ICAN

ACCURACY & INTEGRITY

# THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

# PATHFINDER

## MAY 2019 DIET
## SKILLS LEVEL EXAMINATIONS

Question Papers

Suggested Solutions

Examiner's Reports

Plus

Marking Guides

# FOREWARD

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

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

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

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

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

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

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

## NOTES

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

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# SKILLS LEVEL EXAMINATION – MAY 2019

## FINANCIAL REPORTING

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. Explain why consolidated financial statements are useful to the users of financial statements as opposed to just the parent company's separate financial statements. (5 Marks)

b. You are provided with the following statement of financial position for Ajakaye Limited and Ajalorun Limited.

**Statement of financial position as at 31 March 2019**

| | **Ajakaye Ltd.** | **Ajalorun Ltd.** |
|---|---|---|
| | **₦'000** | **₦'000** |
| Non-current assets: | | |
| Property plant & equipment | 367,500 | 84,000 |
| Investment | 140,000 | -- |
| | 507,500 | 84,000 |
| **Current assets:** | | |
| Inventory at cost | 154,000 | 49,000 |
| Trade receivables | 101,500 | 73,500 |
| Bank balance | 70,000 | -- |
| | 325,500 | 122,500 |
| **Total Assets** | 833,000 | 206,500 |

| | | |
|---|---|---|
| **Equity and liabilities:** | | |
| Ordinary shares at ₦1 each | 490,000 | 119,000 |
| Retained earnings | 150,500 | 35,000 |
| | 640,500 | 154,000 |
| **Current liabilities:** | | |
| Trade payables | 192,500 | 38,500 |
| Bank overdraft | ______ | 14,000 |
| | 833,000 | 206,500 |

**The following information is also available:**

i. Ajakaye Ltd acquired 70% of the issued ordinary share capital of Ajalorun Ltd. four years ago, when the retained earnings of Ajalorun were ₦14million. There has been no impairment of goodwill;

ii. For the purpose of the acquisition, property plant & equipment with a carrying amount of ₦35million was revalued to its fair value of ₦42million. The revaluation was not recorded in the accounts of Ajalorun Ltd. Depreciation is charged at 20% using the straight line method;

iii. It is the group's policy to value non-controlling interest at fair value;

iv. The market price of the shares of the non-controlling shareholders just before the acquisition was ₦1.50;

v. Ajakaye Ltd sells goods to Ajalorun Ltd. at a markup of 25%. At 31 March 2019, the inventories of Ajalorun Ltd. included ₦31.5million of goods purchased from Ajakaye Ltd; and

vi. Ajalorun Ltd. owes Ajakaye Ltd. ₦24.5million for goods purchased and Ajakaye Ltd owes Ajalorun Ltd. ₦10.5million.

**You are required to:**

Prepare the consolidated statement of financial position of Ajakaye Group Ltd. as at 31 March, 2019. (20 Marks)

(c) Abuja Plc., a company with a subsidiary acquired 7,500,000 shares out of the 30million ₦1 ordinary shares in Abaji Ltd. for ₦15million on 1 January,2018. In the year to 31 December, 2018. Abaji Limited earned profit after tax of ₦6million from which it declared a dividend of ₦1,500,000.

**Required:**
Explain how Abaji Limited's result should be accounted for in the separate and consolidated accounts of Abuja Limited for the year ended 31 December, 2018. (5 Marks)

**(Total 30 Marks)**

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

**QUESTION 2**

Babafrayo Nig. Ltd. is a company located in Lagos and is engaged in hotel and tourism business. The financial statements of the company are as follows:

**Statement of profit or loss and other comprehensive income for the year ended 31 December, 2018**

| | ₦'000 |
|---|---|
| Revenue | 994,500 |
| Cost of sales | (884,000) |
| Gross profit | 110,500 |
| Admin expenses | (21,250) |
| Distribution cost | (44,200) |
| Finance costs | (4,250) |
| Profit before taxation | 40,800 |
| Income tax expense | (5,100) |
| Profit for the year | 35,700 |
| Other comprehensive income: | |
| Gains on property revaluation | 17,000 |
| Total comprehensive income | 52,700 |

**Statement of financial position as at 31 December, 2018**

| | 2018 | 2017 |
|---|---|---|
| **Non-current assets:** | **₦'000** | **₦'000** |
| Property plant & equipment | 242,250 | 174,250 |
| | 242,250 | 174,250 |
| | | |
| **Current assets:** | | |
| Inventories | 49,300 | 51,000 |
| Trade receivables | 35,700 | 25,500 |
| Cash and cash equivalent | 2,550 | 4,250 |
| **Total current assets** | 87,550 | 80,750 |
| | 329,800 | 255,000 |

| | | |
|---|---|---|
| **Equity and liabilities:** | | |
| Equity | | |
| Share capital | 93,500 | 76,500 |
| Share premium | 17,000 | 8,500 |
| Retained earnings | 83,300 | 51,850 |
| **Non-current liabilities:** | | |
| Loan notes | 80,750 | 68,000 |
| | | |
| **Current liabilities:** | | |
| Trade payables | 24,650 | 27,200 |
| Bank overdraft | 1,700 | 10,200 |
| Current tax payable | 3,400 | 4,250 |
| | 29,750 | 41,650 |
| | **329,800** | **255,000** |

**Additional information**

(i) Property, plant and equipment with a carrying value of ₦23,800,000 was sold during the year ended 31 December 2018 for ₦24,650,000. The asset had originally cost ₦38,250,000.

(ii) Depreciation on property, plant and equipment for the year 2018 amounted to ₦34,000,000.

(iii) Dividend paid during the year 2018 amounted to ₦4,250,000 and is reported in the statement of changes in equity for the year.

**Required:**

a. Prepare statement of cash flows for the year ended 31 December 2018 in accordance with IAS 7 using indirect method. (12 Marks)

b. Prepare net cash flows from operating activities **only** using the direct method. (6 Marks)

c. Discuss the advantages of the direct method of preparing statement of cash flows over the indirect method. (2 Marks)

**(Total 20 Marks)**

**QUESTION 3**

Shown below are the financial statements of Kobape Limited for its most recent two years.

**Extract from statement of profit or loss for the year ended 30 April**

| | **2019** | **2018** |
|---|---|---|
| | **₦'000** | **₦'000** |
| Revenue | 224,000 | 195,000 |
| Cost of sales | (169,200) | (136,500) |
| Gross profit | 54,800 | 58,500 |
| Administrative costs | (32,700) | (38,040) |
| Distribution costs | (10,900) | (12,680) |

| | | |
|---|---|---|
| Finance cost – loan note interest | (1,900) | (1,380) |
| | 9,300 | 6,400 |

**Statement of financial position as at 30 April**

| | 2019 | | 2018 | |
|---|---|---|---|---|
| **Assets** | **₦'000** | **₦'000** | **₦'000** | **₦'000** |
| Non-current assets | | 37,000 | | 28,600 |
| Current assets: | | | | |
| Inventory | 12,800 | | 9,800 | |
| Trade receivables | 24,600 | | 21,600 | |
| Cash balance | 1,600 | | 2,400 | |
| | | 39,000 | | 33,800 |
| **Total assets** | | **76,000** | | **62,400** |
| | | | | |
| **Equity and liabilities** | | | | |
| Ordinary share capital | | 16,000 | | 16,000 |
| Retained earnings | | 26,200 | | 18,600 |
| | | 42,200 | | 34,600 |
| **Non-current liabilities:** | | | | |
| 10% loan notes | | 16,000 | | 12,000 |
| Current liabilities: | | | | |
| Bank overdraft | 2,200 | | 1,600 | |
| Trade payables | 15,000 | | 13,800 | |
| Taxation | 600 | | 400 | |
| | | 17,800 | | 15,800 |
| **Total equity and liabilities** | | **76,000** | | **62,400** |

The following are the ratios calculated for Kobape Limited based on the financial statements of the previous year and also the latest industry average ratios:

| | **Kobape Ltd 30 April 2018** | **Industry Average** |
|---|---|---|
| Net profit margin | 3.99% | 4.73% |
| ROCE (Capital employed = equity + loan notes) | 16.69% | 18.50% |
| Asset turnover | 4.19times | 3.91times |
| Current ratio | 2.14:1 | 1.90:1 |
| Quick ratio | 1.52:1 | 1.27:1 |
| Gross profit margin | 30.0% | 35.23% |
| Account receivables collection period | 40days | 52days |
| Account payables payment period | 37days | 49days |
| Inventory turnover (Times) | 13.9times | 18.3times |
| Gearing ratio | 25.75% | 32.71% |

**Required:**

a. Calculate the cash operating cycle of Kobape Limited for the year ended 30 April, 2018 and 2019. (5 Marks)

b. Calculate the comparative ratio(s) (to two decimal places where appropriate) for Kobape Limited for the year ended 30 April, 2019. (5 Marks)

c. Draft a report addressed to the board of directors of Kobape Limited, analysing the performance of the company for the year 2019 based on the result of the previous year and the industry average. (10 Marks)

**(Total 20 Marks)**

**QUESTION 4**

a. The objectives of IAS 16 is to prescribe the accounting treatment of property, plant and equipment (PPE).

**Required:**
Explain how initial costs of property, plant and equipment (PPE) should be measured and state the circumstances in which subsequent expenditure on non-current assets should be capitalised. (7 Marks)

b. You are a senior accounting officer in Chidinma Ventures Plc. The chief accountant of the company has requested you to explain to some newly recruited trainee accountants, the requirements of IAS 16 as regards the revaluation of non-current assets and accounting treatment of surpluses and deficits on revaluation as well as gain and losses on disposal of assets.

**Required:**
Explain the transactions as required by the chief accountant. (5 Marks)

c. Chidinma Ventures Plc. acquired a 12 years lease on a property on 1 October, 2016 at a cost of ₦132million. The company's policy is to revalue its properties to their market value at the end of each year.

Accumulated amortisation is eliminated and the property is restated to the revalued amount. Annual amortisation is calculated on the carrying values at the beginning of the year. The market values of the property on 30 September 2017 and 2018 were ₦127.05million and ₦96.25million respectively. The existing balance on the revaluation surplus at 1 October, 2016 was ₦27.5million. This is related to some non-depreciable land whose value had not changed significantly since 1 October 2016.

**Required:**
Prepare extracts of the statement of profit or loss and statement of financial position for the year ended 30 September 2017 and 2018 in respect of the leasehold property. (8 Marks)

**(Total 20 Marks)**

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

**QUESTION 5**

Grandkano Nig. Plc. is a company listed on the Nigerian Stock Exchange (NSE) and located in the northwestern part of the country.

The company has been paying yearly penalties to NSE in respect of non-disclosure of related party transactions in its published financial statements.

The company has therefore approached a partner in your firm to assist in this regard in order to avoid payment of these yearly penalties.

The partner in your firm has requested for a list of all transactions with parties connected with the company and the directors of the company provided the following summary:

(i) A factory building had been sold to the brother of Alhaji Nagode the Managing director of Grandkano Nig. Plc. for ₦300million (net of selling cost of ₦5miilion). The market value of the property (factory building) was ₦322.5million.

The carrying amount of the factory building was ₦375million and its value in use was ₦270million.

(ii) Every month Grandkano Nig. Plc sells ₦750,000 worth of goods to Malam Bayero the finance director. The finance director has set up a small retail business for his son (Dongoyaro) and the goods are sold at cost price to him.

The annual turnover of Grandkano Nig. Plc is ₦4.5billion. Also Malam Bayero has purchased his official company's car from the company for ₦675,000 (market value ₦1.2million). Malam Bayero earns a salary of ₦7.5million per annum and he is a very wealthy man.

**Required:**
Draft a report that the partner will present to the Chairman of the board of directors of Grandkano Nig. Plc. Your report should cover the following:

a. Reasons why it is important to disclose related party transactions. (5 Marks)

b. The nature of any disclosures required in transactions (i) and (ii) above under IAS 24 related party disclosures. (10 Marks)

**(Total 15 Marks)**

## QUESTION 6

a. A company might incur significant interest cost if it has to raise a loan to finance the purchase or construction of an asset. IAS 23 on borrowing costs defines borrowing costs and sets out guidance on the circumstances under which such interest are to be capitalised as part of the cost of qualifying assets.

**Required:**
Discuss the conditions that must be met in order to capitalise borrowing cost under IAS 23, setting out when capitalisation of the borrowing cost should commence, be suspended or cease. (8 Marks)

b. JACKO Company Limited has three major sources of borrowings stated below as at 1 January 2018.

| Types | Average loan in the year | Interest expense incurred in the year | Income earned from temporary investment of the amount borrowed |
|---|---|---|---|
| | ₦'000 | ₦'000 | ₦'000 |
| 7 years loan notes | 128,000 | 20,000 | 12,480 |
| 10 years loan notes | 160,000 | 14,400 | -- |
| Bank overdraft | 80,000 | 14,400 | -- |

The 7 years loan notes has been specifically raised to fund the building of a qualifying asset.

During the year to 31 December, 2018 Jacko Company Limited spent ₦144million on the building and the fair value of building is ₦147million as at 31 December, 2018.

The company also incurred the following expenditure on a qualifying project funded from the other borrowings for the year ended 31 December 2018.

| Date Incurred | Amount (₦'000) |
|---|---|
| 31 March, 2018 | 16,000 |
| 31 July, 2018 | 19,200 |
| 31 October, 2018 | 12,600 |

**Required:**
Calculate the amount to be capitalised in respect of the qualifying capital work- in-progress for the year ended 31 December 2018. (7 Marks)

**(Total 15 Marks)**

## QUESTION 7

a. Soft Solutions Limited is a Nigerian company that specialises in the development of software applications. The company has been in operation for over 16 (sixteen) years and they have invested considerable amount of money internally, in developing accounting and banking softwares. The treatment of these assets is prescribed by IAS 38 – Intangible Assets.

**Required:**

As a partly qualified accountant working in the accounts department of Soft Solutions Limited, the financial controller of the company asked you for a memo which addresses the following:

i. Whether internally developed intangible assets should be recognised and if so, how should they be recorded initially and subsequently accounted for. (5 Marks)

ii. The criteria for revaluation of intangible assets? (3 Marks)

b. During the year ended 31 December, 2018 Soft Solutions Limited carried out the following transactions:

- ₦720m was spent on developing a new "Microfinance Software" which received the approval of software regulatory authority in Nigeria on 1 July, 2018 and is proving commercially successful.

  The financial controller expects the project to be in profit within 12 months of the approval date. The patent was registered with Federal Ministry of Trade and Investment on 1 July, 2018; it costs ₦180m and remains in force for three years.

- On 1 September, 2018 Soft Solutions Limited acquired an up to date list of Global Positioning System (GPS) at a cost of ₦60m and the company has been visiting the tracked customers to explain the operations of the new microfinance software in rural and urban areas. This is expected to generate sales throughout the life-cycle of the microfinance software.

- A research project was set up on 1 October, 2018 which is expected to result in a new banking software called "Recent Bankers". ₦24m was spent on computer equipment and ₦48m on staff salaries. The equipment has an expected life of four years.

**Required:**

Using the above information:

i. Prepare the extract of statement of financial position of Soft Solutions Limited as at 31 December, 2018. (5 Marks)

ii. Prepare the summary of the cost to be charged to statement of profit or loss for the year ended 31 December, 2018. (2 Marks)

**(Total 15 Marks)**

## SOLUTION 1

(a) **Usefulness of consolidated financial statements to users of group financial statements**

- The main reason for preparing consolidated accounts is that the group operates as a single economic unit and it is not possible to understand the affairs of the parent without taking into account the financial position and performance of all companies that it controls.

- The directors of the parent should be held fully accountable for all money they have invested on their shareholders' behalf, done directly by parent or via subsidiary.

- The parent's own financial statements only shows the original cost of the investment and the dividends received from the subsidiary, and this sometimes hide the true value and nature of the investment in the subsidiary hence without consolidation this could be used to manipulate the reporting result of the parent.

- Without showing the consolidated results, the assets and liabilities of the subsidiary are disguised e.g. a subsidiary could be very highly geared, making its liquidity and profitability volatile. Also, a subsidiary assets might consist of intangible assets or other assets with highly subjective value.

- The parent sometimes control the dividend policy of the subsidiary, enabling it to smooth-out profit fluctuations with a steady dividend; consolidation will reveal the underlying profit of the group.

- Over time the net assets of the subsidiary could increase, but the cost of the investment will stay fixed and will soon bear no relationship to the true value of the subsidiary.

- It enables users to view the group performance and how members of the group is contributing to the performance.

