have destablising effects on economic activities;

(iv) **Promotion of equitable income distribution**. The distribution of income in a market economy is usually skewed against the poor and in favour of the rich. This calls for government intervention to ensure equitable income distribution;

(v) **Activities with negative externalities**: Some people that are engaged in activities that impact negatively on other people's welfare such as noise, pollution, erosion and other environmental hazards may need to be sanctioned while the victims are compensated by government; and

(vi) **Non-competitive market or market power abuse**: This may happen when a single buyer or supplier is able to exert significant influence over prices or supply as in the case of monopoly or monopsony, thus government intervention

EXAMINER'S REPORT

The question tests candidates' understanding of 'market failure' as a basis for government intervention in the Nigerian economy. Candidates are required to explain the meaning of 'market failure' and practical situations that could warrant government intervention in the economy.

Majority of the candidates attempted the question but the performance was very much below average. The candidates lacked good grasp of the requirements of the question. Virtually all the candidates failed to explain the concept of 'market failure' while only a few provided satisfactory discussion of the justifications for government intervention.

Candidates are advised to pay attention to this aspect of the syllabus and consult the Institute's Study Text for better understanding of the role of the market system in a developing economy like Nigeria.

Marking guide		**Marks**	**Marks**
a.	Definition of market failure	2	
	Stating main sources of market failure	2	
	Adverse consequences of market failure	1	5
b.	Mentioning any four justifications@1 mark per point	4	
	Explanation any four justifications@1½ marks per point	6	10
	Total		**15**

SOLUTION 7

(a) **Fiscal federalism** deals with the assignment to or division of functions among the different levels or tiers of government and appropriate instruments are used in carrying out these functions. Fiscal federalism may be in terms of political federalism. It also looks at the constitutional division of powers between the tiers of government and administrative federalism, which involves the delegation of functions to sub-national units or levels of government based on the guidelines and control created by higher levels of government (Federal or States).

The objectives of an ideal fiscal relation among sub-national units in a federation are to:

(i) Ensure correspondence between sub-national expenditure responsibilities and their financial resources (including transfers from the central government) so that the functions assigned to sub-national government can be effectively carried out;

(ii) Increase the autonomy of sub-national governments by incorporating incentives for them to mobilise revenues of their own;

(iii) Ensure that macroeconomic management policies of the central government are not undermined or compromised;

(iv) Give expenditure discretion to sub-national governments in appropriate areas in order to increase the efficiency of public spending and improve the accountability of sub-national officials to their constituents in the provision of sub-national services;

(v) Be consistent with nationally agreed income distribution goals;

(vi) Support the emergence of a governmental role that is consistent with market - oriented reforms;

(vii) Incorporate intergovernmental transfers that are administratively simple, transparent and based on objective, stable, non-negotiated criteria;

(viii) Minimise administrative costs and thereby economise on scarce administrative resources;

(ix) Incorporate mechanisms to support public infrastructure development and its appropriate financing; and

(x) Provide "equalisation" payments to offset differences in fiscal capacity among states and among local governments so as to ensure that poorer sub-national governments can offer sufficient amount of key public services.

(b) Problems of intergovernmental fiscal relations are:

(i) **Overdependence on oil revenue**. The overdependence of the states on the oil revenue has made them to be an appendage of the central government. It has also established a master-servant relationship between the federal government and the component units. The current revenue sharing formula of the government has equally encouraged laziness and idleness as states rely heavily on the federal allocation which has made most states to be parasitic in nature and are then lacking in vision which has not helped their development;

(ii) **Corruption and financial fraud.** Financial mismanagement has caused a serious problem in intergovernmental fiscal relations and this has compounded the problems of corruption in the country. Part of these problems arises as a result of the congestion in the governmental system emanating from the creation of different ministries, offices and various political posts (advisers, personal assistants, etc.). These problems have been significantly noticed in the federal and state levels but its scale is very low at the local levels due to budget cuts;

(iii) **Conflicts over revenue sharing formula.** Revenue sharing among the sub-national units in the country (either vertical or horizontal) has been faced with a lot of agitations, controversies and outright rejections due to the nature of politics involved. From the inception, there has been no acceptable revenue sharing formula and set of principles among and within the tiers of government. These problems have been based on certain number of reasons which include, lack of consensus on the criteria of distribution, absence of reliable socio-economic data, strong bargaining powers of the regions, revenue sharing formula based on the region or state in control of power in Nigeria;

(iv) **Centralising tendency of fiscal relations**. This has led the federal government of Nigeria in most cases to unilaterally spend or decide the modes and methods of spending the resources of the country. Federal government enjoys unlimited power and too many responsibilities in the exclusive legislative list. Moreover, fiscal laws seem to give more tax powers to the federal government than the lower tiers of government;

(v) **Agitation for resource control.** This has led to various conflicts and criminal activities in the country. Such activities include, kidnapping, vandalisation of oil pipes, instabilities, desperation and high scale violence;

(vi) **Loyalty to political parties.** Loyalties to political parties have also been a problem of intergovernmental relations. This is due to the fact that if the federal government and any state happen to be in different political parties with different ideologies, it will have serious implications on the state who will want to be loyal to his own party rather than the federal government; and

(vii) **Increase in the demand for skilled administrator by the government sector**. This is as a result of the fact that each state and local authority requires their own administrative staff to function efficiently. Thus, the expenses of the government are thereby increased.

EXAMINER'S REPORT

The focus of the question is on fiscal relations in Nigeria: the main objectives and problems. It is a question that should be examined in the context of the ideal system of decentralised fiscal relations.

It was the least attempted question in this paper. The performance in the question was average. Candidates did not demonstrate a clear understanding of fiscal relations and the defining objectives. However, a good number of them were able to discuss the relevant problems of inter-governmental fiscal relations in Nigeria.

Candidates are advised to pay particular attention to this aspect of the syllabus. In particular, they should endeavour to have a good grasp of the concept of fiscal relations and its relevant objectives which are well spelt out in the Institute's Study Text.

Marking guide		**Marks**	**Marks**
a.	Definition of fiscal federalism @ 1½ marks	1½	
	Stating any three objectives @ 1½ marks each	<u>4½</u>	6
b.	Mentioning any three problems @1 mark each	3	
	Explanation any three problems@ 2 marks each	<u>6</u>	<u>9</u>
	Total		**<u>15</u>**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION - NOVEMBER 2018

MANAGEMENT, GOVERNANCE AND ETHICS

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

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

SECTION A COMPULSORY QUESTION (30 MARKS)

QUESTION 1

Igbadun Nigeria Limited is a private limited liability company engaged in the business of online content streaming to registered subscribers through a dedicated website "igbadun.com". Contents offering of the company includes movies, TV episodes, cartoon series, educational series, documentaries and reality shows.

The subscriber base growth rate of Igbadun has been phenomenal, jumping from about 3,000 in 2013 to 30,000 at the end of 2017. This is in spite of the fact that the industry is relatively new in Nigeria. The growth has led to an increase in revenue from ₦72 million in 2013 to ₦450 million by the year ended 31 December, 2017. However, the only source of revenue to the company is customers' subscription.

The impressive performance of Igbadun Nigeria Limited has been attributed to a number of factors that include:

- Increasing internet usage;
- Increased patronage of streamed online programmes;
- Improved access to the internet at reduced cost;
- Affordability of internet enabled devices suitable for viewing online video contents;
- Cost reduction strategies, competitive and very affordable subscription rate, which has been reduced from ₦2,000 in 2013 to ₦1,500 in 2017. This is the second lowest rate in the industry;
- Aggressive marketing strategy and investment in advertisement;
- Reduction in marketing cost as a percentage of revenue from 16% in 2013 to 12.8% in 2017;
- Growth of gross subscribers in excess of 100% per annum;
- Investment of over 60% of its earnings for growth and development, especially the purchase of the best hardware and software available;
- Aggressive R & D policy that has led to in-house development of most of its software, with all of them duly patented;
- Effective Human Resource Management strategy that has helped to attract, motivate, train and retain highly qualified and experienced manpower; and
- Management team of highly experienced personnel.

A report recently released by a reputable consulting firm in Nigeria, Arthur Baker and Company, predicted that the demand for online programme streaming in Nigeria will grow significantly to 5 million by 2020. Consequently, existing rivals, such as Netcom and other smaller competitors, jostle to gain competitive advantage. The relatively liberal legal requirements for entry have also facilitated an influx of new entrants into the industry. Netflox, the world's biggest provider of online programme streaming service recently commenced operations in Nigeria.

Copyright activists recently proposed a bill to the National Assembly allowing online programme streaming providers to stream new releases only after 2 months of the release. This bill will adversely affect the subscription revenue of igbadun.com if passed into law.

A major part of Igbadun subscription revenue is received through online payments with the use of debit cards. However, a recent report released by an independent consultant shows a decline in the use of online payment platforms due to increased security concerns. This has the potential of hurting Igbadun's revenue stream.

Igbadun is also struggling to compete with other movie entertainment media such as cable TV, DVDs and cinemas. The most worrisome for the company has been DVDs. Activities of pirates have made the price of DVDs of new releases to be as low as ₦500 each. If this continues unabated, the company stands the risk of losing its subscriber base.

However, in spite of these challenges, Igbadun plans to grow its subscriber base to 200,000 by the end of 2020.

Required:

a. With the aid of a Mini Resource Audit and Porter's Five Forces Model, prepare a SWOT analysis for the management of Igbadun Nigeria Limited. (25 Marks)

b. Provide a detailed account of **two** of the risks business entities might face by adopting a strategy of cost leadership. (5 Marks)

(Total 30 Marks)

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

QUESTION 2

PKL Restaurants Limited was established in 1995 and now has 12 branches in different parts of Lagos. The company wants to expand its operations to Abuja and Port Harcourt. Consequently, it seeks to restructure the business and build structures for good corporate governance

Required:

a. Develop a proposal highlighting **five** key issues of corporate governance. (10 Marks)

b. Evaluate **five** principles of good corporate governance that the company should adhere to. (10 Marks)

(Total 20 Marks)

QUESTION 3

Success and profit maximisation in business are premised on factors that include the ability to identify, assess and measure risks. as a risk manager, how would you explain the following to a group of prospective entrepreneurs in ways that would adequately equip them to deal with operational, business and strategic risks?

a. Risk identification. (4 Marks)
b. The impact of risk on any **four** stakeholders. (4 Marks)
c. Assessing risks: impact and probability. (4 Marks)
d. Measuring risks. (4 Marks)
e. Prioritising risks. (4 Marks)

(Total 20 Marks)

QUESTION 4

There is an increasing demand on professional accountants to pay close attention to ethical standards as they carry out their professional duties. This requires, among other considerations, that accountants act professionally and in the public interest. They are also expected to abide by the code of ethics of their profession and the corporate code of ethics of the organisation in which they work.

a. Discuss the ethical considerations a professional accountant should attend to in the discharge of professional duties? (6 Marks)

b. What specific actions are you expected to take in order to serve public interest? (5 Marks)

c. Discuss the nature and purpose of corporate code of ethics. (9 Marks)

(Total 20 Marks)

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

QUESTION 5

You have been invited to facilitate a session on how to deal with ethical conflicts based on the Institute of Chartered Accountants of Nigeria code of professional conduct.