- An investment in a company is usually included in the statement of financial position of the parent at cost and this does not reflect the substance of the situation. It is the consolidated financial statement that reflects the reality of the substance of the situation.

b. i. **Ajakaye Ltd**
**Consolidated statement of financial position**
**As at March 31, 2019**

| **Non-current assets** | **Notes** | **₦'000** | **₦'000** |
|---|---|---|---|
| Property plant & equipment | (w1) | | 452,900 |
| Goodwill | (w2) | | 53,550 |
| **Current assets:** | | | |
| Inventory | (w3) | 196,700 | |
| Trade receivables | (w4) | 140,000 | |
| Bank | | 70,000 | |
| | | | 406,700 |
| | | | 913,150 |
| **Equity & liabilities** | | | |
| Share capital | | | 490,000 |
| Retained earnings | (w5) | | 154,980 |
| | | | 644,980 |
| Non-controlling interest (NCI) | (w6) | | 58,170 |
| | | | 703,150 |
| **Current liabilities:** | | | |
| Trade payables | | 196,000 | |
| Bank overdraft | | 14,000 | |
| | | | 210,000 |
| | | | 913,150 |
| | | | |

| | **Working notes** | **₦'000** | **₦'000** |
|---|---|---|---|
| (w1) | **Property plant & equipment** | | |
| | Ajakaye Ltd. | | 367,500 |
| | Ajalorun Ltd: | | |
| | As per question | 84,000 | |
| | Revaluation reserve (42,000-3 5,000) | 7,000 | |
| | Depreciation on revalued plant (7,000 x 20% x 4) | (5,600) | |
| | | | 85,400 |
| | | | 452,900 |
| | | | |
| (w2) | **Goodwill** | | |
| | Consideration transferred | | 140,000 |
| | FV of NCI (30% x 119,000 x ₦1.50) | | 53,550 |
| | Less: | | |
| | Net asset acquired: | | |
| | Share capital | 119,000 | |
| | Retained earnings | 14,000 | |

| | | | |
|---|---|---|---|
| | Revaluation surplus (40,000 – 35,000) | 7,000 | |
| | | | 140,000 |
| | | | 53,550 |
| (w3) | **Inventory:** | | |
| | Ajakaye Ltd | | 154,000 |
| | Add: | | |
| | Ajalorun Ltd: | 49,000 | |
| | Less: | | |
| | Unrealised profit (URP (31,500 x $^{25}/_{125}$) | (6,300) | |
| | | | 42,700 |
| | | | 196,700 |
| | | | |
| (w4) | **Trade receivables** | | |
| | Ajakaye Ltd | | 101,500 |
| | Less: Intra- group transactions | | (24,500) |
| | | | 77,000 |
| | Ajalorun Ltd | 73,500 | |
| | Less: Intra- group transactions | (10,500) | |
| | | | 63,000 |
| | | | 140,000 |
| | | | |
| (w5) | **Retained earnings** | Ajakaye | Ajalorun |
| | | N'000 | N'000 |
| | As per question | 150,500 | 35,000 |
| | UR Profit (w3) | (6,300) | |
| | Excess depreciation PPE (w1) | | (5,600) |
| | Profit at date of acquisition (pre profit) | | (14,000) |
| | Total Post-acquisition profit of Ajalorun Ltd | | 15,400 |
| | Add: | | |
| | Share of Ajalorun post acquisition profit (15,400 x 70%) | 10,780 | |
| | | 154,980 | |
| | | | |
| (w6) | **Non-controlling Interests** | | |
| | At acquisition (w2) | | 53,550 |
| | NCI Share of post-acquisition profit (15,400 x 30%) | | 4,620 |
| | | | 58,170 |
| | | | |
| (w7) | **Trade payables** | | |
| | Ajakaye Ltd | | 192,500 |
| | Less: Intra- group Ajalorun Ltd | | (10,500) |
| | | | |
| | Ajalorun Ltd. | 38,500 | 182,000 |
| | Less: Intra- group | (24,500) | 14,000 |
| | | | 196,000 |

b. ii. Explanation of the treatment of results of associates in Abuja Plc's separate and consolidated financial statements.

**Treatment in separate account**

- In the separate financial statement of Abuja Ltd. investment in Abaji Ltd will be stated at cost or cost less any impairment (fair value) i.e. – Also ₦15,000,000 investment will be recognised in the separate statement of financial position of Abuja Plc.

- Also in statement of profit or loss of Abuja Plc. dividend received of (₦1,500,000 x 25%) ₦375,000 will recognised as income from shares in associates.

**Treatment in consolidated account**

In the consolidated financial statements of the Abuja Plc., investment in associates will be accounted for using equity method as follows:

| | ₦'000 |
|---|---|
| Cost of investment | 15,000 |
| Add: Share of post-acquisition profit from associates (₦6,000,000 x 25%) | 1,500 |
| Carrying amount of investment | 16,500 |

Therefore investment in associates in Abuja Plc. statement of financial position will be ₦16,500,000 and consolidated statement of profit or loss will show income from associates as ₦1,500,000.

**EXAMINER'S REPORT**

**The question tests candidates' knowledge of the preparation of consolidated statement of financial position, treatment of the results of associated companies in group financial statements and usefulness of consolidated financial statements.**

**Majority of the candidates attempted the question and performance was below average.**

**The commonest pitfalls include the following:**

- **Inability of the candidates to explain why consolidated financial statements are useful to users of financial statements as opposed to just the parent company's separate financial statement.**

- **Failure of some candidates to be able to give correct explanation of the treatment of the associates results in the parent company's separate financial statement and in the consolidated financial statements.**
- **Also some of the candidates could not correctly calculate the goodwill arising from consolidation and non-controlling interest (NCI).**

**Candidates are advised to cover all areas of the syllabus relating to preparation of consolidated statement of financial position.**

## MARKING GUIDE

| | | Marks | Marks |
|---|---|---|---|
| Explanation of usefulness of consolidated financial statements (any 5 points at 1 mark each) | | | 5 |
| i. | Preparation of consolidated statement of Financial position: | | |
| | - Correct title of statement | $^1/_3$ | |
| | - Determination of Goodwill on consolidated | 3 | |
| | - Determination of consolidated PPE | 3 | |
| | - Determination of consolidated current assets | $5^1/_3$ | |
| | - Determination of non-controlling interest | $1^1/_3$ | |
| | - Determination of consolidated retained earnings | $3^1/_3$ | |
| | - Determination of consolidated current liabilities | $3^1/_3$ | |
| | - Stating the share capital | $\underline{^1/_3}$ | $\underline{20}$ |
| ii | Explanation of treatment of results of associations: | | |
| | Treatment in separate financial statement | | |
| | - Investment to be stated at cost or fair value | ½ | |
| | - Amount for investments to be disclosed in statement of financial position | 1 | |
| | - Amount for dividend received to be disclosed in income statement | 1 | |
| | * Treatment in consolidated financial statement | | |
| | - Amount for investments using equity method to be disclosed in statement of financial position | 1½ | |
| | - Amount for income from associate disclosed in statement of profit of loss | $\underline{1}$ | $\underline{5}$ |
| | Total marks | | $\underline{30}$ |

## SOLUTION 2

(a) **Babafrayo Nig. Ltd.**

**Statement of cash flows for the year ended December 31, 2018**

| <u>Cash flow from operating activities:</u> | Notes | ₦'000 | ₦'000 |
|---|---|---|---|
| Profit before taxation | | | 40,800 |
| Adjustments: | | | |
| Depreciation | | 34,000 | |
| Profit on sale of PPE | (w1) | (850) | |

| | | | |
|---|---|---|---|
| Interest Exp. (finance cost) | | 4,250 | |
| | | | 37,400 |

| | | | |
|---|---|---|---|
| **Movement in working capital:** | | | |
| Increase in trade receivables | | (10,200) | |
| Decrease in inventories | | 1,700 | |
| Decrease in trade payables | | (2,550) | |
| | | | (11,050) |
| Cash generated from operations | | | 67,150 |
| Interest paid | | | (4,250) |
| Income tax paid | (w2) | | (5,950) |
| Net cash flow from operating activities | | | 56,950 |
| **Cash flow from investing activities** | | | |
| Acquisition of PPE | (w3) | (108,800) | |
| Proceed from sale of PPE | | 24,650 | |
| | | | (84,150) |
| **Cash flow from financing activities:** | | | |
| Proceeds from issue of shares (17,000 + 8,500) | | 25,500 | |
| Proceed from increase in loan notes (80,750 – 68,000) | | 12,750 | |
| Dividend paid | | (4,250) | |
| | | | 34,000 |
| Net increase in cash and cash equivalent | | | 6,800 |
| Opening cash & cash equivalent (10,200 – 4,250) | | | (5,950) |
| Closing cash and cash equivalent | | | 850 |
| **Cash analysis:** | | | |
| Cash & Bank 2018 | | 2,550 | |
| Bank overdraft 2018 | | (1,700) | |
| | | 850 | |

**Working notes (a):**

| | | |
|---|---|---|
| **W1** | **Profit on sale of PPE** | **₦'000** |
| | Costs | 38,250 |
| | Accumulated depreciation | (14,450) |
| | | 23,800 |
| | Sales proceeds | 24,650 |
| | Profit on sale of PPE | 850 |

**W2 Income tax**

**Current income tax payable**

| | ₦'000 | | ₦'000 |
|---|---|---|---|
| | | b/d | 4,250 |
| Cash/bank | 5,950 | | |
| | | P or L | 5,100 |
| C/d | 3,400 | | |
| | 9,350 | | 9,350 |

**W3 Property plant & equipment**

| | ₦'000 | | ₦'000 |
|---|---|---|---|
| B/d | 174,250 | | |
| | | Deptn. (P Or L) | 34,000 |
| Revaluation surplus | 17,000 | Disposal – carrying value | 23,800 |
| Purchase of PPE | 108,800 | C/d | 242,250 |
| | 300,050 | | 300,050 |

(b) Net Cash flows from operating activities – using direct method for the year end 31 December, 2018

| | Notes | ₦'000 |
|---|---|---|
| Cash received from customers | (w4) | 984,300 |
| Cash paid to suppliers<br>Cash paid to employees | (w6)<br>(w7) | (884,850)<br>(32,300) |
| | | 67,150 |
| Interest exp. paid | | (4,250) |
| Taxation paid | (w2) | (5,950) |
| | | 56,950 |

**Working notes for (b)**

**W4 Trade receivables**

| | ₦'000 | | ₦'000 |
|---|---|---|---|
| B/d | 25,500 | | |
| Revenue | 994,500 | Cash received from customers | 984,300 |
| | | C/d | 35,700 |
| | 1,020,000 | | 1,020,000 |

**W5** **Inventories**

| | ₦'000 | | ₦'000 |
|---|---|---|---|
| B/d | 51,000 | | |
| | | Cost of Sales | 884,000 |
| Purchases | 882,300 | | |
| | | C/d | 49,300 |
| | 933,300 | | 933,300 |

**W6** **Trade payables**

| | ₦'000 | | ₦'000 |
|---|---|---|---|
| | | B/d | 27,200 |
| Payment to supplies | 884,850 | Purchases (w5) | 882,300 |
| C/d | 24,650 | | |
| | 909,500 | | 909,500 |

**W7** **Cash paid to employee & other overheads**

| | ₦'000 | ₦'000 |
|---|---|---|
| Admin Exp. | 21,250 | |
| Distribution costs | 44,200 | |
| | | 65,450 |
| Adjustments: | | |
| Depreciation | | (34,000) |
| Profit on disposal of PPE | | 850 |
| | | 32,300 |

(c) **Advantages of direct method of preparing statement of cash flows**

(i) Direct method of preparing cash flows discloses major class of gross receipts and gross cash payments not shown by indirect method.

(ii) It shows the items that affect cash flows and size of those cash flows e.g. cash received from customers, cash paid to suppliers and employees.

(iii) Users of financial statements also see and understand the actual cash flows and how they relates to income and expenses.

(iv) It also discloses information not directly available in financial statements which could be used in estimating future cash flows.

(v) The direct method is easier to understand than the indirect method.

## EXAMINER'S REPORT

The question tests the candidates' knowledge of preparation of statement of cash flows using indirect and direct methods, as well as the explanation of the advantages of direct method of preparing statement of cash flows over that of indirect method.

About eighty percent (80%) of the candidates attempted the question and performance was above average.

However, some candidates could not correctly calculate the net cash flow from operating activities using the direct method, and this led to loss of marks. Also few of the candidates could not state the major advantages of direct method of preparing statement of cash flows over the indirect method.

Candidates are advised to pay more attention to international financial reporting standards (IAS 7) on statement of cash flows and to also ensure that they practise past questions on statements of cash flows for better performance in future examinations.

## MARKING GUIDE

| | | Marks | Marks |
|---|---|---|---|
| (a) | Preparation of statement cash flows: | | |
| | Determination of cashflows from operating activities | 6 | |
| | Determination of cashflows from investing activities | 3 | |
| | Determination of cashflows from financing activities | 3 | 12 |
| (b) | Presentation of cashflows from operating activities using the direct method (any 18 ticks at $^1/_3$ each) | | 6 |
| (c) | Advantages of direct method of preparing statement of cashflows | | 2 |
| | ($^1/_2$ mark each for any 4 points) | | |
| | Total marks | | 20 |

## SOLUTION 3

(a)

| Kobape Limited | | |
|---|---|---|
| Computation of cash operating cycle for the year ended 30 April, 2018 and 2019 | | |
| | April 30, 2019 | April 30, 2018 |
| Inventory days period | 28 days | 26 days |
| Receivable collection period | 40 days | 40 days |
| Payable payments period | (32 days) | (37 days) |
| Cash operating cycle (in days) | 36 days | 29 days |

| Workings | | |
|---|---|---|
| Inventory days period = Inventory x 365 days / Cost of Sales | 12,800 x 365 days / 169,200 = 28days | 9,800 x 365 days / 136,500 = 26days |
| Receivable collection period = Trade rec. x 365 days / Revenue | 24,600 x 365 days / 224,000 = 40days | 21,600 x 365 days / 195,000 = 40days |
| Payable payments period = Trade payable x 365 days / Purchases | 15,000 x 365 days / 169,200 = 32days | 13,800 x 365 days / 136,500 = 37days |

(b)

**Kobape Limited**
**Computation of comparative ratios for the year ended 30 April, 2019**

| | 2019 |
|---|---|
| Net profit margin = PBIT / Revenue x 100 | (9,300+1,900) x 100 / 224,000 = 5% |
| Return on capital employed (ROCE) = Profit before interest and tax x 100 / Capital Employed (Equity + loan note) | (9,300+1,900) x 100 / (42,200+16,000) = 19.24% |
| Asset turnover = Revenue / Capital employed | 224,000 / 58,200 = 3.85 times |
| Current ratio = Current assets / Current liabilities | 39,000 / 17,800 = 2.19:1 |
| Quick ratio = Current assets – Inventory / Current liabilities | 39,000 – 12,800 / 17,800 = 1.47:1 |
| Gross profit margin = Gross profit x 100 / Revenue | 54,800 x 100 / 224,000 = 24.46% |
| Account receivable collection period = Trade rec. x 365 days / Revenue | 24,600 x 365 days / 224,000 = 40days |
| Account payable payments period = Trade payable x 365 days / Purchases | 15,000 x 365 days / 169,200 = 32days |
| Inventory turnover = Cost of sales / Average Inventory | 169,200 / 12,800 = 13.2times |
| Gearing ratio = Long term debt / Long term fund x 100 / 1 | 16,000 x 100 / (42,200+16,000) = 27.49% |

(c) **To:** Board of directors

**From:** Accountant **Date:** xx/xx/xx

**Subject:** Analysis of performance of Kobape Limited

This report should be read in conjunction with the appendix attached, which shows the relevant ratios.

i. **Trading and profitability**

Return on capital employed has improved considerably between 2018 and 2019 and is now higher than the industry average.

Net profit as a proportion of sales has also improved noticeably between the years and is also now marginally ahead of the industry average. Gross margin, however, is considerably lower than in the previous year and is only about 70% of the industry average. This suggests, either that there has been a change in the cost structure of Kobape Limited or that there has been a change in the method of cost allocation between the periods. Either way, this is a marked change that requires investigation. The company may be in a period of transition as sales have increased by nearly 15% during the year and it would appear that new non-current assets have been purchased.

Asset turnover has declined between the periods although the 2019 figure is in line with the industry average. This reduction might indicate that the efficiency with which assets are used has deteriorated or it might indicate that the assets acquired in 2019 have not yet fully contributed to the business. A longer term trend would clarify the picture.

ii. **Liquidity and working capital management**

The current ratio has improved slightly during the year and is marginally higher than the industry average. It is also in line with what is generally regarded as satisfactory (2:1).

The quick ratio has declined marginally but is still better than the industry average. This suggests that Kobape Limited has no short term liquidity problems and should have no difficulty in paying its debts as they become due.

Receivables as a proportion of sales is unchanged from 2018 and are considerably lower than the industry average. Consequently, there is probably little opportunity to reduce this further and there may be pressure in the future from customers to increase the period of credit given. The period of credit taken from suppliers has fallen from 37 days purchases to 32 days and is much lower than the industry average; thus, it may be possible to finance any additional purchases by negotiating better credit terms from suppliers.

Inventory turnover has fallen slightly and it is much slower than the industry average, this may partly reflect stocking up ahead of a significant increase in sales. Alternatively, there is some danger that the inventory could contain certain obsolete items that may require writing off. The relative increase in the level of inventory has been financed by increased overdraft which may reduce if the inventory levels can be brought down.

iii. **Gearing**
The level of gearing has increased only slightly during the year and is below the industry average. Since the return on capital employed is nearly twice the rate of interest on the loan notes, profitability is likely to be increased by a modest increase in the level of gearing.

Signed: Accountant

**EXAMINER'S REPORT**

**The question tests the following areas of the syllabus:**

- **computation of cash operating cycle;**
- **calculation of comparative ratios of a Limited Liability Company; and**
- **interpretation of the comparative ratios calculated, presenting the interpretations in report format.**

**Majority of the candidates attempted the question and performance was average.**

**The commonest pitfalls of the candidates include the following:**

- **their inability to correctly calculate the cash operating cycles**
- **some of the candidates could not correctly interprete the comparative ratios calculated**
- **while others did not present their interpretation in report format despite the fact that the examiner specifically requested for this, hence it led to loss of marks**

**Candidates are advised to pay more attention to this area of the syllabus and they should also adhere strictly to examiner's instructions for better performance in future examinations of the Institute.**

**MARKING GUIDE**

| | | Marks | Marks |
|---|---|---|---|
| (a) | Calculation of cash operating cycles: | | |
| | Determination of inventory day period | | |
| | Determination of receivable collection period | | |
| | Payable payments period | 2½ | |
| | Stating cash operating cycle | 2½ | 5 |
| | | | |
| (b) | Computation of comparative ratios: | | |
| | Stating of correct formulae for ratios | 2½ | |
| | Correct calculation of ratios | 2½ | 5 |

(c) Report of Board of Directors:

| | | |
|---|---|---|
| Presentation in report format | 1 | |
| Correct interpretation of profitability | 3 | |
| Correct interpretation of liquidity | 3 | |
| Correct interpretation of gearing | 2 | |
| Signing the report | <u>1</u> | <u>10</u> |
| Total marks | | <u>20</u> |

**SOLUTION 4**

a. **How initial cost of property plant and equipment are measured**

The costs of an item of property plant and equipment must be recognised as an asset if and only if:

- It is probable that future economic benefit associated with the item will flow to the entity; and
- The cost of the item can be measured reliably.