Discuss the **six** stages in handling ethical conflicts. **(Total 15 Marks)**

QUESTION 6

As part of a training session in strategic management, deploy a diagram, to explain how a firm would use the Boston Consulting Group (BCG) model to analyse its business portfolio. Explain each category of products identified in the BCG model. **(Total 15 Marks)**

QUESTION 7

It is important that, as a member of the board of directors of a company, you have a good understanding of the nature, types and structures of a board.

You are required to:

a. Provide a defence for the unitary board structure. (5 Marks)

b. Outline the core roles of a board of directors. (5 Marks)

c. Provide a broad overview of the composition and size of a unitary board of directors. (5 Marks)

(Total 15 Marks)

SOLUTION 1

a.i Mini Resource Audit identifies all significant resources that are used by the company and how their availability/non-availability can affect the ability of the entity to achieve its strategic objectives.

Human Resources

- The company invests heavily in Human Resource Development
- Remuneration package is highly competitive
- The company has in place a Human Resources attraction and retention strategy that is working.

Management

- The company possesses experienced and skilled management team
- They had led the company to experience phenomenal growth in subscriber base

Technology (Non-current Assets)

- The company has an R and D strategy in place to support in-house development of indigenous technology
- The company has access to needed technology
- The company possesses state-of the art technology that will support the achievement of its objectives.

Intangible Resources

- The company possesses patent right to the software developed internally
- The workforce is well motivated.

Financial Resources

- A growing subscriber base provides a steady inflow of liquidity.

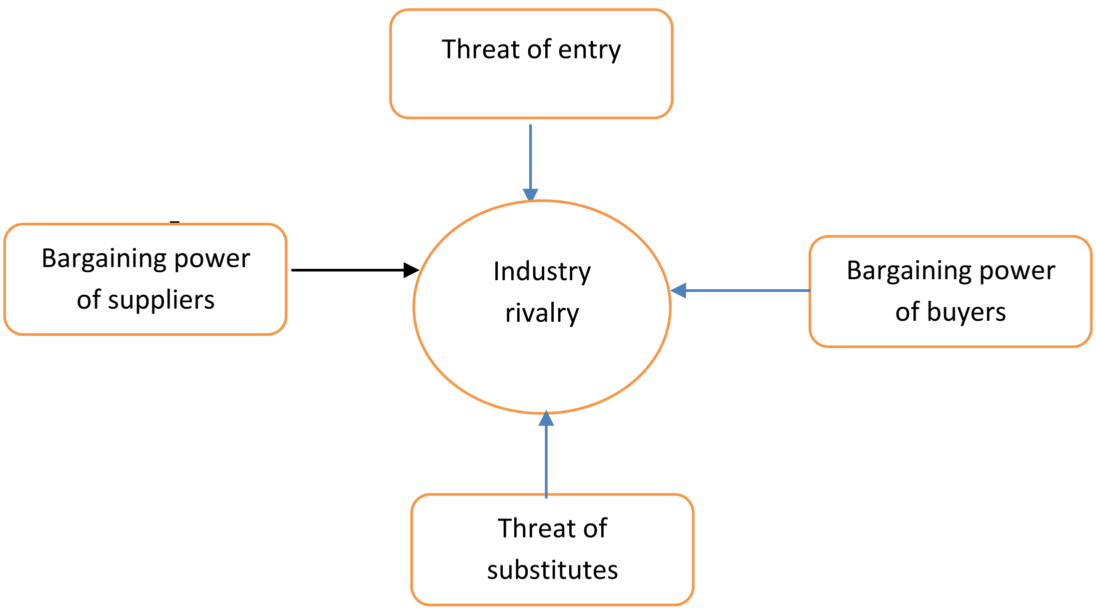
This is further supported by the fact that services are prepaid in cash.

- The major source of new capital is retained earnings

a.ii Porter's Five Forces Model is an analysis tool that uses five forces to determine the profitability of an industry and shape a firm's competitive strategy.

It is a framework that classifies and analyses the most important forces affecting the intensity of competition in an industry and its profitability level.

Five Forces Model was created by M. Porter in 1979 to understand how five key competitive forces are affecting an industry. The five forces identified are:



These forces determine an industry structure and the level of competition in that industry. The stronger competitive forces are the industry, the less profitable it is. An industry with low entry barriers, few suppliers but many substitute products and competitors will be seen as very competitive and, thus, not so attractive due to its low profitability.

Application of Michael Porter's 5 Forces Model to Igbadun Nigeria Limited:

- **Threats from potential (new) entrants**

  - Based on the Consultant's prediction that the steaming business in Nigeria will grow significantly, potential and existing rivals, such as Netcom and other smaller competitors, began to compete for a share in the market.

  - The company had to compete with other movie entertainment media such as cable TV, DVD and cinemas.

- Another reason that lowers the entry barrier for competitors is the cost of entry into the business.

- The liberal legal requirements (i.e) weak legal requirements for setting up the business facilitated the influx of new entrants.

- **Threats of substitute products or services.**
  - Igbadun Nigeria limited is faced with the threats of customers dropping its products or services for other movie entertainment media such as cable TV, DVDs and cinemas.
  - There is also threat of losing subscribers who prefer to buy cheap DVDs for as low as ₦500.
  - The switching cost from Igbadun Nigeria limited to cable TV or cinemas is very low.
  - The relative cheap price of the substitute made this threat to be very strong.
  - Availability of these substitute products to all customers without extra cost made this threat so strong.

- **Bargaining power of customers/buyers**

  The bargaining power of customers may be strong given the availability of various options provided by rival companies, cinemas, cable TV and cheap pirated DVDs.

- **Suppliers' bargaining power**
  - The bargaining power of Igbadun Nigeria Limited is weakened by the entrance of various competitors into the market.
  - It is also weakened by the availability of the cinema, cable TV and DVD alternatives.

- **Competitive industry rivalry**

  Competitive industry rivalry is strong with the entrance of global players and other small competitors into the market.

a.iii SWOT analysis for the management of Igbadun Nigeria limited.

SWOT is an acronym for

- Strength
- Weakness
- Opportunity
- Threat

- **Strength**
  - Increase in its subscriber base in excess of 100% per annum
  - Increase in revenue from ₦72 million in 2013 to ₦450 million in 2017
  - Cost reduction strategies, competitive and affordable subscription rate i.e it has the second lowest rate in the industry
  - Aggressive marketing strategy
  - Growth of subscribers in excess of 100% per annum
  - Investment in the best hardware and software devices
  - In-house production of softwares through effective research and development
  - Highly qualified and motivated staff through effective human resources strategy.
  - The management team consists of highly experienced personnel
  - Its products were patented to discourage being imitated

- **Weakness**
  - Inability to raise barriers to new entrants
  - Struggling to compete with other movie entertainment media in the industry
  - The company has only one major source of revenue, which is customers' subscription

- **Opportunity**
  - The growing popularity of internet usage
  - Increased patronage of online streaming content
  - Improved access to the internet at reduced rate
  - Affordability of internet enabled devices suitable for viewing online video contents

- **Threats**
  - Influx of new entrants
  - The coming into the industry of a world player and market mover - Netflox
  - Activities of pirates that make DVD, TV and cinemas product available at cheap rate.
  - Decline in the use of online payments by subscribers
  - The copyrights activists' bill sponsored to the National Assembly limiting -the number of streaming releases per month
  - Availability of a substitute at a cheap rate

b. **Risks an entity might face by adopting a cost leadership strategy**

An organisation adopting a strategy of overall cost leadership might face a number of risks. These include:

i. **Risk of Technological Change**

This risk could result in more capital investment to keep up to date.
This might nullify all the cost advantages so far achieved by experience and the learning curve process

ii. **Threat of Competition**
There is a threat of competition from other countries where costs might be even lower

iii. **Risk of Competitors Attempting to Fragment the Market**
There is a risk that competitors may attempt to fragment the market and build up a high quality brand image

An overall low cost producer would have to compete on cost in each market segment it operates in and hope that cheaper prices can compete successfully with brand image

iv. **Risk of cost inflation**
There is a risk of cost inflation, especially if competitors in other countries are not affected in the same way

Fluctuations in exchange rates do not necessarily nullify the inflation differences between countries.

EXAMINER'S REPORT

This compulsory question tests candidate's ability to apply a Mini Resource Audit and Porter's Five Forces Model to a SWOT analysis of Igbadun Plc. It also tests their understanding of the elements associated with the adoption of Cost Leadership Strategy.

All candidates attempted the question, but, performance was just average.

The commonest pitfall of the candidates is lack of knowledge of Mini Resource Audit as it applies to SWOT analysis. Many of the candidates were also not able to account for risk elements associated with Cost Leadership Strategy.

Marking Guide Q1		Marks	Marks
a.i.	Mini Resources Audit		
	1 mark for each of any 5 points		5
ii.	Porter's Five Forces Model		
	- Diagram	3	
	- Explanation 1 x 5	5	8
iii.	Application to SWOT Analysis to the case		
	Strength - 1 mark for each of the 4 points 1 x 4	4	
	Weakness - 1 mark for each of any 2 points 1x2	2	
	Opportunity - 1 mark for each of 2 points 1 x 2	2	
	Threat - 1 mark for each of any 4 points 1 x 4	4	12
b.	Risk elements to Cost Leadership Strategy		
	$2^1/_2$ marks for each of any 2 points 2 x $2^1/_2$		5
	Total		**30**

SOLUTION 2

KEY ISSUES IN CORPORATE GOVERNNANCE

a. **Corporate Governance Issues**

Key issues in corporate governance which establish how well or badly a company is governed, include the following:

i. **The role and responsibilities of the board of directors:** The board of directors should have a clear understanding of its responsibilities and should fulfill these by providing suitable leadership to the company. Governance is therefore concerned with establishing what the responsibilities of the board should be and ensuring that they are carried out properly;

ii. **The composition and balance of the board of directors**: A board of directors should act with integrity, bring independence of thought and judgment to their role. The board should not be dominated by a powerful chief executive and/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 fully accountable to its shareholders, and should be open and transparent with investors generally. To make a board properly accountable, high standards of financial reporting (and narrative reporting) and external auditing must be upheld. The major 'scandals' of corporate governance in the past have been characterised by misleading financial information in the company's account;

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 on which companies are frequently criticized;

v. **Risk management and internal control**: The 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; and

vi. **Shareholders' rights**: Shareholders' rights vary between countries. These rights might be weak or 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.

b. There are several principles of good corporate governance that companies should adhere to:

Some of these principles should also apply to the company's dealings with its employees, customers, suppliers and the general public. The principles described here might seem 'obvious'. However, it is useful to think about what might happen if they are not applied, that is, how the neglect might affect the relationship between the board of directors and the shareholders.