Cost comprise the following components:

- Purchase price less trade discount or rebates but not settlement discount.
- Import duties and non-refundable purchase taxes.
- The directly attributable costs of bringing the assets to working condition for its intended use. These costs include the cost of site preparation, initial delivery and handling costs, installation costs and professional fees. Also included is the estimated costs of removing the assets and restoring the site to the extent that it is recognised as provision under IAS 37 - Provision, Contingent Liabilities and Contingent Assets.
- In case of self constructed assets, the principles are the same as for acquired assets. This may include labour costs of the entity's own employees. Abnormal costs such as wastage and errors are excluded.

**Circumstances in which subsequent expenditure on non-current assets should be capitalised**

- There may be subsequent expenditure on an item of property plant and equipment after its purchase and recognition.

  Such expenditure may be added to the carrying amount of the assets but only when the original criteria are met.

  All other subsequent expenditure is recognised as an expense as it is incurred.

- In practice it means that the expenditure is capitalised if it:
    - Improves the assets (for example by enhancing its performance or extending its useful life) or

    - Is for a replacement part (provided that the part that it replaces is treated as an item that has been disposed off).

(b) **Revaluation of non-current assets:** This is the process required to accurately describe the true value of the non-current assets. This will enable the non-current assets to reflect the current market value. IAS 16 permits an entity to revalue its assets after complying with the following requirements:

i. Revaluation should be carried out with subsequent regularity so that the carrying amount of an asset does not differ from the fair value at the end of reporting date. (constant revaluation);

ii. Once an item of PPE is revalued, the entire class to which it belongs must be subsequently revalued; and

iii. The revalued amount should be depreciated over the remaining useful life of the assets.

**Revaluation surplus:** This is the excess of the revalued amount of an asset over its carrying amount. This should be treated as part of owners' equity by debiting the non-current assets and crediting the owners' equity (Revaluation surplus).

**Revaluation deficit:** This is the excess of the carrying amount of an asset over its revalued amount. This should be recognised as an expense in the statement of profit or loss and other comprehensive income by debiting the profit or loss and crediting the assets. However, if there had been a credit balance in revaluation reserve the deficit should be set-off against that balance.

**Gain on disposal of non-current asset:** This occurs when the net proceeds from disposal of an asset is in excess of its carrying amount. This should be recognised as an income in the statement of profit or loss.

**Loss on disposal of non-current asset:** This occurs when the carrying amount of the asset is in excess of net proceeds from disposal of the asset. It should be recognised as an expense in the statement of profit or loss.

(c) **Chindima ventures Plc extract of statement of profit or loss for the year to 30 September**

| | 2017 | 2018 |
|---|---|---|
| | **₦'000** | **₦'000** |
| Amortisation | (11,000) | (11,550) |
| Revaluation loss | -- | (13,750) |

**Statement of financial position extract as at 30 September**

| | 2017 | 2018 |
|---|---|---|
| | **₦'000** | **₦'000** |
| Leasehold property (w1) | 127,050 | 96,250 |
| Revaluation surplus: | | |
| B/f as at 1 Oct. 2016 | 27,500 | |
| Revaluation gain (w1) | 6,050 | |
| | 33,550 | |
| Transfer to retained earnings (6,050 x $^1/_{11}$) | (550) | |
| Portion of revaluation loss | (5,500) | |
| | 27,500 | |

**Workings:**

| W1 | ₦'000 |
|---|---|
| Cost 1/10/2016 | 132,000 |
| Amortisation = $\frac{132,000}{12}$ | (11,000) |
| 30/09/2016 | 121,000 |
| Revaluation gain | 6,050 |
| Carrying amount as at 30/09/2017 | 127,050 |
| B/d | 127,050 |
| Amortisation to 30/09/2018 | |
| $\frac{127,050}{11 \text{ years}}$ | (11,550) |
| | 115,500 |
| Revaluation loss to revaluation surpluses | (5,500) |
| Revaluation loss to profit or loss | (13,750) |
| Carrying amount 30 September 2018 | 96,250 |

**EXAMINER'S REPORT**

**The question tests candidates' knowledge of the application of the provisions of IAS 16 accounting for property plant and equipment.**

**Few of the candidates attempted the question and performance was below average.**

**Most of the candidates that attempted the question could not properly account for the leasehold property using the provisions of IAS 16, while other could not correctly explain revaluation of non-current assets, accounting treatments of surplus/deficit on revaluation as well as gain/losses on disposal of non-current assets.**

**Candidates are advised to familiarise themselves with provisions and applications of international financial reporting standards that are relevant at the skills level of the Institute's examination.**

**MARKING GUIDE**

| | **Marks** | **Marks** |
|---|---|---|
| Explanation of initial measurement of PPE and circumstances in which subsequent expenditure on non-current assets should be capitalised (any 7 points at 1 mark each) | | 7 |
| | | |
| Explanation of requirements of IAS 16 on: | | |
| Revaluation of non-current assets | 1 | |
| Revaluation surplus | 1 | |
| Revaluation deficit | 1 | |
| Gain on disposal of non-current assets | 1 | |
| Loss of disposal of non-current assets | 1 | 5 |
| | | |
| Preparation of extracts of financial statement: | | |
| Statement of profit or loss extract | 2 | |
| Statement of financial position extract | 4 | |
| Workings for applicable of statements | 2 | 8 |
| Total marks | | 20 |

**SOLUTION 5**

**REPORT**

**To**: The Chairman Board of Directors **Date:** May 2019

**From**: Partner XYZ & Co. (Chartered Accountants)

**Subject**: Related Party Transactions

(a) **Reasons why its important to disclose related party transactions:**

i. The user of financial statements will normally expect the financial statement to reflect transactions that have taken place on normal commercial terms (at arm's length).

ii. The users of financial statements would want to be informed if:

- Transactions have taken place that were not at arm's length; or

- There are parties that could enforce transactions on the entity that are not on an arm's length basis.

iii. The objective of IAS 24 is to ensure that an entity's financial statements contain sufficient disclosures to draw attention to the possibility that the entity's financial position or profit or loss may have been affected by:

- The existence of related parties; and
- Transactions and outstanding balances with related parties.

Therefore IAS 24 requires specific disclosure on:

- Related party relationship; and
- Related party transactions

(b) **Disclosures required: Transaction (1) – Factory building**

- The factory building sold to the brother of the Managing Director is a 'related party transaction' and it appears to have been undertaken below the market price.

- IAS 24 envisage disclosure of the substance of the transaction.

- IAS 24 requires disclosure of information about the transaction and outstanding balance necessary for an understanding of the potential effect of the relationship on the financial statements.

- Not only must the transaction itself be disclosed but the question of impairment due to fall in property prices must be considered.

- The factory building should be shown at lower of carrying value (₦375,000million) and recoverable amount.

  Recoverable amount is the higher of fair value less cost of disposal (₦322.5million less ₦5million) = ₦317.5m and value in use ₦270million.

Therefore the factory building was sold at a price lower than it value by (₦317.5m – ₦300million) = ₦17.5million. This should be highlighted in the notes under related party transaction.

**Transaction (ii) – Sale of good to finance director**

- Disclosure of related party transaction is only necessary when the transaction is material, therefore sales of ₦9m (₦750,000 x 12) is not material when compared to the turnover of ₦4.5billion.

- In this situation the transaction is not material to both the company and the finance director who is a wealthy person.

- However, IAS 24 confirms that the director is a related party and transactions with the director should be disclosed.

- IAS 24 requires disclosure of compensation paid to the director, compensation includes subsidised goods and benefit in kind. (e.g. sale of official company's car below the market value).

- Therefore details of the transaction should be disclosed including the amount of the transaction and any outstanding balance.

**EXAMINER'S REPORT**

**The question tests candidates' knowledge of the application of the provisions of IAS 24 on related party transactions.**

**About twenty-five percent (25%) of the candidates attempted the question and performance was poor.**

**Most of the candidates that attempted the question could not identify the reasons why it is important to disclose related party transactions in an entity's statement of financial position. Similarly, others could not correctly apply the provisions of the accounting standards to the scenarios provided by the examiner in the question and this led to loss of valuable marks.**

**Candidates are advised to pay special attention to the provisions and applications of IAS 24 on related party transactions.**

## MARKING GUIDE

| | | Marks | Marks |
|---|---|---|---|
| (a) | Report of Chairman of Board of Directors on related party transactions: | | |
| | - Stating appropriate reasons why it is import to disclose related party transactions (any four points at 1 mark each) | | 4 |
| (b) | Disclosures required for two related party transactions: | | |
| | i. Factory building (any five points at 1 mark each) | | 5 |
| | ii. Sale of good to Finance Director (any five points at 1 mark each) | | 5 |
| | Presentation in report format | | 1 |
| | Total marks | | 15 |

## SOLUTION 6

(a)

i. **Conditions to be met in order to capitalise borrowing cost**

Most borrowing costs are treated as an expense as incurred. However, a special case exists in the case of interest paid on money borrowed to bring substantial assets into use.

The required treatment is to capitalise such borrowing cost as part of the cost of the assets subject to the following conditions:

- the assets take a substantial period of time to get ready for its intended use or sale;

- the borrowing costs can be reliably measured;

- only cost incurred up to the time the asset is substantially ready for use may be considered for capitalisation;

- to the extent that the funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset shall be determined as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowing.

- If general borrowed funds are used to purchase the asset, then an average borrowing rate may be applied to expenditure on the assets, provided the total borrowing costs capitalised do not exceed the total borrowing cost incurred.

- The capitalised cost of any asset cannot exceed its recoverable amount.

ii. **Commencement of capitalisation**

Capitalisation of borrowing cost should start only when:

- Expenditure for the assets are being incurred;
- Borrowing costs are being incurred; and
- Activities necessary to prepare the asset have started.

**Suspension of capitalisation**

Capitalisation of borrowing costs should be suspended if development of the asset is suspended for an extended period of time. However, borrowing costs are not suspended when the delays are due to normal production process or for periods, when substantial technical or administrative work is taking place.

**Cessation of capitalisation**
Capitalisation of borrowing costs should cease when the asset is substantially completed. The costs that have been capitalised remain as a part of the asset's costs but no additional borrowing costs may be capitalised.

(b) **Amount to be capitalised in respect of building**

| | **₦'000** | **₦'000** |
|---|---|---|
| Cost incurred | | 144,000 |
| | | |
| Interest capitalised: | | |
| Actual interest exp. | 20,000 | |
| Less: Return on temp investment | (12,480) | |
| | | 7,520 |
| | | 151,520 |
| Less: | | |
| Impairment (151,520 - 147,000) | | (4,520) |
| Fair value to be capitalised | | 147,000 |
| | | |
| N:B | | ₦'000 |
| The net interest to be capitalised | | |
| (20,000 – 12,480 – 4,520) = | | 3,000 |

**Amount to be capitalised in respect of qualifying project**

| | ₦'000 | ₦'000 |
|---|---|---|
| Cost incurred | | |
| 31 March, 2018 | 16,000 | |
| 31 July, 2018 | 19,200 | |
| 31 Oct., 2018 | 12,600 | 47,800 |
| Add: | | |
| Interest capitalised for the period | | |
| 31 March, 2018 (16,000 x 12% (w1) x $^9/_{12}$ | 1,440 | |
| 31 July, 2018 (19,200 x 12% (w1) x $^5/_{12}$ | 960 | |
| 31 Oct, 2018 (12,600 x 12% (w1) x $^2/_{12}$ | 252 | 2,652 |
| | | 50,452 |
| Total amount to be capitalised (147,000 + 50,452) | | 197,452 |

**WORKINGS:**

(w1) Weight average interest rate

| **Other loans** | **Loan** | **Interest loan** |
|---|---|---|
| 10 year loan notes | 160,000 | 14,400 |
| Bank overdraft | 80,000 | 14,400 |
| | 240,000 | 28,800 |

Capitalisation rate = $\frac{28,800}{240,000} \times 100$ = 12%

**OR**

10 year loan notes = $\frac{14,400}{60,000} \times 100 = 9\%$

Bank overdraft = $\frac{14,400}{80,000} \times 100 = 18\%$

Weighted av rate = $9\% \times \frac{160,000}{240,000} + 18\% \times \frac{80,000}{240,000}$

$= 6\% + 6\% = 12\%$

## EXAMINER'S REPORT

The question tests candidates' knowledge of the provisions and application of IAS 23 on borrowing cost.

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

Most candidates were able to explain the basic provisions of the accounting standard, such as circumstances under which interest on borrowing cost should be capitalised. However, only few of the candidates were able to apply the provisions for the determination of the amount of interest on borrowing cost to be capitalised in respect of a qualifying capital work-in-progress.

Candidates are advised to pay more attention to various sections of the syllabus, particularly the relevant international financial reporting standards.

## MARKING GUIDE

| Solution 6 | | Marks | Marks |
|---|---|---|---|
| (a) | i. Conditions for capitalisation of borrowing cost (any 2 points at 1 mark each) | 2 | |
| | ii. Commencement, suspension and capitalisation of borrowing costs | | |
| | - Commencement of capitalisation (any 2 points at 1 mark each) | 2 | |
| | - Suspension of capitalisation (any 2 points at 1 mark each) | 2 | |
| | - Cessation of capitalisation (any 2 points at 1 mark each) | 2 | 8 |
| (b) | Calculation of amount to be capitalised: | | |
| | In respect of building | 3 | |
| | In respect of qualifying project | 3 | |
| | Determination of capitalisation rate | 1 | 7 |
| | Total marks | | 15 |

**SOLUTION 7**

a(i) **From**: Assistant accountant **Date**: xxxxxxx

**To**: Financial controller

**Subject**: Intangible assets

(i) Before an internally generated intangible assets can be recognised it must first of all meet all the definition of intangible assets as stipulated in IAS 38, that is:

- it must be controlled by the entity;
- it must be separably identifiable;
- it must be something from which the entity expects future economic benefit; and
- It must also meet the recognition criteria of having a cost that can be measured reliably.

- For these reasons internally-generated intangibles are not normally recognised as assets. They have not been acquired for a consideration and therefore do not have cost or value that can be measured reliably. For this reasons a brand name that has been acquired can be capitalised but a brand name that has been internally developed cannot be capitalised. The exception to this is development cost which can be capitalised if or when they meet the IAS 38 criteria. They are initially recognised at cost.

- After initial recognition development costs are amortised over the life cycle of the product. If at any point it becomes apparent that the development cost no-longer meet the capitalisation criteria they should be written-off. Intangible assets with an indefinite useful life are not amortised but tested annually for impairment.

(ii) Paragraph 75 of IAS 38 states that revaluation must be at fair value at the date of the revaluation by reference to an active market.

Revaluation shall be made with regularity that at the end of the reporting period the carrying amount of the asset does not differ materially from its fair value.

An active market is a market where all the following condition exist:

- The items traded are identical;

- Willing buyers and sellers can normally be found at any time; and
- Prices are available to the public.

Intangible assets are carried at a valued amount less any subsequent accumulated amortisation and any subsequent accumulated impairment losses, where active market is no longer existing for an intangible asset, the carrying amount of the asset going forward is the revalued amount as at the date the of last revaluation.

(b) **Soft solutions Ltd**

**Extract of statement of financial position as at 31 december, 2018**

| | Notes | ₦'000 |
|---|---|---|
| Property plant & equipment | (w1) | 22,500 |
| Intangible asset | (w2) | 802,940 |

**Extract of statement of profit or loss for the year ended 31 dec., 2018**

| | ₦'000 |
|---|---|
| Depreciation (w1) | 1,500 |
| Amortisation (w2) | 157,060 |
| Staff salaries | 48,000 |

**WORKINGS:**

| **W1** | **Property Plant & equipment (PPE)** | **₦'000** |
|---|---|---|
| | Computer equipment | 24,000 |
| | Depreciation (24,000 x $^{3}/_{48}$) | (1,500) |
| | Carrying amount | 22,500 |

| **W2** | **Intangible assets** | | | |
|---|---|---|---|---|
| | **Patent** | **Development cost** | **Customers list** | **Total** |
| | **₦'000** | **₦'000** | **₦'000** | **₦'000** |
| Cost: | 180,000 | 720,000 | 60,000 | 960,000 |
| Amortisation: | | | | |
| Development ($^{6}/_{36}$) | -- | (120,000) | -- | (120,000) |
| Patent ($^{6}/_{36}$) | (30,000) | -- | -- | (30,000) |
| GPS ($^{4}/_{36-2}$) | -- | -- | (7,060) | (7,060) |
| | 30,000 | 120,000 | 7,060 | 157,060 |
| Carrying amount | 150,000 | 600,000 | 52,940 | 802,940 |

**EXAMINER'S REPORT**

**The question tests candidates' knowledge of the application of the provisions of IAS 38 on intangible assets.**

**Few of the candidates attempted the question and performance was very poor.**

**Most candidates displayed lack of knowledge of the accounting standard, has most of them could not apply the provisions of the standard hence they were unable to prepare the extracts of the financial statement, showing the statement of movement of intangible assets for the relevant year.**

**"International financial reporting standards" is one of the core areas of financial reporting syllabus of the Institute's examination, hence candidates are advised to pay more attention to them for better performance in future.**

**MARKING GUIDE**

| | | | Marks | Marks |
|---|---|---|---|---|
| (a) | Memo to financial controller on: | | | |
| | i. | Recongnition of internally generated intangibles | | |
| | | - Definition of intangibles | 1 | |
| | | - Reasons why internally generated intangibles are not reconised | 1 | |
| | | - Mentioning that acquired intangibles like brand name can be capitalised | 1 | |
| | | - Stating initial recognition of development cost which are amortised over the life cycle | 1 | |
| | ii. | Criteria for revaluation of intangible assets stating any three criteria at 1 mark each | 3 | |
| | | Presentation in memo format | 1 | 8 |
| (b) | i. | Preparation of statement of financial position extract (any ten ticks at ½ mark each) | 5 | |
| | ii. | Summary of statement of profit or loss (any four tick at ½ mark each) | <u>2</u> | <u>7</u> |
| | | | | <u>15</u> |

# THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

## SKILLS LEVEL EXAMINATION – MAY 2019

## 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**

ABC Limited was incorporated on 1 November, 2015 as a limited liability company to carry out general merchandise business. It commenced business on 1 January, 2016. Your firm was appointed as external auditors on 5 February, 2017 with a mandate to audit the company's accounts for the year ended 31 December, 2016. Following receipt of the signed copy of the engagement letter from the managing director, your team went to the company to commence the audit assignment.