(i) **Fairness**

In corporate governance, fairness refers to the principle that all shareholders should receive fair treatment from the directors. At a basic level, it means that all the equity shareholders in a company are entitled to equal treatment, such as one vote per share at general meetings of the company and the right to the same dividend per share.

In the UK, for example, the concept of fair treatment for shareholders is supported by the law (which provides some protection for minority shareholders against unjust treatment by the directors or the majority shareholders). However, in some countries, the law provides little or no protection for minority shareholders. For example, in a takeover bid for a company, the law might permit a higher price to be offered to large shareholders than the price offered to small shareholders.

(ii) **Openness/Transparency**

Openness or transparency means 'not hiding anything'. Intentions should be clear, and information should not be withheld from individuals who ought to have a right to receive it.

Transparency means clarity. In corporate governance, it refers to the ability of the shareholders to see what the directors are trying to achieve, but also to the ease with which an 'outsider', such as a potential investor or an employee, can make a meaningful analysis of the company and its intentions.

Transparency therefore means providing information about what the company has done, what it intends to do in the future, and what risks it faces.

(iii) **Independence**

Independence means freedom from the influence of someone else. A principle of good corporate governance is that a substantial number of the directors of a company should be independent, which means that they should be able to make judgments and give opinions that are in the best interests of the company, without bias or pre-conceived ideas.

Similarly, professional advisers to a company such as external auditors and solicitors should be independent of the company, and should give honest and professional opinions and advice.

- The independence of a director is threatened by having a connection to a special interest group. For instance executive directors can never be independent, because their views will represent the opinions of the management team. Similarly, a retired former executive might still be influenced by the views of management, because he or she shares the 'management culture'. Directors who represent the interests of major shareholders are also incapable of being independent.

- The independence of external auditors can be threatened by over-reliance on fee income from a client company. When a firm of auditors, or a regional office of a national firm, earns most of its income from one corporate client there is a risk that the auditors might choose to accept what they are told by the company's management, rather than question them rigorously and risk an argument. It has been suggested that this occurred in the Houston office of Arthur Andersen, the audit firm that collapsed in 2002 as a result of the Enron scandal.

- Familiarity can also remove an individual's independence, because when one person knows another well he is more likely to accept what that person tells him and support his point of view. Auditors are at risk of losing their independence if they work on the audit of the same corporate client for too many years.

(iv) **Honesty and integrity (probity)**

It seems obvious that honesty should be an essential quality for directors and their advisers. An individual who is known to be honest is believed by others and is therefore more likely to be trusted.

However, honesty is not as widespread as it might seem. Business leaders, as well as political leaders, may prefer to 'put a spin' on the facts, and manipulate them for the purpose of presenting a more favourable impression.

Integrity is similar to honesty, but it also means behaving in accordance with high standards of behaviour and a strict moral or ethical code of conduct. Professional accountants, for example, are expected to act with integrity, by being honest and acting in accordance with their professional code of ethics.

If shareholders in a company suspect that the directors are not acting honestly or with integrity, there can be no trust, and good corporate governance is impossible.

(v) **Responsibility and accountability**

The directors of a company are given most of the powers for running the company. Many of these powers are delegated to executive managers, but the directors remain responsible for the way in which those powers are used.

- An important role of the board of directors is to monitor the decisions of executive management and to satisfy themselves that the decisions taken by management are in the best interests of the company and its shareholders.

- The board of directors should also retain the responsibility for certain key decisions, such as setting strategic objectives for their company and approving major capital investments.

  A board of directors should not ignore their responsibilities by delegating too many powers to executive management, and letting the management team 'get on with the job'. The board should accept its responsibilities.

With responsibility, there should also be accountability. In a company, the board of directors should be accountable to the shareholders. Some of the ways in which the board are accountable are as follows:

- Presenting the annual report and accounts to the shareholders, for the shareholders to consider and discuss with the board. In Nigeria, for example, this happens at the annual general meeting of the company.

- If shareholders do not approve of a director, they are able to remove him from office. Individual directors may be required to submit themselves for re-election by the shareholders at regular intervals. In Nigeria for example, it is common practice for directors to be required to retire every three years and stand for re-election at the company's annual general meeting.

(vi) **Reputation**

A large company is known widely by its reputation or character. A reputation may be good or bad. The reputation of a company is based on a combination of several qualities, including commercial success and management competence. However, a company might earn a good reputation with investors, employees, customers and suppliers in other ways. As concerns for the environment have grown, companies have recognised the importance of being 'environment- friendly' or 'eco-friendly'.

Reputation is also based on honesty and fair dealing, and on being a good employer.

(vii) **Judgment**

Directors are expected to have sound judgment and to be objective in reaching conclusions. They should avoid bias and conflicts of interest. In its principles of corporate governance, for example, the Organisation for Economic Cooperation and Development (OECD) states that: 'the board should be able to exercise objective judgment on corporate affairs independent, in particular, from management.'

EXAMINER'S REPORT

The question tests candidates' knowledge of key issues covered in Corporate Governance and its basic principles.

About 85% of the candidates attempted the question and performance was above average.

The commonest pitfall was that many of the candidates could not differentiate between key issues and principles of Corporate Governance.

Marking Guide		**Marks**	**Marks**
a.	5 key issues in Corporate Governance 1 mark x 5	5	
	Explanation of 5 key issue 1 mark x 5	<u>5</u>	10
b.	5 principles of Corporate Governance 1 x 5	5	
	Explanation of five principles 1 mark x 5	<u>5</u>	
			<u>10</u>
	Total		**<u>20</u>**

SOLUTION 3

(a) Risk identification is the initial stage in a system of risk management designed to understand the risks faced by a company. Some companies set up risk committees to identify risks.