Consequently, the audit manager in-charge assigned members of the audit team to the various job schedules as stated in the Audit Planning Memorandum. The audit which was concluded within the budgeted time-frame of two weeks was done with a review of the accounting system and internal controls of the company. The following were the accounting systems recorded at the commencement of the audit exercise:

(a) **Income Recognition**

Income is recognised by the client on the basis of the amounts in the sales invoices issued for the goods supplied and the amounts of the sales orders are recognised as income for all the pending supplies as at 31 December of each year. Commissions are paid to the sales executives in the first week of January following the year end on the basis of the turnover figure in the management accounts prepared by the chief accountant before the year-end audit is done by the external auditors.

(b) **Salary Payment**

Staff salaries are prepared in a register maintained by the accountant from where the salary summary sheet is prepared for submission to the chief accountant for approval. The cashier consequently withdraws cash needed for the salary payment and the salary due to each staff is put in an envelope. On the pay day, payment of salaries is done by the cashier and staff members are not made to sign for the payment because management believes that the payment process is witnessed by another staff from the sales department. At the end of the payment, the cashier stamps the salary summary sheets with "Paid Stamp" which is regarded as evidence of the salary payment.

(c) **Directors' Drawings**

The chief accountant gives approval for personal drawings requested by the directors on the basis of the telephone discussion such a director had with him. No separate drawings account is maintained for each of the directors in the general ledger. The accountant only has the consolidated outstanding balance in the Directors' Drawings account without showing the amount drawn by each of the directors.

The engagement partner discovered during his review of the audit file that the following adjustments were passed by the audit manager which made some of the figures in the draft accounts to be different from those of the management accounts prepared by the client.

(i) The turnover figure was adjusted by ₦250 million which made the figure of ₦1 billion in the management accounts drop to ₦750 million in the draft copy of the audited financial statements.

(ii) Part of the staff salaries, ₦12 million included in the cost of sales in the management accounts was reclassified to increase staff salary figure to ₦27 million in the draft copy of the audited financial statements.

(iii) The directors' personal drawings totalling ₦50 million included in the cost of sales in the management accounts was adjusted and taken to directors' current account which consequently reduced the cost of sales in the management accounts to ₦600 million.

(d) The managing director disagreed with the firm on the above audit journals passed and gave the following reasons to support his argument.

(i) The turnover of ₦250 million that was adjusted represented the sales orders received on 30 December, 2016 for new supplies to be made in the following year. He said that their decision to recognise the amount as income in the year 2016 was to help the company reach a turnover benchmark of ₦1 billion required to competitively bid for government contracts. He also said that commission on sales has been paid to the sales executives on the basis of the turnover of ₦1 billion disclosed in the management accounts.

(ii) Staff salaries of ₦12 million was included in the cost of sales so as to reduce the PAYE tax to be paid by the company.

(iii) The directors' personal drawing of ₦50 million was included in the cost of sales so that the amount could be hidden from the company's shareholders.

The board of directors refused to sign the audited financial statements because of the disagreement that occurred on the above audit adjustments.

**As the audit senior in charge, you are required to:**

a. Highlight **FIVE** major contents to be included in the engagement letter. (10 Marks)

b. Identify **FIVE** major weaknesses in the internal control system of ABC Limited. (10 Marks)

c. Advise by recommending suggestions that would address the identified weaknesses. 10 Marks)

**(Total 30 Marks)**

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

**QUESTION 2**

Most large audits would be split into two phases. The systems assessment work and transaction testing are carried out during interim audit which takes place close to end of the year. The balance of the work and testing of items of statement of financial position takes place at the final audit shortly after the year end.

**You are required to:**

a. Identify **FOUR** key benefits that may arise from spreading the audit work across interim audit and final audit. (2 Marks)

b. Explain **THREE** audit procedures that would be carried out during the interim audit and **FIVE** of the audit procedures that can be carried out during the final audit. (8 Marks)

c. ISA 300 specifically states that some procedures can only be performed at or after the year end. Identify **TWO** of these procedures. (2 Marks)

d. An auditor is required by ISA 315 to identify and assess the risks of material misstatement at both the financial statement and assertion levels. Explain **FOUR** of the issues to be considered by the auditor on risk assessment at the planning stage of the audit. (4 Marks)

e. Compare systems based audit approach with substantive approach. (4 Marks)

**(Total 20 Marks)**

**QUESTION 3**

When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. He gives an opinion on whether the financial statements present fairly in all material respects the financial position and performance of the entity.

**You are required to:**

a. Explain the term "Materiality". (4 Marks)

b. Identify the stages in the audit when the auditor should apply the concept of materiality. (8 Marks)

c. Discuss the phrase "true and fair view" in this context. (8 Marks)

**(Total 20 Marks)**

## QUESTION 4

Over time, the annual audit was developed as a way of adding credibility to the financial statements produced by management. The statutory audit is now a key feature of company law throughout the world.

**You are required to:**

a. Identify and explain **THREE** key features of an audit report. (12 Marks)

b. Explain the conditions under which a company can be classified as a small company in order to be exempted from an audit. (5 Marks)

c. Identify **THREE** points that would be included in the scope of the statutory audit as described in the independent auditor's report. (3 Marks)

**(Total 20 Marks)**

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

## QUESTION 5

In the course of an audit assignment, an auditor requires an independent and external confirmation for the following items:

- Receivables
- Payables
- Bank Balances

**You are required to:**

a. Justify the need for confirmation in respect of the items listed above. (9 Marks)

b. State the contents of each of the letters sent to request for confirmation in **TWO** of the items stated above. (6 Marks)

**(Total 15 Marks)**

## QUESTION 6

Rules-based code of ethics contains specific rules about how accountants should act in specific situations. Principles-based code of ethics specifies general principles of ethical behaviour and requires professional accountants to act in accordance with the principles. Both are issued by professional accountancy bodies to regulate the conduct of accountants in the course of performing their duties.

All accountants who are members of a professional body, such as the Institute of Chartered Accountants of Nigeria are required to comply with the regulations of that professional body which apply to both external and internal auditors. The reason for the wide reach of ethical guidelines is that the accountancy profession accepts that its members have responsibility to act in the public interest while discharging their duties.

**You are required to:**

a. State **THREE** of the weaknesses of rules-based code of ethics. (3 Marks)

b. Identify **FIVE** key fundamental principles in the principles-based code. (5 Marks)

c. Explain the phrase "Duty of skill and care". (2 Marks)

d. When are accountants said to be "acting in the public interest"? (5 Marks)

**(Total 15 Marks)**

## QUESTION 7

For many businesses (except service organisations), inventory is one of the areas that needs most attention from the auditor. Hence, audit work on inventory is often given to more experienced members of the audit team who will subject the work to a more rigorous review and quality control. In addition, IAS 2 requires that inventory should be valued at the lower of cost and net realisable value on an item-by- item basis.

**You are required to:**

a. Briefly explain **SIX** reasons why closing inventory is very important to the auditor. (6 Marks)

b. Explain **FIVE** principal risks of misstatement associated with closing inventory. (5 Marks)

c. Identify the constituents of cost and net realisable value in an inventory valuation exercise. (4 Marks)

**(Total 15 Marks)**

**SOLUTION 1**

(a) Engagement Letter which is considered as basis of the contract between the company and the auditors will include details of the following:

i. The objective and scope of the audit;

ii. The responsibilities of the auditors;

iii. The responsibilities of management;

iv. Identification of the underlying financial reporting framework;

v. Reference to the expected form and content of any reports to be issued;

vi. More details on the scope of the audit, such as reference to applicable legislation, regulations, International Standards on Auditing (ISAs) and ethical pronouncements;

vii. The fact that because of the inherent limitations of an audit and internal controls, there is an unavoidable risk that some material misstatements may not be detected even though the audit was properly planned and performed in accordance with ISAs;

viii. Arrangements regarding the planning and performance of the audit including the composition of the audit team;

ix. The expectation that management will provide written representations;

x. The basis on which fees are computed and any billing arrangements;

xi. A request for management to acknowledge receipt of the engagement letter and to agree to its terms;

xii. Arrangements concerning the involvement of other auditors, experts or internal auditors (or other staff of the entity); and

xiii. Any restriction of the auditors' liability when such possibility exists.

(b) The weaknesses that can be identified in internal control system of ABC Limited are briefly described as follows:

i. Income was recognized for goods not yet supplied on the basis of the purchase orders received on 30$^{th}$ December, 2016;

ii. Commission was paid to Sales Executives at the end of the year on the basis of the turnover figure contained in the management accounts;
iii. There was no payroll prepared for staff salary which will show details of the gross salary, the statutory deductions and other deductions as well as the net pay due to each staff;

iv. No form of independent checking of the payroll is carried out by another department to ensure correctness of salary computations before payment is made to staff;

v. The use of pay slip which shows details of the salary paid to each staff is not in place;

vi. Payment of salary is done by cash;

vii. No form of acknowledgement of receipt of salary paid to staff is in place;

viii. Directors' drawings are paid on the basis of telephone discussion with the Chief Accountant without any form of documentary approval process;

ix. No separate drawings account is maintained for each director and no form of reconciliation is done to determine the outstanding balance of each director; and

x. Poor organisation culture that expects ethically acceptable behaviour from its directors and managers.

(c) The following are the recommended suggestions that will address the above weaknesses in the internal control system of ABC Limited:

i. Income should be recognised only on the basis of the invoices raised for the goods supplied to customers;

ii. Commission payable to sales executives at the end of each year should be based only on the audited turnover figure as contained in the audited financial statements;

iii. Payroll should be prepared for the monthly salary;

iv. Payroll must be checked by an independent department (like internal audit department) before approval is given for the payment;

v. Payment of salary should not be made by cash to avoid possible frauds and robbery incidents that could lead to loss of funds to the company;

vi. The use of pay slip must be put in place;

vii. Staff should be made to acknowledge receipt of the salary paid to them on the payroll summary sheet;

viii. Payment of directors' drawings should be based on the approved payment request;

ix. Separate drawings account must be maintained for each director where their drawings will be posted;

x. There should be regular reconciliation of the drawings account of each director so that amount outstanding against them can be determined at any time; and

xi. The directors should be apprised of risks inherent in padding financial statements and underdeclaring and under payment of tax, among other things.

**EXAMINER'S REPORT**

**The question is in three parts. Part (a) tests candidates' on the contents of an engagement letter. Part (b) requires candidates to identify major weaknesses in a given scenario, while part (c) asks candidates to recommend suggestions to address the weaknesses identified in (b) above.**

**Almost all the candidates attempted the question. They exhibited good understanding of the requirements of the question. Performance generally was above average.**

**The major pitfall especially in part (a) was candidates stating solution out of context. Candidates are advised to make use of the Institute's Study Text and relate their learning to the requirements of the question.**

| **Marking guide** | | **Marks** |
|---|---|---|
| 1a | 2 marks for any five points | 10 |
| 1b | 2 marks for any five weaknesses | 10 |
| 1c | 2 marks for any five suggestions | 10 |
| | Total | 30 |

## SOLUTION 2

(a) Key benefits of spreading the work across the interim audit and final audit are as follows:

i. It encourages flexible resource planning within the audit firm as it will help the firm to reduce the demand for audit staff during busy season especially during the first few months of a calendar year when many clients require their final audit to take place;

ii. It helps earlier identification of significant matters;

iii. Shareholder and other users receive audited financial statements earlier; and

iv. Increased audit efficiency;

(b) The audit procedures to be carried out are as follows:

i. **Interim Audit**

- Understanding the entity, assessing inherent risk and identifying significant matters which will be reflected in the subsequent audit strategy and audit plan;
- Recording and evaluating the design and testing the entity's system of internal control;
- Performing substantive testing to ensure the books and records are a sound basis for performing the year-end audit;

ii. **Final Audit**

- Substantive testing is carried out but where it was done during the interim audit, the auditors test the subsequent period between the interim audit and year end;
- Tests to ensure conclusions formed at interim audit remain valid;
- Obtaining third party confirmations such as bank letters and trade receivables confirmations;
- Analytical review;
- Subsequent events review;
- Obtaining written representations from client;

(c) Procedures that can only be carried out at or after the year end according to ISA 300 are stated as follows:

i. Agreeing the financial statements to the accounting records;

ii. Examining adjustments made during the course of preparing the financial statements; and

iii. Carry out procedures to respond to a risk that at the year end, the entity may have entered into improper sales contracts or transactions may not have been finalised.

(d) Issues to consider in the risk assessment of an auditor are as follows:

i. The areas where risk of misstatement (error) appear to exist and the nature of the risk;

ii. When an error should be considered material and when it may be ignored;

iii. What aspects of the audit will be the most difficult to plan because of the high risk of misstatement;

iv. Assessment of inherent risks and control risks and the identification of significant audit areas;

v. Setting material levels;

vi. The possibility of material misstatements including those arising because of fraud; and

vii. The identification of complex areas particularly those involving accounting estimates.

(e) i. **Systems-based approach of auditing:** The approach was developed to avoid over-auditing. Under this method, the underlying accounting systems are tested with less emphasis on the testing of individual transactions and balances. However, the approach could still lead to over-auditing as systems covering low-risk or immaterial areas are also tested.

ii. **Substantive approach of auditing:** It is an approach used whereby every Item in the financial statements is tested and vouched to supporting documents. The approach is still sometimes used for small entities where internal controls are weak and there are few transactions. It may be more efficient to just test everything especially if the auditor is also providing accountancy services.

**EXAMINER'S REPORT**

**The question in parts (a) to (e) tests candidates on audit procedures. Part (a) asks candidates to identify key benefits of spreading the audit work across interim and final audit, part (b) tests audit procedures that are carried out during interim and final audits respectively and part (c) tests candidates on year end and post year-end audit procedures as required by ISA 300. Part (d) asks candidates to identify and assess risks of material misstatements as required by ISA 315, while Part (e) requires candidates to compare system based audit approach and substantive audit approach.**

**About 50% of the candidates attempted the question. The understanding exhibited by the candidates was generally low especially in parts (c) and (e) as reflected by their performance which was below average.**

**The candidates pitfall was their disregard for knowing the requirements of the international standards of auditing (ISAs). Candidates are advised to pay attention to the regulatory requirements of the auditing standards. The Institute's Study Text and materials will also be of immense benefit.**

| Marking guide | | Marks | Marks |
|---|---|---|---|
| a) | ½ mark each for any of the four (4) points | 2 | |
| b) | 1 mark each for any of the procedures | 8 | |
| c) | 1 mark each for each of the two (2) procedures | 2 | 12 |
| d) | 1 mark each for any one of the four (4) issues | 4 | |
| e) | 2 marks each for the comparison | 4 | 8 |
| | Total marks | | **20** |

**SOLUTION 3**

(a) **Materiality**

In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements.

Materiality therefore relates to the significance of transactions, balances and errors contained in the financial statements. It defines the threshold or cutoff point after which financial information becomes relevant to the decision making needs of the users.

Information is therefore material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. For example, if an error of ₦10 million in a financial statement will affect the economic decision of users of the financial statement, that amount is considered material.

(b) International Standards on Auditing (ISA) 320 requires the auditor to apply the concept of materiality as follows:

i. **During the planning and performance stage of the audit**

In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments provide a basis for;

Determining the nature, timing and extent of risk assessment procedures;

Identifying and assessing the risks of material misstatement; and

Determining the nature, timing and extent of further audit procedures.

As the audit progresses, the auditor could revise materiality for particular areas of the audit if he becomes aware of information which would have caused him to have initially set different levels, had that information been known to him at the time.

ii. **When evaluating the effect of misstatements on the financial statements and therefore on his audit opinion**

International Standards on Auditing (ISA) 450 requires an auditor to reassess materiality set at the beginning of the audit to confirm whether it remains appropriate in the context of the entity's actual financial results. He shall determine whether uncorrected misstatements are material individually or in aggregate. This will enable him determine if the overall audit objective has been achieved and conclude on whether the financial statements are free from material misstatement.

iii. **As the audit progresses** – The auditor must revise materiality (and if appropriate, materiality for particular areas and performance materiality) if he becomes aware of information which would have caused him to have initially set different levels, had that information been known to him at the time.

iv. **Documentation** – Must include details of all materiality levels set and any revision of these levels as the audit progresses.

v. **Setting materiality levels** – Materiality levels are often based on quantitative factors and expressed as a percentage of revenue, pre-tax profit, equity or total assets.

(c) **True and fair view (fair presentation)**
The auditor reports on whether (or not) the financial statements give a true and fair view, or present fairly, the position of the entity as at the end of the financial period and the performance of the entity during the period. The auditor does not certify or guarantee that the financial statements are correct.

Although the phrase 'true and fair view' has no legal definition, the term 'true' implies free from error, and 'fair' implies that there is no undue bias in the financial statements or the way in which they have been presented.

In preparing the financial statements, considerable judgement is exercised by the directors. Similarly, judgement is exercised by the auditor in reaching his opinion. The phrases "true and fair view' and' present fairly' indicate that a judgement is being given that the financial statements can be relied upon and have been properly prepared in accordance with an appropriate financial reporting framework.

**EXAMINER'S REPORT**

**Parts (a) and (b) of the question test on the concept of materiality, while part (c) tests on 'true and fair' concept. More than 50% of the candidates attempted the question and their performance was average.**

**Candidates' commonest pitfall was their inability to identify the stages in the audit the auditor applies the concept of materiality. Candidates are advised to pay more attention to this area of the syllabus.**

| **Marking guide** | | **Marks** |
|---|---|---|
| a) | 4 points for explanation | 4 |
| b) | 2 points each for 4 stages identified | 8 |
| c) | 8 marks for explanation | <u>8</u> |
| | Total marks | **<u>20</u>** |

**SOLUTION 4**

(a) The key features of the audit report are as follows:
   i. the auditors producing the report are independent from the directors producing the financial statement;

ii. the report gives an opinion on whether the financial statements give a true and fair view or present a fairly the position and results of the entity; and

iii. the report considers whether the financial statements give a true and fair view in all materials respects. The concept of materiality is applied in reaching an audit opinion.

**Independence of the auditor**
The external auditor must be independent from the directors, otherwise his reports will have little value. If he is not independent, his opinion is likely to be influenced by the director. The independence of the statutory auditor is a matter of public confidence in the audit process and the report.
**True and fair view (fair presentation)**
The auditor reports on whether (or not) the financial statements give a true and fair view or present fairly, the position of the entity as at the end of the financial period and the performance of the entity during the period. The auditor does not certify or guarantee that the financial statements are correct. Although the phrase "true and fair view" has no legal definition, the term "true" implies free from error and "fair" implies that there is no undue bias in the financial statements or the way in which they have been presented. In preparing the financial statements, a large amount of considerable judgement is exercised by the directors. Similarly, judgement is exercised by the auditor in reaching his opinion. The phrases "true and fair view" and "present fairly" indicate that a judgement is being given that the financial statements can be relied upon and have been properly prepared in accordance with an appropriate financial framework.

**Materiality Concept**
The auditor reports in accordance with the concept of materiality. He 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, it could influence the economic decisions of users should it be omitted or misstated. Applying the concept of materiality means that the auditor will not aim to examine every number in the financial statement. He will concentrate his efforts on the more significant items in the financial statements either:

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

(b) Conditions under which a company can be classified as a small company.

A company qualifies as a small company in a year if for that year the following conditions are satisfied:

i. it is private company having a share capital.

ii. the amount of its turnover for that year is not more than ₦2million or such as may be fixed by the commission.

iii. Its net assets value is not more than ₦1million.

iv. None of its members is an alien.

v. None of its members is a Government or a Government corporation or agency or its nominee.

vi. The directors between themselves hold not less than 51% of its equity share capital.

(c) **The Scope of Statutory Audit**

The scope of the statutory audit as described in the independent auditor's report contains the following:

i. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements;

ii. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements whether due to fraud or error;

iii. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate on the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control; and

iv. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management as well as evaluating the overall presentation of the financial statements.

**EXAMINER'S REPORT**

**The question tests candidates' in three parts: part (a) key features of an audit, part (b) conditions for classification of a company as 'small company' as stated by company legislations and part (c) points in the 'scope' area of the statutory auditor's report.**

**About 60% of the candidates attempted the question, but their understanding, as shown by their performance was generally poor, hence the low marks earned by the majority by the candidates that attempted the question.**

**The commonest pitfall of the candidates was misinterpretation of the requirements of the question, especially in part (a) where candidates' answers relate to actual contents of the audit report, and in part (c) as to the content in the 'scope' area of the statutory report.**

**Part (b) solutions given by candidates did not reflect the factual conditions as given by relevant sections of the law.**

**Candidates should study well and utilise relevant texts and materials for preparation for their examination.**

| **Marking guide** | | **Marks** |
|---|---|---|
| a) | 4 marks for each feature identified and explained | 12 |
| b) | 1 mark for each point (maximum of 5) | 5 |
| c) | 1 mark for each point (maximum of 3) | 3 |
| | Total marks | **20** |

**SOLUTION 5**

(a) The need for confirmation in respect of:

i. **Receivables**

Direct confirmation involves asking customers to provide written confirmation, direct to the auditors of their account balance with the client entity. Written confirmation by customers can normally be taken as high-quality audit evidence because it is a strong source of written, external audit evidence. A direct confirmation of receivables is intended to check:

- Existence assertion – that the receivables do in fact exist and there is no over-statement of receivables in the financial statements;
- Rights and obligations assertion – that the client entity has the legal right to the amount receivable;
- Valuation assertion – that receivables have been stated at their appropriate amounts; and
- Cut-off assertion – that transactions have been recorded in the correct accounting period.

ii. **Payables:**

Trade payables are a material item in the statement of financial position of many entities. Therefore, this area is likely to receive a significant level of audit attention. In some respect, the approach is similar to the approach used for the audit of the trade receivables. However, a major difference lies in the fact that direct confirmation of balances with suppliers, although sometimes used, it is not a typical audit testing procedure. The reasons why direct confirmation is not widely used is that the audit normally has an alternative external source of written evidence. This evidence is provided in the form of suppliers' statements.

iii. **Bank Balances**

Bank balances are amounts held in a bank account. Assets held as bank balances can be at risk of loss. There may be fraudulent activity or misappropriation particularly when many individuals have authority for dealing with receipts and payments. Bank balances can be confirmed directly in writing by the bank (third parties). Bank balances are usually subject to rigorous internal controls to prevent loss and theft. The audit client may omit some bank balances or accounts.

(b) Contents of Confirmation Letter

i) **Receivable balances**

A letter to a customer asking for confirmation of the outstanding balance using positive confirmation method will contain the following:

- Customer's name and address;
- Name of auditors to whom the reply should be sent;
- The outstanding amount;
- Confirmation number (where applicable);
- The clause requesting confirmation whether the amount is or is not in agreement with the client's record and details of any reconciling items;
- Account number (where applicable);
- Date;
- Title or position of the principal officer authoring the letter; and
- Authorised signatory.

ii. **Payables balances**

A letter to a customer asking for confirmation of the outstanding balance using positive confirmation method will contain the following:

- Customer's name and address;
- Name of auditors to whom the reply should be sent;
- The outstanding amount;
- Confirmation number (where applicable);
- The clause requesting confirmation whether the amount is or is not in agreement with the client's record and details of any reconciling items;
- Account number (where applicable);
- Date;
- Title or position of the principal officer authoring the letter; and
- Authorised signatory.

iii. **Bank balances**

Typical areas covered by the confirmation letter include the following:

- Confirmation of balances on all bank accounts at the end of the reporting period;
- Details of any unpaid bank charges;
- Details of any lien (charge) over assets of the client entity;
- Details of any asset of the client entity held by the bank as security for lending; and
- Details of any other client bank account that is known to the bank but not listed in the request to the bank for confirmation of balances.

Please note that in practice, the receivables confirmation letter is usually written by the management of the client company. This provides authorisation for the customer to provide the required information direct to the auditor.

**EXAMINER'S REPORT**

**The question tests in two parts audit procedures of obtaining audit evidence through independent confirmation. The question was attempted by majority of the candidates, but the understanding exhibited especially in part (a) was below average. The performance consequently was below average in both part (a) and also part (b).**

**The commonest pitfall was their inability to acknowledge and understand the practical aspects of audit procedures.**

**Candidates should be able to apply their skills to the practical side of auditing.**

| **Marking guide** | | **Marks** |
|---|---|---|
| a) | 3 marks for explanation under each of the 3 points | 9 |
| b) | 1 mark for a maximum of 3 contents from each of the two items | <u>6</u> |
| | Total marks | <u>**15**</u> |

**SOLUTION 6**

(a) The following are the weaknesses of rule-based ethics codes:

i. There are many different situations that an accountant might face where an ethical decision must be made. Circumstances can be complex and varied and it is impossible to plan for every type of ethical problem that will arise and make a rule in advance without knowing the exact details of the situation and what course of action the accountant must take;

ii. Over time, the type of situations that an accountant might face could change as the business environment changes. It might therefore be necessary to review and update the rule book regularly; and

iii. Ethical views differ between countries and cultures. Behaviour that might be considered slightly unethical in one country might be perfectly normal and acceptable in another country. In such a situation, a rule book cannot easily make allowances for national and cultural differences in ethical viewpoint.

(b) The key fundamental principles of principles-based codes are as follows:

i. **Integrity:** Members should be straight forward and honest in all professional and business relationships. Integrity implies not just honesty but also fair dealing and truthfulness;

ii. **Objectivity:** Members should not allow bias, conflicts of interest or undue influence of others to override their professional or business judgments;

iii. **Professional competence and due care:** Members have a duty to maintain their professional knowledge and skill at such a level that a client or employer receives a competent service based on current developments in practice, legislation and techniques. Members should act diligently and in accordance with applicable technical and professional standards;

iv. **Confidentiality:-** Members should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose such information to third parties without authority or unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should therefore not be used for the personal advantage of members or third parties; and

v. **Professional behaviour:-** Members should comply with relevant laws and regulations and should avoid any action which discredits the profession. They should behave with courtesy and consideration towards all with whom they come into contact in a professional capacity.

(c) The phrase 'duty of skills and care' is a fundamental principle that ICAN members (and also IFAC members) should carry-out their work with professional competence and due care;

The statement "due skill and care" is a requirement from accountants that reinforces the basic principle of law of contract as it operates in many countries. It expects accountants to perform a contract for the provision of services with a reasonable degree of skill and care;

The concept of "due care" or "reasonable care" is important and the implication is that audit work performed by an auditor for a client must be adapted to the specific circumstances and characteristics of the client. A number of consequences may follow if an auditor fails to exercise a proper degree of care in the course of performing his duty which includes:

- Legal claims against the auditor in the law of contract or the law of tort may Arise;
- Disciplinary proceedings may be taken against the auditor by ICAN; and
- The auditor or audit firm may earn a bad reputation in the business community for poor standard of work which may consequently lead to loss of clients.

(d) **Acting in the public interest:** It is an aspect of the professional ethics which says that members of the profession are expected to act in the public interest. It is therefore a responsibility of the accountancy profession not to act exclusively to satisfy the needs of a particular client or employer especially when the demands or needs of such client or employer appear to be contrary to the public interest. Public interest can be associated with the following matters:

- Detecting and reporting any serious misdemeanor or crime;
- Protecting health and public safety;
- Preventing the public from being misled by a statement or action by an individual or an organisation;
- Exposing the misuse of public funds and corruption in government; and
- Revealing the existence of any conflict of interest of those individuals Who are in a position or power or influence.

**EXAMINER'S REPORT**

**The question tests candidates' in parts (a) and (b) on principles of rules – based and principles - based code of ethics respectively.**

**Part (c) tests 'duty of skill and care'.**

**Part (d) tests candidates on when accountants are said to be 'acting in public interest'.**

**About 40% of the candidates attempted the question. The understanding of those that attempted was generally average, but the performance in part (d) was poor. Candidates apparently did not cover this area of the syllabus well.**

**Candidates are advised to cover adequately all areas of the syllabus and make good use of the Institute Study Text while preparing for the examinations.**

| Marking guide | | Marks |
|---|---|---|
| a) | 1 mark each for the three (3) weaknesses | 3 |
| b) | 1 mark each for the five (5) principles | 5 |
| c) | 2 marks for the explanation | 2 |
| d) | 5 marks for the discussion | 5 |
| | Total marks | 15 |

**SOLUTION 7**

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

i. Inventory is often a material item in the financial statements;

ii. Inventory may be a high risk area involving a high degree of judgement in areas such as valuation;

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

iv. Inventory may be highly technical in nature and where inventory is complex, the auditor may need to consider the need reliance on the work of an expert;

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

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

(b) The following are the principal risks of misstatement associated with closing inventory:

i. **Completeness assertion:** Not all inventory that is owned by the reporting entity are included in the financial statements;

ii. **Existence assertion:** Inventory in the financial statements may not actually Exist;

iii. **Valuation assertion:** Inventory being incorrectly valued due to either incorrect recording of costs or failing to value at net realisable value;

iv. **Rights or obligations assertion:** Inventory which actually belongs to third parties being included in the financial statements; and

v. **Presentation and disclosure assertion:**- Inventory being incorrectly disclosed in the financial statements.

(c) Elements of cost and net realisable value of an inventory include the following:

**Cost**

- Costs of purchase and all other costs incurred in bringing the inventory to its present location and condition; and

- In the case of work-in-progress; this includes an amount incurred as production overheads.

**Net Realisable Value**

It is the estimated selling price of the inventory in the ordinary course of business after deducting the following other incidental expenses:

- Any estimated costs incurred to complete the items and make it available for Sale; and

- The estimated costs of making the sale.

**EXAMINER'S REPORT**

**The question is in three parts. It tests candidates on audit work on inventory. More than 75% of the candidates attempted the question. The understanding reflected by their answers was generally average for parts (a) and (b), but below average for part (c). Performance was therefore generally average overall.**

**The main pitfall of the candidates was mix-up of the principal risks of misstatements associated with closing inventory.**

**Candidates should understand the requirements of a question properly to prevent avoidable mix-ups in the answers they provide.**

| **Marking guide** | | **Mark** |
|---|---|---|
| a) | 1 mark each for any of the six (6) reasons | 6 |
| b) | 1 mark each for any of the five (5) risks | 5 |
| c) | 2 marks for cost and 2 marks for net realisable value | 4 |
| | Total marks | 15 |

# THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

## SKILLS LEVEL EXAMINATION – MAY 2019

## 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) Obi Consults is a civil engineering consulting firm of many years. The founding partners are Bibi, Kose and Fowora. The financial year-end of the firm is December 31, each year.

The following information was extracted from the partnership's financial statements/records for the year ended December 31, 2018:

| | | ₦ |
|---|---|---|
| (i) | Net profit for the year | 21,575,000 |
| (ii) | Provision for depreciation | 13,250,000 |
| (iii) | Fine paid in respect of traffic offence committed by the principal partner's son while driving his father to catch up a flight to Abuja for a business transaction | 25,000 |
| (iv) | Donations to "politicians in business" | 150,000 |
| (v) | Donation to National Library Board of Nigeria | 165,000 |
| (vi) | Profit from sale of excavator | 1,600,000 |
| (vii) | Capital allowances | 6,575,000 |
| (viii) | Balancing allowance | 677,000 |
| (ix) | Balancing charge | 1,315,000 |

The following additional information was provided:

- Profit sharing ratio as agreed:
  - Bibi $^1/_2$
  - Kose $^1/_4$
  - Fowora $^1/_4$
- Bibi and Fowora are both entitled to interest of 5% per annum on loan of ₦10,500,000 each, introduced to the firm. Fowora's loan was refunded in full on the day of his retirement.
- Salaries paid to the partners were:

| | | ₦ |
|---|---|---|
| - | Bibi | 10,800,000 |
| - | Kose | 8,250,000 |
| - | Fowora | 8,250,000 |

- On June 30, 2018, Fowora who is the oldest of the partners, retired at the mandatory age of 60 years.
- In order to fill the vacuum created by Fowora's retirement, Jaycee was admitted as a new partner on July 1, 2018, based on an annual salary of ₦8,250,000.
- Jaycee is also entitled to 5% interest per annum having introduced a fresh loan of ₦7,000,000 on July 1, 2018.
- The profit sharing ratios after Jaycee's admission are as follows:

  Bibi $^1/_2$

  Kose $^7/_{20}$

  Jaycee $^3/_{20}$
- Fowora has no further income within six months after his retirement, but a sum of ₦900,000 which was paid towards his annual vacation was included in the partnership's expenses for the year.

  The tax authority agreed that the business should be treated as ongoing such that commencement or cessation rules will not apply.

**You are required to:**

(i) Compute the adjusted/assessable income of the partnership. (5 Marks)
(ii) Determine the share of profits among the partners (3 Marks)
(iii) Show relevant workings for prorated salaries and interest on loans of the affected partners, assuming simple interest. (2 Marks)
(iv) Compute the assessable income of each partner. (10 Marks)

(b) ABCEE Limited has been in the business of clearing and forwarding in Nigeria since 2007.

The company has a standing policy of declaring dividends to the shareholders and has continued to do so despite the dwindling business activities in recent years.

The following information was extracted from the ABCEE Limited's income tax returns submitted to Federal Inland Revenue Service for 2016 year of assessment:

| | ₦ |
|---|---|
| Total profit per 2016 tax computation | 10,899,000 |
| Tax assessed based on total profit @ 30% | 3,269,700 |
| Dividend declared | 14,000,000 |

**Required:**

As the desk officer in charge of ABCEE Limited, compute the revised tax liability of the company in line with Section 19 of the Companies Income Tax Act Cap C21 LFN 2004(as amended). (10 Marks)

**(Total 30 Marks)**

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

**QUESTION 2**

Mr. Ade is a Nigerian who has lived in Europe for a very long time. He is now planning to return to Nigeria to set up a business which he considers to be profitable in a developing country like Nigeria. Despite the appeal of the business in terms of profitability, he is skeptical about the perceived harsh tax environment in the country.

He has approached you to explain some fundamental areas of taxation in Nigeria.

**You are required to:**

a) Identify **five** major objectives and purposes of taxation. (5 Marks)
b) Compare direct and indirect taxes giving **four** examples of each. (6 Marks)
c) In relation to an incorporated company carrying on business in Nigeria, **explain** to Mr. Ade the:
   (i) Documents to be filed as annual returns to the Federal Inland Revenue Services (FIRS). (3 Marks)
   (ii) Time limit for filing annual tax returns. (3 Marks)
   (iii) Penalties prescribed by law for a company which failed to file its income tax returns on due date. (3 Marks)

**(Total 20 Marks)**

## QUESTION 3

Mr. Chukwudi, your mentee from childhood, has always been guided by your advice. He travelled to the United States to actualise his dreams. He subsequently obtained a degree in accountancy/taxation from a leading University and worked in the United States until November 30, 2016, when he returned to Nigeria.