(b) Impact of the risk on any four shareholders

(i) **Employees**
- Loss of jobs
- Threat to health or safety

(ii) **Investors**
- Loss of investment which may result to sale of investment
- Denial of credit
- High interest charges
- Inability of the company to pay those who they are owing (Bankruptcy)
- Fear of liquidation
- Fluctuation in share prices

(iii) **Creditors**

- The company will not be able to pay what they owe
- The company will stop buying goods and services from them
- Credit risk – A high risk company has a high credit risk
- Insolvency risk – inability to settle outstanding bills

(iv) **Communities and the General Public**

- Decline in business activities within the community
- Health and safety risk from failures by a company to supply goods that meet health and safety standards
- Environmental/pollution risk invariably affects quality of life

(v) **Government**

- Transfer of investment from one country to the others (loss of revenue)
- Unavailability of goods and services
- Brain drain
- Loss of employment leading to loss of tax revenue to the government
- Political instability may arise as a result of unemployment

(vi) **Customers**

- Delays in providing goods and services
- Operational risks from human error or system breakdown of operations
- Product safety risk to customers that utilise goods and services

(vii) **Business Partners**

- Joint venues risks
- Risks in managing contracts
- Partnership reputation risk

C: Assessing risks: Impact and probability

i. Using Risk Map

Impact of potential loss	High impact	H L High impact Low probability Consider the need for control measurement, such as insurance	H H High Impact High probability Take immediate action to control the risk
	Low impact	L L Low impact Low probability Review periodically Low probability	L H Low impact High probability Consider the need for control action High probability frequency

Probability or frequency of the risk materialising

OR

ii. Using Prose: It is a 2 x 2 matrix with four quadrants

- High impact, low probability (H L) consider the need for control measures, such as insurance.
- High impact, high probability (H H). Take immediate action to control the risk.
- Low impact, low Probability (L L) review periodically.
- Low impact, high probability (L H) consider the need for control action.

(d) Measuring Risks means:

i. Quantifying the risk;
ii. Setting targets for maximum risk tolerance and measuring; actual performance against the target;

iii. Qualitative measurement;
iv. Risk management decisions;
v. Risk measurement can be financial measurement (Profit/loss measurement); and

vi. Non-financial measurement (i.e. measurement of expected injuries to employees at work

(e) **Priotising Risks**

(i) Use of Risk Dashboard

Simple Dashboard

	Risk item
High Risk	RED
	AMBER
Low Risk	GREEN

OR

Level of Risk

Complex Dashboard

Risk item	
Red	High risk
Red/amber	
Green/amber	
Green	Low risk

Risk appetite and residual risk can both be shown on the dashboard

OR

- Risk appetite of a company might be low in which case it can be recorded in the green section of the dashboard.

  If the risk appetite is higher, it can be shown in the green-amber or red/amber sections.

- Residual risk can also be recorded, in the green, green/amber, red-amber or red section of the dashboard.

  When risk appetite and residual risk are in the same section of the dashboard, this means that current risk management/risk control measures are appropriate for the risk.

  When the risk appetite is in a lower-risk section of the dashboard than the residual/risk, this indicates that further control action is needed to reduce the residual risk to an acceptable level.

C: Assessing risks: Impact and probability

j. Using Risk Map

Impact of potential loss		
High impact	H L High impact Low probability Consider the need for control measurement, such as insurance	H H High Impact High probability Take immediate action to control the risk
Low impact	L L Low impact Low probability Review periodically Low probability	L H Low impact High probability Consider the need for control action High probability frequency

Probability or frequency of the risk materialising

OR

ii. Using Prose: It is a 2 x 2 matrix with four quadrants

- High impact, low probability (H L) consider the need for control measures, such as insurance.

- High impact, high probability (H H). Take immediate action to control the risk.

- Low impact, low Probability (L L) review periodically.

- Low impact, high probability (L H) consider the need for control action.

(d) Measuring Risks means: This involves quantifying risks to determine how they should be managed. Risk measurement can be financial or non-financial.

(e) Priotising Risks: This is to determine which risks are tolerable and which need more control measures to reduce them. A risk dashboard may be used to prioritise risks.

(i) Use of Risk Dashboard

Simple Dashboard

	Risk item
High Risk	RED
	AMBER
Low Risk	GREEN

OR

Level of Risk

Complex Dashboard

Risk item	
Red	High risk
Red/amber	
Green/amber	
Green	Low risk

EXAMINER'S REPORT

This question tests candidates understanding of some aspects of risk management.

About 85% of the candidates attempted this question. Performance was average.

The commonest pitfall was candidates' misunderstanding of the basic concepts relating to risk mabagement.

Candidates are advised to master the various concepts related to risk management.

Marking Guide		**Marks**
a.	Risk Identification 1 mark x 4	4
b.	Impact of Risk on any four stakeholders 1 mark x 4	4
c.	Assessing Risk: Impact and Probability 1 mark x 4	4
d.	Measuring Risks 1 mark x 4	4
d.	Priotising Risks: Using Risks Dashboard or Explanation	4
	Total	**20**

SOLUTION 4

a. The ethical considerations a professional accountant should attend to are embodied in the following principles:

(i) **Integrity:** This consists in acting with integrity, and being honest and straight-forward.

(ii) **Objectivity:** This involves providing objective opinions and advice, free from bias, undue influence or conflicts of interest.

(iii) **Professional competence and due care:** This requires the use of specialist knowledge and skill at an appropriate level for the work.

(iv) **Confidentiality:** This is about respecting the confidentiality of information provided by clients.

(v) **Professional behaviour:** Avoiding any action that brings the reputation of the profession into disrepute.

(vi) Compliance with all relevant laws and regulations.

b. A professional accountant is expected to take the following actions in order to serve public interest:

(i) Detecting and reporting any serious misdemeanour or crime;
(ii) Protecting health and public safety;
(iii) Preventing the public from being misled by a statement or action by an individual or an organisation;
(iv) Exposing the misuse of public fund and corruption in government; and
(v) Revealing the existence of any conflict of interests of those individuals who are in a position of power or influence.

c. The nature and purpose of a corporate code of ethics

(i) **<u>Nature</u>**

- A corporate code of ethics is a code of ethical behaviour issued by the board of directors of a company.
- It is a formal written statement, which should be distributed and made available to all employees.
- The decisions and actions of all employees in the company must be guided by the code.
- The effectiveness of a code of ethics depends on the leadership of the company, that is, its directors and senior managers. These individuals must

be seen to comply with the ethical code; otherwise, other employees will see no purpose in complying with the code of ethics.

- The culture of a company drives its ethical behaviour and a code of ethics provides useful guidance.

(ii) **<u>Purpose</u>**

- **Managing for compliance:** The company wants to ensure that all its employees comply with relevant laws and regulations, and conduct themselves in a way that the public expects.
- **Managing stakeholder relations:** A code of ethics can help to improve and develop the relationship between the company and its stakeholders by improving the trust that the stakeholders have in the company. The code might therefore include the ethical stance of the company on disclosing information to stakeholders and the investing public and on respecting the rights of shareholders.
- **Creating a value-based organization:** A company might recognize the long-term benefits of creating an ethical culture and encouraging employees to act and think in a way that is consistent with the values in its code of ethics.

EXAMINER'S REPORT

This question test candidates' understanding of:

a) Roles of an accountant in the discharge of his professional duties;
b) Specific actions required the public interest; and
c) Nature and purpose of corporate code of ethics

About 80% of the candidates attempted the question. Performance was, however, below average.

Many candidates did not understand the specific actions required to serve the public interest and failed to discuss the nature and purpose of corporate code of ethics.

Candidates are advised to effectively utilise ICAN Study Text as these issues are well addressed in it.

	Marks
Marking Guide	
Roles of Professional accountant (1 mark x 6)	6
Professional Accountant Actions to serve Public Interest	**5**
Nature of corporate code of ethics (1 mark x 3)	**3**
Purpose of corporate code of ethics (2 marks x 3)	6
Total	**20**

SOLUTION 5

Stage 1: Define the issues

Accountants are expected to identify potential threats to their compliance with fundamental ethical principles. To do this, they must be able to recognize the ethical issues that exist, or might possibly exist, in a particular situation.

The first step is therefore to define the issues. To do this, it might be necessary to establish the facts. An accountant might suspect that an ethical issue exists, but cannot be sure because he does not have enough facts to inform him about the situation.

In addition, the accountant should ask whether he has considered all the available alternative courses of action, and whether there are any courses of action that could avoid the threats.

Yet another question the accountant should ask is whether the problem is his, or whether it is the problem of someone else. An accountant does not have a duty to take on the ethical responsibilities of another person.

Stage 2: Identify the threats to compliance with ethical principles

Having established the facts and defined the ethical issues, the accountant must consider next about his own involvement. The concern for the accountant should be whether his compliance with the fundamental ethical principles is under threat, and if so, what is the nature of the threat.

- Is there a self-interest threat, a self-review threat, an advocacy threat, a familiarity threat or a threat from intimidation?

- How does this threaten the accountant's ability to comply with the requirements for integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.

Stage 3: Assess the significance of the threats

The next stage is to identify the significance of the threats to compliance with the fundamental ethical principles. If existing controls are sufficient to eliminate the risk of non-compliance, or if the existing controls are sufficient to reduce the risk to an insignificant level, no further action is needed.

If the threats to compliance with fundamental ethical principles are higher than insignificant, additional safeguards should be considered in order to eliminate or reduce the threats.

Stage 4: Introducing safeguards

Safeguards, or additional safeguards, can be introduced to reduce the threats to compliance with the fundamental ethical principles. These threats must be eliminated entirely or reduced to an insignificant level.

Stage 5: Taking action

Introducing additional safeguards might be sufficient to deal with the problem.
However, if the threats to compliance with the fundamental ethical principles cannot be eliminated or reduced to a insignificant level, more extreme measures are necessary. These may include:

- To decline to work for a particular client or to cease working for a client.
- To become a 'whistleblower', and to report concerns to an appropriate authority.
- For the accountant to resign from his or her job.

Stage 6: **Deciding what to do:**

Members of ICAN are able to obtain confidential advice about the appropriate course of action from ICAN.

EXAMINER'S REPORT

The question tests candidates understanding of the six stages in handling ethical conflicts, using the ICAN Model.

Less than 40% of the candidates attempted this question with performance being less than average.

The commonest pitfall was the use of different models, other the ICAN Model as required by the question.

Candidates are advised to be conversant with the contents of ICAN Code of Conduct to equip them deal with ethical conflicts.