In January 2017, he attended a written interview for a post of a tax manager at the Federal Inland Revenue Service but failed the interview because of his poor knowledge of the Nigerian tax laws.

Mr. Chukwudi is likely to be shortlisted for the position of inspector of taxes in his state of origin and sought has your advice on some areas of the Nigerian tax laws.

**You are required to provide explanations on the following:**

(a) (i) The various tiers of government and their revenue authorities, responsible for the collection of levies and taxes in Nigeria. (3 Marks)

(ii) **Four** specific taxes and levies collectible by different tiers of government. (6 Marks)

(iii) A resident individual in Nigeria, for a particular year of assessment. (3 Marks)

(b) In 2016, Mr. James Muhammed lived at Ojodu Abiodun village, Ogun State and worked for Federal High Court, Ikeja, Lagos State, on an annual salary of ₦1,600,000. Mr. Muhammed contributes to an approved pension scheme at the appropriate rate of 8% and also pays life assurance premium equivalent to 5% of his annual salary.

**Required:**

(i) Identify the relevant tax authority to which he will be subjected to tax. (2 Marks)

(ii) Compute his personal income tax liability for the relevant assessment year. (6 Marks)

**(Total 20 Marks)**

## QUESTION 4

Mr. Bulamoyoh who lived in the Eastern part of Nigeria died testate in January 2015. He had 3 children: Moses, Peter and Nana but left his business with the trustees.

Moses, the eldest son, thought he should be fully in charge of his father's entire business and told the trustees not to bother about payment of tax.

The trustees claimed that they had statutory obligation to render yearly tax returns for the estate to the relevant tax authority.

**You are provided with the following information:**

(i) Net profit of the business as adjusted for tax purposes for the year ended June 30, 2018 was ₦10,270,000.

(ii) Qualifying property, plant and equipment acquired during the year ended June 30, 2018 were:

| | | ₦ |
|---|---|---|
| - | Motor vehicles | 3,650,000 |
| - | Plant and machinery | 1,250,000 |
| - | Furniture | 220,000 |

(iii) The tax written down value of motor vehicle acquired prior to the current year, was ₦345,000, out of which, ₦315,000 is to be allowed as annual allowance in the current assessment year.

(iv) Moses, Peter and Nana are entitled to ¼ each of the net distributable income.

(v) Fixed annuity paid to a beneficiary was ₦250,000.

(vi) Interest on debt repayment by the trustees was ₦120,000

(vii) Trustees' fixed remuneration was ₦260,000 per annum.

(viii) Administration and other expenses by the trustee amounted to ₦45,000.

(ix) The trustees in line with the terms of the trust deed made the following discretionary payments to the children:

| | | ₦ |
|---|---|---|
| - | Moses | 310,000 |
| - | Peter | 225,000 |
| - | Nana | 460,000 |

**Required:**

(a) Explain the following terminologies:

(i) Trust (1 Mark)

(ii) Beneficiary (1 Mark)

(iii) Life tenant (1 Mark)

(b) Compute capital allowances for the relevant year of assessment. (8 Marks)

(c) Compute the income tax payable by the trustees on the income for the relevant year of assessment. (9 Marks)

**(Total 20 Marks)**

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

## QUESTION 5

Oloriogun Logistics Limited renders consultancy services to newspaper publishing companies in Nigeria.

All the publishers are limited liability companies which deduct appropriate withholding taxes from all consultancies and remit to relevant tax authorities within the time limit specified by the law.

Oloriogun Logistics Limited makes up its accounts to December 31, each year, and suffered withholding tax on the invoices raised for specific dates as follows:

| Date of remittance | Month of transaction | Invoice Number | Amount |
|---|---|---|---|
| | | | ₦ |
| 19/2/2015 | Jan. 2015 | 002/01 | 350,000 |
| 19/3/2015 | Feb. 2015 | 003/02 | 670,000 |
| 20/4/2015 | March 2015 | 004/03 | 810,000 |
| 20/5/2015 | April 2015 | 005/04 | 305,000 |
| 19/6/2015 | May 2015 | 006/05 | 295,000 |
| 20/8/2015 | June 2015 | 008/07 | 922,000 |
| 21/9/2015 | Aug. 2015 | 009/08 | 270,000 |
| 21/10/2015 | Sept. 2015 | 010/09 | 195,000 |
| 20/11/2015 | Oct. 2015 | 011/10 | 408,000 |
| 21/12/2015 | Nov. 2015 | 012/11 | 495,000 |
| 21/01/2016 | Dec. 2015 | 012/12 | 396,000 |
| 21/03/2016 | Jan. & Feb. 2016 | 01/02 | 1,649,000 |

Withholding tax credit notes on the above invoices were forwarded to Diederik Logistics Limited but the accountant was confused as to which year of assessment to claim these tax credits.

**Required:**

(a) Calculate the withholding tax credits for each of the above invoices. (6 Marks)

(b) Determine total amount of withholding tax credits to be claimed for each year of assessment. (3 Marks)

(c) What is the due date for remitting withholding tax returns to the tax authority. mentioned in (b) above? (1 Mark)

(d) State **three** transactions exempted from withholding tax in Nigeria. (3 Marks)

(e) List **four** distinct groups referred to as agents of the government for the collection and remittance of withholding tax in Nigeria. (2 Marks)

**(Total 15 Marks)**

## QUESTION 6

Duru Cobbler Limited has been in the business of shoe manufacturing for many years. Information contained in the company's statement of profit or loss for the year ended November 30, 2018, are as follows:

| | ₦ | ₦ |
|---|---|---|
| Revenue | | 18,546,000 |
| Other income | | |
| - Rental income (gross) | 240,000 | |
| - Profit on sale of property, plant and equipment | 120,000 | |
| - Interest on bank deposits (net) | 234,000 | 594,000 |
| | | 19,140,000 |
| Less: | | |
| Staff salaries and wages | 6,180,300 | |
| Finance cost | 1,144,000 | |
| General administration expenses | 10,585,190 | |
| Impairment loss | 420,000 | |
| Depreciation and amortisation | 1,690,000 | 20,019,490 |
| Loss before tax expense | | (879,490) |
| Income tax expense | | - |
| Deferred tax provision | | (64,380) |
| Loss after tax | | (943,870) |

**Additional notes provided by the accountant are as follows:**

(i) Finance cost include bank charges and interest on overdrafts obtained by the company.

(ii) General and administrative expenses include:
- Bad debts of ₦655,000 which arose from bulk sales of shoes to the managing directors' relations; and
- Value added tax in the sum of ₦985,000 which was not imposed on some of the invoices raised by the accountant.

(iv) A sum of ₦1,294,000 has been computed and agreed for capital allowances for the relevant year of assessment.

**Required:**

(a) Compute the total profit and tax liabilities payable by Duru Cobbler Limited for the relevant year of assessment. (10 Marks)

(b) Describe zero-rated goods and services under Value Added Tax Act Cap VI LFN 2004 (as amended) and identify **two** transactions that may fall under this category. (3 Marks)

(c) Identify the penalties for non-registration for VAT? (2 Marks)

**(Total 15 Marks)**

## QUESTION 7

(a) Mr. Adele has just retired from the public service and trying to venture into business. He is, however, concerned about the taxes that may affect his new business.

As the tax consultant to Mr. Adele, he wants you to explain some terminologies to enable him have a better understanding of same.

**Required: Explain the following:**

(i) Proportional tax and progressive tax (2 Marks)

(ii) Direct tax and indirect tax (2 Marks)

(iii) Statute laws and case laws (2 Marks)

(iv) Franked investment income (3 Marks)

(v) Taxes collectible by local governments (4 Marks)

(b) Identify **four** types of information that are expected to be disclosed in a tax clearance certificate. (2 Marks)

**(Total 15 Marks)**

# NIGERIAN TAX RATES

## 1. CAPITAL ALLOWANCES – COMPANIES

| | Initial % | Annual % |
|---|---|---|
| Building expenditure | 15 | 10 |
| Industrial building expenditure | 15 | 10 |
| Mining expenditure | 95 | Nil |
| plant expenditure (excluding furniture and 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. CAPITAL ALLOWANCES – INDIVIDUALS

| | Initial % | Annual % |
|---|---|---|
| Building expenditure | 5 | 10 |
| Industrial building expenditure | 15 | 10 |
| Mining expenditure | 20 | 10 |
| Plant expenditure (excluding furniture and fittings) | 20 | 10 |
| Plant expenditure (manufacturing, construction and agricultural production) | 25 | 10 |
| Furniture and fittings expenditure | 15 | 10 |
| Motor vehicle expenditure | 25 | 20 |
| Motor vehicle (public transportation expenditure | | |

| | | |
|---|---|---|
| with at least 3 buses) | 30 | 20 |
| Plantation equipment expenditure | 20 | $33^1/_2$ |
| Housing estate expenditure | 20 | 10 |
| Ranching and plantation expenditure | 30 | 15 |
| Research and development expenditure | 25 | $12^1/_2$ |

3. INVESTMENT ALLOWANCE 10%

4. RATES OF PERSONAL INCOME TAX

Graduates 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.

5. COMPANIES INCOME TAX RATE 30%
6. TERTIARY EDUCATION TAX (2% of assessable profit)
7. CAPITAL GAINS TAX 10%
8. VALUE ADDED TAX 5%

## SOLUTION 1

### (a) Obi Consults

#### (i) Computation of adjusted/assessable income for 2019 year of assessment

| | ₦ | ₦ |
|---|---|---|
| Net profit per accounts | | 21,575,000 |
| Add back: | | |
| Provision for depreciation | 13,250,000 | |
| Fine for traffic offence | 25,000 | |
| Donation to politicians | 150,000 | 13,425,000 |
| | | 35,000,000 |
| Profit on sale of excavator | | (1,600,000) |
| **Adjusted profit** | | 33,400,000 |
| Balancing charge | | 1,315,000 |
| | | 34,715,000 |
| *Deduct:* | | |
| Capital allowances | 6,575,000 | |
| Balancing allowances | 677,000 | (7,252,000) |
| **Assessable profit** | | 27,463,000 |

(ii) **Determination of share of profit amongst old partners**

- Bibi, Kose and Fowora (1/1/2018 - 30/6/2018)

(Assessable profit divided by 2)

$^{₦27,463,000}/_{2}$ = ₦13,731,500

| | ₦ |
|---|---|
| Bibi $^{1}/_{2}$ of ₦13,731,500 | 6,865,750 |
| Kose ¼ of ₦13,731,500 | 3,432,875 |
| Fowora ¼ of ₦13,731,500 | 3,432,875 |
| | 13,731,500 |

**Determination of share of profit among current partners**

- Bibi, Kose and Jaycee (1/7/2018 - 31/12/2018)

(Assessable profit divided by 2)

$^{₦27,463,000}/_{2}$ = ₦13,731,500

| | ₦ |
|---|---|
| Bibi $^{1}/_{2}$ of ₦13,731,500 | 6,865,750 |
| Kose $^{7}/_{20}$ of ₦13,731,500 | 4,806,025 |
| Jaycee $^{3}/_{20}$ of ₦13,731,500 | 2,059,725 |
| | 13,731,500 |

**(iii) Determination of Fowora's salaries for the relevant period**

(1/1/2018 - 30/6/2018) = $^{6}/_{12}$ x ₦8,250,000 = **₦4,125,000**

**Determination of amount due to Fowora as interest on loan for the relevant period** 1/1/2018 - 30/6/2018 = 5% of ₦10,500,000

= ₦525,000 x $^{6}/_{12}$ = **₦262,500**

- **Determination of salaries earned by Jaycee for the relevant period**

  1/7/2018 - 31/12/2018 = $^{6}/_{12}$ of ₦8,250,000 = **₦4,125,000**

- Interest on Loan due to Jaycee for the relevant period

  1/7/2018 -31/12/2018 = 5% of ₦7,000,000 = ₦350,000 x $^{6}/_{12}$= **₦175,000**.

**(iv) Computation of assessable income of each partner**
**For 2019 year of assessment**

| | | Bibi | Kose | Fowora | Jaycee | Total |
|---|---|---|---|---|---|---|
| Share of profit | | ₦ | ₦ | ₦ | ₦ | ₦ |
| 1/1/18 – 30/6/18 | (c) | 6,865,750 | 3,432,875 | 3,432,875 | - | 13,731,500 |
| 1/7/18 – 31/12/18 | (d) | 6,865,750 | 4,806,025 | - | 2,059,725 | 13,731,500 |
| Total share of profit | | 13,731,500 | 8,238,900 | 3,432,875 | 2,059,725 | 27,463,000 |
| Salaries | | 10,800,000 | 8,250,000 | 4,125,000 | 4,125,000 | 27,300,000 |
| Interest on loan | | 525,000 | - | 262,500 | 175,000 | 962,500 |
| Vacation income | | 0 | - | 900,000 | | 900,000 |
| | | 25,056,500 | 16,488,900 | 8,720,375 | 6,359,725 | 56,625,500 |

(b) **Abcee Limited**

**Revised income tax liability for 2016 year of assessment**

| | ₦ |
|---|---|
| Total profit per tax computation | 10,899,000 |
| Dividend declared | 14,000,000 |
| Companies income tax on dividend @ 30% ₦14,000,000 | 4,200,000 |
| Tax already assessed | (3,269,700) |
| Additional income tax due | 930,300 |

**EXAMINER'S REPORT**

**The question tests candidates' knowledge of the principles of a partnership with emphasis on computation of adjusted profit, determination of the share of profits for the partners and computation of assessable income of each partner. The question also tests candidates' understanding of dividend as a basis of ascertaining companies income tax liability.**

**Candidates' performance was average. The inability of the candidates to correctly determine the disallowable items led to wrong computations of assessable and adjusted profits.**

**Candidates are advised to read ICAN Study Texts, relevant textbooks and applicable statutes for proper understanding of disallowable expenses for future examinations.**

**SOLUTION 1**

| | **Marking Guide** | Marks | Marks |
|---|---|---|---|
| a. i | Computation of adjusted/assessable income of the partnership: | | |
| | Heading | $^1/_2$ | |
| | Net profit per accounts | $^1/_2$ | |
| | Provision for depreciation | $^1/_2$ | |
| | Fine for traffic offence | $^1/_2$ | |
| | Donation to politicians | $^1/_2$ | |
| | Profit on sale of excavator | $^1/_2$ | |
| | Balancing charge | $^1/_2$ | |
| | Capital allowance | $^1/_2$ | |
| | Balancing allowance | $^1/_2$ | |
| | Assessable profit | ½ | |
| | | | 5 |
| ii | Determination of share of profit amongst old and current partners – ($^1/_2$ mark for each of the six correct calculations | | 3 |

| | | | |
|---|---|---|---|
| iii | Correct workings for prorated salaries and interest – ($^1/_2$ mark for each of the four correct workings | | 2 |
| iv | Computation of the assessable income of each partner: | | |
| | Heading | $^1/_2$ | |
| | Share of profit - 1/1/18 – 30/6/18 | 2 | |
| | 1/7/18 – 31/11/18 | 2 | |
| | Salaries | $2^1/_2$ | |
| | Interest on loan | 2 | |
| | Vacation of income | 1 | |
| | | | 10 |
| b | Computation of revised tax liability of ABCEE Limited: | | |
| | Total profit per tax computation | 2 | |
| | Dividend declared | 2 | |
| | CIT on dividend | 3 | |
| | Tax already assessed | 2 | |
| | Additional income tax due | 1 | |
| | | | 10 |
| | | | 30 |

## SECTION B

## SOLUTION 2

(a) Objectives to be considered by the government in designing a tax policy are:

**(i) Revenue generation**

The primary objective of taxation is to raise money to meet government expenditure. Taxation has always been employed to raise sufficient revenue to satisfy the needs of the government, such as, in the provision of services like defence, law and order, health services and education. Revenue from taxation can also be spent on capital projects, otherwise called capital expenditure, creating a social and economic infrastructure which will improve the social life of the people and also enable the economy of the country to grow. The most important objective of any tax reform is to raise more revenue for the government.

**(ii) Redistribution of income and wealth**

This can be looked at from two perspectives. The first is the doctrine that taxation should be based on the ability to pay, so that the burden of taxation ought to be heavier for rich men than for the poor, with the taxes collected being used to pay for social services for the less fortunate. This is achieved by the graduation or "progressiveness" of the rates at which the taxes are levied.

(iii) **Management of the economy**
Taxation is important in the planning of savings and investments and harmonising it with development strategy and changing economic structure. The government can use taxation as a powerful fiscal weapon to plan and develop a country, for example, control of inflation through fiscal measures, preservation of foreign exchange reserve, protection of infant industries in the country, encouragement of industrialists to develop the country, control of the importation of harmful or dangerous goods, etc.

(iv) **Harmonisation of economic objectives**
Harmonisation of diverse trade or economic objectives of different countries can be achieved through a good tax system, for example, tax system can be employed by member states of Economic Committee of West African States (ECOWAS) so as to achieve the philosophy of the single market (free movement of people and goods) within the region.

(v) **Improvement in gross national income**
Taxation is a device to improve gross national income, induce economic development and influence favourable balance of payments.

(b) **Direct tax** is a form of tax assessable directly on a taxpayer who is required to pay tax on his property, income or profit, etc.

Types of taxes that fall under this heading are:
(i) Personal income tax;
(ii) Companies income tax;
(iii) Capital gains tax;
(iv) Tertiary education tax; and
(v) Petroleum profits tax.

**Indirect taxes** are those which are imposed on commodities before they reach the consumer and are paid by those upon whom they ultimately fall, not as taxes, but as part of the selling price of the commodity.

Types of taxes that fall under this heading include:
(i) Value added tax;
(ii) Stamp duties;
(iii) Excise duties; and
(iv) Customs duties.

(c) (i) Companies are required to file various tax returns applicable to them. These tax returns must comply with laid down regulations and be accompanied by the following statements:

- Originals of financial statements for the relevant financial year containing:

- Auditors' report with the seal of an audit partner of the audit firm and the official stamp of the audit firms regulatory professional body;
- Statement of financial position signed by two directors of the company;
- Statement of profit or loss and comprehensive income;
- Directors' report;
- Statement of cash flows; and
- Notes to the financial statements.

- Computations of capital allowances;
- Income tax computations, including minimum tax computations where applicable;
- Relevant schedules to the financial statements;
- Duly completed FIRS self assessment forms for companies income tax and tertiary education tax; and
- Evidence of payment of tax in full or a part of an agreed assessment by installment plan.

(ii) **Time limit for filing tax returns are:**

- **In the case of an old company**
  Tax returns must be filed latest six months after the end of a company's accounting year.
- **In the case of a newly incorporated company**
  Tax returns must be filed latest eighteen months from the date of incorporation, or six (6) months after the end of its first accounting period, whichever is earlier.

(iii) **Section 55, CITA** makes provision for payment of penalty by any company that fails to comply with the requirements for filing of annual tax returns as follows:

- ₦25,000 in the first month in which it fails to file its annual returns; and
- ₦5,000 for each subsequent month in which the failure continues.

In addition, any director, manager, secretary, servant or agent of a defaulting company who has been proven to be guilty of connivance, neglect or acquiescence to the commission of the offence of non-compliance with the above provision, shall be liable to a fine of ₦100,000 or imprisonment for 2 years or both.

**EXAMINER'S REPORT**

**The question tests candidates' knowledge of the objectives and purposes of taxation, direct and indirect taxes and the documents to be filed for tax returns, time limit and penalties for not filing tax returns on due dates.**

**The candidates' performance was fair. The common pitfalls of the candidates were lack of understanding of the documents to be filed as annual returns and wrong definition of indirect taxes.**

**Candidates are advised to read and digest the introduction to Nigeria tax system for proper understanding of the fundamental principles of taxation when preparing for future examinations.**

| **Marking Guide** | | Marks | Marks |
|---|---|---|---|
| a. i | Major objectives and purposes of taxation: | | |
| | - Revenue generation | 1 | |
| | - Redistribution of income and wealth | 1 | |
| | - Management of the economy | 1 | |
| | - Harmonisation of economic objectives | 1 | |
| | - Improvement in gross national income | 1 | |
| | | | 5 |
| b | Comparison of direct and indirect taxes | | |
| | (1 mark for each of the comparisons) | 2 | |
| | Examples of direct and indirect taxes | | |
| | Direct taxes ($^1/_2$ mark for each of the 4 points) | 2 | |
| | Indirect taxes ($^1/_2$ mark for each of the 4 points) | 2 | |
| | | | 6 |
| c | Documents to be filed at FIRS | | |
| | ($^1/_2$ mark for each of the 6 points) | | 3 |
| | Time limits for filing tax returns | | |
| | (1 mark for each of the 3 points) | | 3 |
| d | Penalties for failure to file tax returns | | |
| | (1 mark for each of the 3 points) | | 3 |
| | | | 20 |

**SOLUTION 3**

(a)(i) **Three tiers of government and their revenue collection authorities in Nigeria are:**

- Federal Government/Federal Inland Revenue Service
- State governments/State Internal Revenue Service
- Local governments /Local Government Revenue Committees

(ii) **Taxes collectible by Federal Government**

These include:

- Companies income tax;
- Withholding tax on companies, residents of the FCT and non-resident individuals;
- Petroleum profits tax;

- Value added tax;
- Tertiary education tax;
- Capital gains tax on companies, residents of FCT and non-resident individuals;
- Stamp duties on corporate bodies and residents of FCT;
- Personal income tax on members of the Armed Forces of the Federation of Nigeria, members of the Nigeria Police, residents of the FCT;
- Staff of the Ministry of External Affairs and non-resident individuals; and
- National information technology development levy.

**Taxes and levies collectible by state governments**

These include:

- Pay As You Earn (PAYE);
- Withholding tax on individuals;
- Capital gains tax on individuals;
- Stamp duties on investments executed by individuals;
- Pools betting, lotteries, gaming and casino taxes,
- Roads taxes;
- Business premises registration fees;
- Development levy (individuals only), not more than ₦100.00 per annum on all taxable individuals;
- Naming of street registration fees in state capital;
- Right of occupancy fees on lands owned by the state in urban cities;
- Market taxes and levies where state finance is involved;
- Direct taxation (self assessment);
- Hotel restaurant or event centre consumption tax, where applicable;
- Entertainment tax, where applicable;
- Environmental (ecological) fee or levy;
- Mining, milling or quarry fees, where applicable;
- Animal trade tax, where applicable;
- Produce sales tax, where applicable;
- Slaughter or abattoir fees, where state finance is involved;
- Infrastructure maintenance charge or levy, where applicable;
- Five service charge;
- Economic development levy, where applicable;
- Social services contribution levy, where applicable;
- Signages and mobile advertisement, jointly collected by states and local governments;
- Property tax; and
- Land use charge, where applicable.

**Taxes and levies collectible by local governments**

These include:

- Shops and kiosks rates;
- Tenement rates:
- Marriage, birth and death registration fees;
- Slaughter slab fees;
- On and off liquor licence fees;

- Street naming registration fee except in state capital;
- Right of occupancy fees on lands in rural areas (exclusive of those collectable by Federal and state governments);
- Market taxes and levies excluding any market where state finance is involved;
- Motor park fees;
- Domestic animal licence fees;
- Bicycle, truck, canoe, wheel barrow and cart fees, other than a mechanical propelled truck;
- Cattle tax payable by cattle farmers only;
- Road closure levy;
- Radio and television licence fees other than radio and television transmitter;
- Radio licence fees to be imposed by the local government of the state in which the car is registered);
- Illegal parking fees;
- Public convenience sewage and refuse disposal fee;
- Customary burial ground permit fees;
- Religious places establishment permit fees;
- Signboard and advertisement permit fees; and
- Wharf landing charge; where applicable.

**Harmonised rates**

Collection of the taxes and levies are to be harmonised among the state and local governments where applicable as follows:

- A single inter-state road taxes sticker for any vehicle within Nigeria designed by the Joint Tax Board for all the states and the sticker is to be administered by all the states;

- A single haulage fee payable at the points of loading in the state of departure and a single haulage fee payable at the points of discharge of the goods which the states are required to set up institutional structure to collect;

- Wharf landing fee collected by the state where there are facilities to administer, such fees which may be jointly administered by the state and local governments and proceeds from collection shared in line with and agreed proportion;

- A single parking permit sticker designed by the JTB and issued by the operators of the parks where vehicles are parked in the courses of their journey;

- Fire service levy should be a charge on business premises and corporate organisations only and Federal Fire Service can only collect fire service levies in the FCT and not in the states; and

- Road worthiness certificate fee should be collected by the state in which the vehicle operates and should be administered by Board of Internal Revenue in conjunction with appropriate agencies.

(iii) **Resident individual**

An individual is regarded as resident in Nigeria in any assessment year if he:

- Is domiciled in Nigeria; or
- Sojourns in Nigeria for a period or periods in all amounting to 183 days or more in a 12 month period; or
- Serves as a diplomat or diplomatic agent of Nigeria in a country other than
  Nigeria.

b.(i) Mr. James Muhammed will be subjected to tax by the Ogun State Internal Revenue Service based on residency rules.

b.(ii) **Mr. James Muhammed**

**Computation of income tax for 2016 assessment year**

| | ₦ | ₦ |
|---|---|---|
| Annual salaries | 1,600,000 | |
| Consolidated relief allowance: | | |
| - ₦200,000 or 1% of gross income whichever is higher + 20% of gross income | | |
| - ₦200,000 + 20% of ₦1600,000 | | |
| - ₦ 200,000+₦320,000) | 520,000 | |
| Exempt items: | | |
| Contribution to pension (₦1,600,000 @ 8%) | 128,000 | |
| Life assurance premium | 80,000 | |
| | (728,000) | |
| **Taxable income** | | |
| | 872,000 | |

| | | |
|---|---|---|
| Applying tax table rates | | |
| First | ₦300,000 @ 7% | 21,000 |
| Next | ₦300,000 @ 11% | 33,000 |
| Balance | ₦272,000 @ 15% | 40,800 |
| | ₦872,000 | |
| **Personal income tax payable** | | 94,800 |

**EXAMINER'S REPORT**

**The question tests candidates' knowledge of the various levies and taxes collectible by each tier of government and the identification of the relevant tax authority for an individual.**

**Candidates' performance was poor. Most candidates did not know the specific taxes and levies collectible by the different tiers of government. State Internal**

**Revenue Service and Local Government Revenue Committee were erroneously written by the majority of the candidates as State Inland Revenue and Local Government Inland Revenue, respectively.**

**Candidates are advised to show more understanding of the topic by reading widely on the subject matter when preparing for future examinations.**

| **Marking Guide** | | Marks | Marks |
|---|---|---|---|
| a. i. | Various tiers of government and their revenue authorities (1 mark for each of the 3 points) | 3 | |
| ii. | Taxes and levies collectible by each tier of government ($^1/_2$ mark for each of the 12 points) | 6 | |
| iii. | Definition of resident individual (1 mark for each of the 3 points) | 3 | |
| | | | 12 |
| b i. | Identification of the relevant authority tax authority | 2 | |
| ii. | Computation of personal income tax liability: | | |
| | Heading | $^1/_2$ | |
| | Annual salaries | $^1/_2$ | |
| | Consolidated relief allowance | 1 | |
| | Contribution of pension scheme | $^1/_2$ | |
| | Life assurance premium | $^1/_2$ | |
| | Subtotal | $^1/_2$ | |
| | Taxable income | $^1/_2$ | |
| | First ₦300,000 | $^1/_2$ | |
| | Next ₦300,000 | $^1/_2$ | |
| | Balance ₦272,000 | $^1/_2$ | |
| | Personal income tax liability | $^1/_2$ | 8 |
| | | | 20 |

**SOLUTION 4**

(a)

(i) **Trust** relates to equitable obligation which binds a person called the trustee, to deal with a property, over which he/she has custody (which is called the trust property), for the benefit of persons (beneficiaries) of which he/she may be one.

(ii) **Beneficiary** is a person who receives income from a settlement, trust or estate.

(ii) **Life tenant** is the person(s) who has a right to the income or property held in trust for life.

(b)

**Estate of late Mr. Bulamoyoh**
**Computation of capital allowances**
**for 2019 year of assessment**

| | Motor vehicles | Plant and machinery | Furniture | Total allowance |
|---|---|---|---|---|
| Initial allowance | 50% | 25% | 25% | |
| Annual allowance | 25% | 20% | 20% | |
| | ₦ | ₦ | ₦ | ₦ |
| T.W.D.V. b/f A.Y. 2019 | 345,000 | - | - | - |
| Additions | 3,650,000 | 1,250,000 | 220,000 | |
| | 3,995,000 | 1,250,000 | 220,000 | |
| Initial allowance | (1,825,000) | (625,000) | (55,000) | 2,505,000 |
| Annual allowance: | | | | |
| Old asset | (315,000) | - | - | 315,000 |
| New asset | (456,250) | (156,250) | (33,000) | 645,500 |
| Investment allowance | - | (125,000) | - | 125,000 |
| | | | | 3,590,500 |
| T.W.D.V. c/f to A.Y.2020 | 1,398,750 | 468,750 | 132,000 | |

**Note:**
Investment allowance should not be deducted from the cost of an asset in arriving at the tax written down value of same which is carried forward to the next assessment year.

(c)

**Estate of late Mr. Bulamoyoh**
**Computation of income tax payable**
**For 2017 year of assessment**

| | ₦ | ₦ |
|---|---|---|
| Adjusted profit | | |
| 10,270,000 | | |
| Less: Capital allowances | | 3,590,500 |
| | | 6,679,500 |
| Less: Allowable expenses: | | |
| Fixed annuity | 250,000 | |
| Interest on debt repayment | 120,000 | |
| Trustee's fixed remuneration | 260,000 | |
| Administration and other expenses | 45,000 | 675,000 |
| Computed income | | 6,004,500 |
| Less: Discretionary payments: | | |
| - Moses | 310,000 | |
| - Peter | 225,000 | |
| - Nana | 460,000 | (995,000) |
| Income available for distribution | | 5,009,500 |
| Less: Distribution to beneficiaries | | |
| • Moses ($^1/_4$ of ₦5,009,500) | 1,252,375 | |
| • Peter ($^1/_4$ of ₦5,009,500) | 1, 252,375 | |
| • Nana ($^1/_4$ of ₦5, 009,500) | 1, 252,375 | (3,757,125) |

| | |
|---|---|
| Net distributable income assessable to tax in the hands of the trustees | 1,252,375 |
| Consolidated relief allowance: | |
| Higher of 1% of gross income or ₦200,000 | |
| plus 20% of gross income | (450,475) |
| Taxable income | 801,900 |

**Tax payable (applying the tax rates)**

| | ₦ K |
|---|---|
| 1st N300,000 @ 7% | 21,000.00 |
| Next N300,000 @ 11% | 33,000.00 |
| Next ₦201,900 @ 15% | 30,285.00 |
| ₦801,900 | |
| **Tax payable** | 84,285.00 |

**EXAMINER'S REPORT**

**The question tests candidates' knowledge of the terminologies relating to trusts and the computation of income tax payable by trustees.**

**Candidates' performance was poor. Most of the candidates were not able to compute capital allowances and investment allowance, hence the wrong computed amount to be shared among the beneficiaries. Additionally, some candidates could not define "Life tenant".**

**Candidates should strive to read and understand the computation of capital allowances. Adequate knowledge of taxation of estate, trust and settlement should be sought for by making use of relevant study texts when preparing for future examinations.**

| **Making Guide** | | Marks | Marks |
|---|---|---|---|
| (a) | Definitions ( 1 mark for each of the 3 correct definitions) | | 3 |
| | | | |
| (b) | Computation of capital allowances: | | |
| | - TWDV b/f (m/v) | $^1/_2$ | |
| | - Additions ($^1/_2$ mark for each of the three points) | $1^1/_2$ | |
| | - Initial allowance (1/2 mark for each of the four points) | 2 | |
| | Annual allowance (old assets) | 1 | |
| | Annual allowance (new assets) | 2 | |
| | Investment allowance | 1 | |
| | | | 8 |
| (c) | Computation of income tax payable by the trustee: | | |
| | Adjusted profit | $^1/_2$ | |
| | Capital allowances | $^1/_2$ | |
| | Fixed annuity | $^1/_2$ | |
| | Interest on debt payment | $^1/_2$ | |
| | Trustee's fixed remuneration | $^1/_2$ | |
| | Administration and other expenses | $^1/_2$ | |
| | Discretionary payments | $1^1/_2$ | |
| | Distribution to beneficiaries | $1^1/_2$ | |
| | Consolidated relief allowance | $^1/_2$ | |
| | Taxable income | $^1/_2$ | |
| | Tax payable based on tax rates | 2 | |
| | | | 9 |
| | | | 20 |

**SECTION C**

**SOLUTION 5**

**(a) Oloriogun Logistics Limited**

**Calculation of withholding tax credits based on the invoices**

| Date | Invoice Number | Month of transaction | Amount ₦ | WHT @ 10% ₦ |
|---|---|---|---|---|
| 19/2/2015 | 002/01 | Jan. 2015 | 350,000 | 35,000 |
| 19/3/2015 | 003/02 | Feb. 2015 | 670,000 | 67,000 |
| 20/4/2015 | 004/03 | Mar. 2015 | 810,000 | 81,000 |
| 20/5/2015 | 005/04 | Apr. 2015 | 305,000 | 30,500 |
| 19/6/2015 | 006/05 | May 2015 | 295,000 | 29,500 |
| 20/8/2015 | 008/07 | Jun. 2015 | 922,000 | 92,200 |
| 21/9/2015 | 009/08 | Aug. 2015 | 270,000 | 27,000 |
| 21/10/2015 | 010/09 | Sept. 2015 | 195,000 | 19,500 |
| 20/11/2015 | 011/10 | Oct. 2015 | 408,000 | 40,800 |
| 21/12/2015 | 012/11 | Nov. 2015 | 495,000 | 49,500 |
| 21/01/2016 | 012/12 | Dec. 2015 | 396,000 | 39,600 |
| **Total for 2015** | | | **5,116,000** | **511,600** |
| 21/03/2016 | 01/02 | Jan. & Feb. 2016 | | |
| **Total for 2016** | | | **1,649,000** | **164,900** |

(b) **Total amount of WHT credits to be claimed**

- ₦511,600 for 2016 Year of Assessment
- ₦164,900 for 2017 Year of Assessment
- (Assuming no other transactions after February 2016)

(b) In practice, due date for remitting withholding tax returns is the **21st day** of the month following the month in which the deductions were made.

The law provides that remittance of withholding tax to Federal Inland Service should be made within 21 days after the date of transaction or put differently; from the date the duty to deduct arises.

(c) Transactions that are exempted from WHT are:

(i) Direct purchase across the counter (cash sales);
(ii) Direct purchases of raw materials from suppliers as distinct from contract of supplies;
(iii) Sale in the ordinary course of business;
(iv) All imported goods;
(v) Inter-bank interest;
(vi) Income exempted from income tax;

(vii) Claims in insurance business;
(viii) Interest on bonds; for and
(ix) Dividends redistributed by holding companies.