Marks Guide	**Marks**
Six stages in handling ethical conflicts	
- Identification of stages 1 mark x 6	<u>6</u>
- Explanation of the stages 1½ marks x 6	<u>9</u>
Total	<u>**15**</u>

SOLUTION 6

Relative Market Share
High Cash Generation **Low**

Cash Usage	**Market Growth Rate**	High	**STARS**	**QUESTION MARKS?**
			CASH COWS	**DOGS**
		LOW		

A firm would use the GGE Model to analyse its Business Portfolio in terms of:

1. Relative market share (Cash Generation)
2. Market growth rate (Cash Usage)

Relative Market Share: Higher corporate market's share results in higher cash returns. Relative market share gives one the size of the market and the product generated in relation to competition. Firm that produces more, benefits from higher economies of scale and experience curve which invariably results in higher profits.

Market growth rate: This is the growth rate of a product in the market relative to other products. High market growth rate means higher earnings and sometimes profits but it also consumes lots of cash, which is used as investment to stimulate further growth. Business units that operate in rapid growth industries are cash users and are worth investing in only when they are expected to grow or maintain market share in the future.
The various categories of products in the BCG Model are:

1. Stars
2. Cash cows
3. Question marks (Problem Child)
4. Dogs

Stars

- A star has a high relative in market share in a high growth market
- It is the market leader
- Stars are both cash generators and cash users
- Stars deserves considerable attention in order to ensure they maintain their lead

Cash cows

- A cash cow is a product in a market where market growth is low, and possibly even negative
- It has a high relative market share, and is the market leader.
- Earns substantial net cash inflows, because of high economies of scale and become efficient through experience.
- Cash cows are cash generators that are found useful in investing in question marks and stars.
- Cash cows are the most profitable brands and should be milked to provide as much cash as possible.

Question marks

- Brands that require much closer consideration
- Holds low market share in fast growing markets
- Question marks consumes large amount of cash and incurs losses
- Unable to maintain market growth will generate low profit
- Invest wisely in question marks
- A well defined plan in order to increase market share.

Dogs

- Products of a business with low growth rate and low market share
- Dogs are cash drainers and should be eliminated to avoid further losses in resources because they use more cash than it earns
- Not a market leader
- Dogs generate low or negative cash returns and not worth investing in
- Dogs can act as a defence to counter competitors moves
- Some of these business can however, generate partial revenue with little costs

EXAMINER'S REPORT

This question tests candidate's ability to apply the BCG Model in the analysis of a business portfolio.

About 80% of the candidates attempted the question and performance was above average.

The commonest pitfall in answering the question was the inability of candidates to identify the products with high market share and market growth in relation to fund generation and utilisation.

Candidates are advised to make effective use of the ICAN Study Text.

Marking Guide			**Marks**
1.	Diagram		4
2.	Explanation of nature market share		1½
	Explanation of market growth		1½
3.	Explanation of BCG model products		
	Star	(1 mark x 2)	2
	Cash cow	(1 mark x 2)	2
	Question mark	(1 mark x 2)	2
	Dog	(1 mark x 2)	2
			15

SOLUTION 7

a. Unitary board structure is a single board formation with sub-committees. It is where all directors, including managing director, departmental directors and non-executive directors have equal legal and executive status in law. All directors under Unitary Board structure are responsible and accountable for all board's actions.

Advantages of unitary board structures

(i) As the board is small in size, there is no requirement to appoint directors who represent shakeholder's interest groups.

(ii) It is easier for non-executive and executive directors to work co-operatively.

(iii) Unitary board works towards a common purpose which is in the best interests of all the shareholders than that of supervisory board which represents different stakeholders' interests.

(iv) There is likelihood of reduction of abuse of power by a small number of senior directors.

(v) More viewpoints are available as the number of directors are more than that of two-tier board.

(vi) All directors have equal legal responsibility for the management of the company and strategic performance.

(vii) The presence of non executive directors can bring independence, experience and expertise.

(viii) There is better goal congruency in unitary board than 2 tier board.

b. **Core roles of the board of directors**

(i) Providing leadership
(ii) Setting up of internal control
(iii) Reviewing management performance
(iv) Responsible for financial reporting
(v) Appointment of top management staff

(vi) Award of contracts
(vii) Risk management control
(viii) Setting the company's values and standards

c. **Composition of a Unitary Board of Directors**

(i) A chairman, who may be an executive director but is more usually a non-executive director
(ii) Deputy/Vice Chairman
(iii) Chief Executive Officer
(iv) Other Executive Directors
(v) Other Non-Executive Directors
(vi) Secretary

b. **Size of a unitary board of directors**

(i) The board and its committee should have the appropriate balance of skills, experience, independence and knowledge of the company.
(ii) All directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively.
(iii) A board of directors should not be too big. The board should examine its size with a view to determining its impact on the company.
(iv) In deciding what is a suitable size, the board should take into account the scope and nature of the operations of the company.
(v) Board diversity in respect of gender, tribe/nationality and age should be taken into consideration when composing the board.

EXAMINER'S REPORT

The question tests candidates understanding of the nature of a unitary board structure and the roles, composition and size of a unitary board of directors.

About 75% of the candidates attempted the question. Performance was average.

The commonest pitfall was the inability of candidates to correctly interpret "board size" and identify board composition.

Marking Guide		**Marks**	**Marks**
a.	Definition of unitary board	1	
	Defence for unitary board 1 mark x 4	<u>4</u>	5
b.	Core roles of a board of directors 1 mark x 5		<u>5</u>
c.	Composition of unitary board of directors		
	½ mark x 4	2	
	Size of unitary board of directors 1 mark x 3	<u>3</u>	<u>5</u>
	Total		**<u>15</u>**