(d) The agents recognized by government for the collection and remittance of withholding tax include:
   (i) Corporate bodies (companies);
   (ii) Individuals, firms and sole traders;
   (iii) A statutory body, public authority and other institutions or organizations; and
   (iv) Government ministries, departments or agencies and local governments.

**EXAMINER'S REPORT**

**The question tests candidates' knowledge of withholding tax.**

**Candidates' performance was fair. Some of the candidates could not determine correctly the due date of remitting withholding tax to the relevant tax authorities and the transactions that are exempted from withholding tax in Nigeria.**

**Candidates are advised to strive hard to understand this topic by consulting relevant texts and applicable statutes (PITA and CITA) for better performance in future examinations.**

| | **Marking Guide** | Marks | Marks |
|---|---|---|---|
| (a) | Calculation of withholding tax credits based on the invoices ($^1/_2$ mark for each of the 12 points) | | 6 |
| (b) | Determination of withholding tax credits to be claimed for each year ($1^1/_2$ marks for each of the 2 years) | | 3 |
| (c) | Due date of remittance of withholding tax | | 1 |
| (d) | Transactions exempted from withholding tax:<br>(x) Direct purchase across the counter (cash sales);<br>(xi) Direct purchases of raw materials from suppliers as distinct from contract of supplies;<br>(xii) Sale in the ordinary course of business;<br>(xiii) All imported goods;<br>(xiv) Inter-bank interest;<br>(xv) Income exempted from income tax;<br>(xvi) Claims in insurance business;<br>(xvii) Interest on bonds; for and<br>(xviii) Dividends redistributed by holding companies.<br>(1 mark each for any of the 6 points) | | 3 |

(e) Agents recognised by the government for the collection and remittance of withholding tax:

- (v) Corporate bodies (companies);
- (vi) Individuals, firms and sole traders;
- (vii) A statutory body, public authority and other institutions or organizations; and
- (viii) Government ministries, departments or agencies and local governments.

($^1/_2$ mark for each of the 4 points) 2

15

**SOLUTION 6**

(a) **Duru Cobbler Limited**

**Computation of total profit and taxes payable**

**For 2019 year of assessment**

| | ₦ | ₦ |
|---|---|---|
| Net loss per accounts | | (879,490) |
| Add back: | | |
| - WHT on interest (₦234,000 x $^{10}/_{90}$) | 26,000 | |
| - Bad debt written off | 655,000 | |
| - Value added tax | 985,000 | |
| - Impairment loss | 420,000 | |
| - Depreciation and amortization | 1,690,000 | 3,776,000 |
| | | 2,896,510 |
| Less: Profit on sale of property, plant and equipment | | 120,000 |
| Adjusted profit | | 2,776,510 |
| Less capital allowances | | 1,294,000 |
| Total profit | | 1,482,510 |
| Companies income tax (30% of total profit) | | 444,753 |
| Tax deducted at source: | | |
| - On rent (₦240,000 x 10%) | 24,000 | |
| - On bank deposits | 26,000 | (50,000) |
| Net income tax payable | | 394,753 |
| Tertiary education tax @ 2% of adjusted profit of ₦2,776,510 | | 55,530.20 |
| **Total tax payable** | | 450,283.20 |

(bi) Certain goods and services are classified as zero-rated. These goods and services are within the ambit of the VAT Act, but the applicable rate is 0%.

(ii) The transactions that are zero-rated are:

- Non-oil exports:

- Goods and services purchased by diplomats; and
- Humanitarian and donor-funded projects which include projects undertaken by non-governmental organizations, religious and social clubs or societies recognized by law whose activity is not for profit but in the public interest.

The penalties for non-registration of VAT or failure or refusal to register with the Board within the specified time. The taxpayer shall be liable to:

(i) A penalty of ₦10,000 for the first month in which the failure occurs; and

(ii) ₦5,000 for each subsequent month in which the failure continues.

(iii) If this persists, the premises where the business is carried on shall be sealed up.

**EXAMINER'S REPORT**

**The question tests candidates' knowledge of the computations of companies income tax and tertiary education tax. It is also designed to test candidates' understanding of the principles relating to value added tax (VAT).**

**The performance was above average, however, some candidates could not describe 'zero-rated goods and services' correctly. They were erroneously described as exempted goods and services.**

**Candidates are advised to read and understand VAT by making use of ICAN Study Text, other relevant textbooks, circulars from Federal Inland Revenue Service and appropriate Acts when preparing for future examinations.**

| **Marking Guide** | | Marks | Marks |
|---|---|---|---|
| (a) | Computation of total profit and tax liabilities | | |
| | Heading | $^1/_2$ | |
| | Net loss per accounts | $^1/_2$ | |
| | WHT on interest | $^1/_2$ | |
| | Bad debts written off | $^1/_2$ | |
| | Value added tax | $^1/_2$ | |
| | Impairment loss | $^1/_2$ | |
| | Depreciation and amortisation | $^1/_2$ | |
| | Sub total | 1 | |
| | Profit or sale of PPE | $^1/_2$ | |
| | Adjusted profit | $^1/_2$ | |
| | Capital allowances | $^1/_2$ | |
| | Total profit | $^1/_2$ | |
| | CIT | $^1/_2$ | |
| | Tax on rent deducted at source | $^1/_2$ | |
| | Tax on bank deposits deducted at source | $^1/_2$ | |

| | | | |
|---|---|---|---|
| | Sub- total | ½ | |
| | Net income tax payable | ½ | |
| | Tertiary education tax | ½ | |
| | Total tax payable | ½ | |
| | | | 10 |
| (b) | Definition of zero-rated goods | 1 | |
| | Examples of zero-rated goods:<br>(i) Non-oil exports:<br>(ii) Goods and services purchased by diplomats; and<br>(iii) Humanitarian and donor-funded projects which include projects undertaken by non-governmental organizations, religious and social clubs or societies recognized by law whose activity is not for profit but in the public interest.<br>(1 mark each for any of the 2 points) | | |
| | | 2 | 3 |
| (c) | Penalties for non-registration for VAT:<br>(iv) A penalty of ₦10,000 for the first month in which the failure occurs; an<br>(v) ₦5,000 for each subsequent month in which the failure continues.<br>If this persists, the premises where the business is carried on shall be sealed up.<br><br>(1 mark each for (i) & (ii) above | | |
| | | | 2 |
| | | | 15 |

**SOLUTION 7**

a) (i) **Proportional tax** is a tax imposed so that the tax rate is fixed, with no change as the taxable base amount increases or decreases. For example, at a flat rate of 10%, a taxpayer with total assessable income of N100,000 will pay tax of N10,000, while a taxpayer with income of ₦1,000,000 pays tax of ₦100,000 and so on.

**Progressive tax** is a form of tax that is calculated on a graduated scale. It applies higher rates of tax as income increases. For example, rate of 5% on assessable income lower than ₦200,000 and 10% for assessable income higher that ₦200,000.

It is a tax whose objective is the redistribution of income from the well to do to the less privileged.

(ii) **Direct tax** is a form of tax that is assessable directly on property, income or profit, etc. An example is companies income tax (CIT).

**Indirect tax** is the form of tax that is imposed on commodities before they reach the consumer, and is paid by those upon whom it ultimately falls, not as tax, but as part of the selling price of the commodity. An example is value added tax (VAT).

(iii) **Statute laws** are tax legislations passed by Acts of the National and State Assemblies and bye-laws by local government authorities in a democratic government or decrees or edicts under the military government. These legislations confer necessary powers on the taxing authorities to impose taxes on the citizens. An example is the Personal Income Tax (Amendment) Act 2011.

**Case laws** are judicial precedents. Judgements pronounced by superior courts of records on principles of tax laws and their interpretations of the provisions of tax statutes are binding on the lower courts.

(iv) **Franked investment income (FII)**

This is an investment income on which tax has already been paid (usually deducted at source) and thus exempted from additional tax on the investor. It can also be described as an income which suffers withholding tax as final tax in the hands of the recipient.

(ix) Taxes and levies to be collectible by local governments. These include:

- Shops and kiosk rates;
- Tenement rates;
- Marriage, birth and death registration fees;
- Slaughter slab fees;
- On and off liquor incense fees;
- Street naming registration fee except in state capital
- Right of occupancy fees on Lands in rural areas. (Exclusive of those collectables by Federal and state Governments);
- Market taxes and levies. (excluding market where state finance is involve);
- Motor park fees;
- Domestic animal licence fees;
- Bicycle, truck, canoe, wheel barrow and court fees, other than a mechanically propelled by cattle farmers only;
- Radio closure levy;
- Radio and television licence fees. (other than radio and television transmitter);
- Radio licence fees (to be imposed by the Local Government of the State which the is registered);

- Illegal parking fees;
- Public convenience sewage and refuse disposal fees;
- Customary burial ground permit fees;
- Religious places establishment permit fees; and
- Signboard and advertisement permit fees

(b) **Information in a tax clearance certificate**

These include:

(i) Name, address and taxpayer's identification Number (TIN) of the company;
(ii) Chargeable income;
(iii) Tax payable;
(iv) Tax paid;
(v) Nature of business;
(vi) Types of assessment BOJ, self-assessment and so on); and
(vii) Expiry date

**EXAMINER'S REPORT**

**The question tests candidates' knowledge of terminologies in respect of types of taxes, franked investment income, statutes, case laws, and taxes collectible by local governments. Additionally, candidates are expected to identify the types of information that are disclosed in a tax clearance certificate.**

**Candidates' performance was above average, however, some candidates did not understand "franked investment income" (FII) and were unable to differentiate between statute and case laws.**

**Candidates should endeavour to read relevant texts to understand in particular, 'franked investment income' and in general, the introduction to Nigeria tax system in preparing for future examinations.**

| | Marking Guide | Marks |
|---|---|---|
| (a) (i) | Proportional tax and progressive tax<br>(1 mark for each of the 2 points) | 2 |
| ii. | Direct and indirect taxes (1 mark for each of the two points) | 2 |
| iii. | Statute laws and case law (1 mark for each of the 2 points) | 2 |
| iv. | Definition of franked investment income (FII) | 3 |
| v. | Taxes collectible by local governments:<br>• Shops and kiosk rates;<br>• Tenement rates;<br>• Marriage, birth and death registration fees;<br>• Slaughter slab fees;<br>• On and off liquor incense fees;<br>• Street naming registration fee except in state capital<br>• Right of occupancy fees on Lands in rural areas. (exclusive of those collectables by Federal and state governments);<br>• Market taxes and levies. (excluding market where state finance is involve);<br>• Motor park fees;<br>• Domestic animal licence fees;<br>• Bicycle, truck, canoe, wheel barrow and court fees, other than a mechanically propelled by cattle farmers only;<br>• Radio closure levy;<br>• Radio and television licence fees. (other than radio and television transmitter);<br>• Radio licence fees (to be imposed by the Local Government of the State which the is registered);<br>• Illegal parking fees;<br>• Public convenience sewage and refuse disposal fees;<br>• Customary burial ground permit fees;<br>• Religious places establishment permit fees; and<br>• Signboard and advertisement permit fees | |
| | (1 mark each for any of the 4 points) | 4 |
| (b) | **Information in a tax clearance certificate:**<br>(viii) Name, address and taxpayer's identification number (TIN);<br>(ix) Chargeable income;<br>(x) Tax payable;<br>(xi) Tax paid;<br>(xii) Nature of business;<br>(xiii) Types of assessment (BOJ, self-assessment and so on); and<br>(xiv) Expiry date. | |
| | ($^1/_2$mark each for any of the 4 points) | <u>2</u> |
| | | <u>15</u> |

# THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

## SKILLS LEVEL EXAMINATION – MAY 2019

## 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**

KK Plc. buys small tablet computers which it customises for the Nigerian market and then resells to electronics retailers. Although a detailed variance analysis is carried out each month, the CEO John, T, has become concerned that no one has a clear responsibility for taking action in response to this analysis or for using it to carry out an ex-post analysis of the outcome of important decisions.

The following is an extract from last month's budget:

| | **Model A** | **Model B** | **Model C** |
|---|---|---|---|
| Selling price/unit (₦) | 1,000 | 1,250 | 1,500 |
| Variable cost/unit (₦) | 400 | 500 | 600 |
| Sales (units) | 25,000 | 40,000 | 15,000 |

The budgeted fixed costs were ₦12,500,000 for the month, which were not dependent on the mix or quantities of products sold. When the budget was being prepared, it was estimated that the total size of the market (including sales by the company and the competitors) would be 400,000 units.

Shortly after the beginning of the month, the marketing director, Okon Nelson, decided that a change of pricing strategy was necessary in response to the recessionary economic conditions. The price of model A was reduced by 10% and the prices of models B and C were each reduced by 20%. The company was partly successful in passing on the impact of these price reductions to its suppliers and as a consequence, the variable cost per unit for all three models was reduced by 5%. Actual fixed costs were 5% higher than budgeted because of the marketing costs associated with publishing the price reductions.

As a result of the recessionary conditions, the actual total market size was just 200,000 units. The actual quantities sold by the company were as follows:

| | Model A | Model B | Model C |
|---|---|---|---|
| Sales (units) | 14,800 | 29,500 | 11,700 |

**Required:**

a. Present a comprehensive analysis of variances, reconciling the budgeted and actual profit for last month in as much detail as possible from the information provided. (25 Marks)

b. Evaluate the financial success (or otherwise) of the decision to change the pricing strategy and assess whether the difference between the budgeted and actual performance was attributable mainly to luck or to factors within the company's control. (5 Marks)

**(Total 30 Marks)**

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

**QUESTION 2**

Peter Drucker opined that "until a business returns a profit that is greater than its cost of capital, it operates at a loss". Therefore, experts have challenged accounting profit as a good measure of increase in the value of a business and have proposed a measure of real economic profit. In their view, this will lead to better measurement of the increase in value of a business during a given period of time. One method that has been suggested to measure economic profit is known as economic value added (EVA).

Tees Nigeria Limited has presented the following income statement and statement of financial position for the year ended 31 December, 2018:

| **Income Statement** | **2018** |
|---|---|
| | **₦000** |
| Profit before interest and tax | 75,000 |
| Interest cost | (9,000) |
| Profit before tax | 66,000 |
| Tax at 30% | (19,800) |
| Profit after tax | 46,200 |
| Dividends paid | (30,000) |
| Retained profit | 16,200 |

| **Statement of Financial Position** | **2018** |
|---|---|
| | **₦000** |
| Non-current assets | 305,000 |
| Net current assets | 190,000 |
| Total Assets | **495,000** |
| Shareholders' funds | 395,000 |
| Long-term and medium-term debt | 100,000 |
| Capital employed | **495,000** |

**Notes**

(i) Capital employed at the beginning of the year was ₦420 million.

(ii) The company had non-capitalised leased assets of ₦24 million in the year. These assets are not subject to depreciation.

(iii) The estimated cost of equity in the year was 10% and the cost of debt was 7%.

(iv) The company's target capital structure is 60% equity and 40% debt.

(v) Accounting depreciation was equal to economic depreciation so there is no need to make an adjustment from accounting depreciation to get economic depreciation.

(vi) Other non-cash expenses were ₦16 million.

The company has decided to evaluate its performance using economic value added approach.

**Required:**

a. Discuss the perceived benefits of using EVA to measure business performance. (10 Marks)

b. Calculate the real economic profit of Tees Nigeria Limited using EVA. (10 Marks)

**(Total 20 Marks)**

## QUESTION 3

Peterpan Nigeria Limited is a holding company with two subsidiaries manufacturing similar products in different regions of the country. These are Peterpan (Eastern) Nigeria Limited and Peterpan (Western) Nigeria Limited. Return on capital employed (ROCE) is used as the group's performance measure and is also used to determine divisional managers' bonuses. The results of the two companies and of the holding company for the year ended 31 December, 2018 and the statement of financial position as at that date are as follows:

| | Western ₦'000 | Eastern ₦'000 | Peterpan ₦'000 |
|---|---|---|---|
| Revenue | 400,000 | 440,000 | 800,000 |
| Cost of sales | (340,000) | (320,000) | (620,000) |
| Gross profit | 60,000 | 120,000 | 180,000 |
| Administrative costs | (20,000) | (60,000) | (80,000) |
| Interest payable | (20,000) | - | (20,000) |
| Pre-tax profit | 20,000 | 60,000 | 80,000 |
| Non-current assets: | | | |
| Original cost | 2,000,000 | 3,000,000 | 5,000,000 |
| Accumulated depreciation | (1,180,800) | (2,213,568) | (3,394,368) |
| Net book value | 819,200 | 786,432 | 1,605,632 |
| Net current assets | 100,000 | 120,000 | 220,000 |
| Total asset | 919,200 | 906,432 | 1,825,632 |
| Non-current borrowings | 300,000 | - | 300,000 |
| Shareholders' fund | 619,200 | 906,432 | 1,525,632 |
| Capital employed | 919,200 | 906,432 | 1,825,632 |

**The following additional information was provided:**

(i) During the year, Eastern Limited sold goods to Western Limited that had cost Eastern Limited ₦20,000,000. The transactions relating to this sale have been eliminated from the holding company's results stated above.

(ii) Both companies use the same depreciation policy of 20% per annum on a reducing balance basis for their non-current assets. Neither company made any additions or disposals of non-current assets during the year.

(iii) During the last board meeting of the holding company, it was decided that the holding company should impose a transfer pricing policy for transfers between the two subsidiaries.

**Required:**

a. Calculate the return on capital employed (ROCE) ratios for each of the two subsidiaries for the year and analyse these into their secondary ratio components of:

   i. Pre-Tax Profit %

   ii. Asset Turnover (3 Marks)

b.

   i. Calculate Eastern Limited's gross profit margin on its internal sales and compare this to the gross profit margin on its external sales. (2 Marks)

ii. Discuss the performance of the two subsidiaries excluding the effects of the intra group transactions. (9 Marks)

c. Explain **THREE** factors that the management should consider when setting the transfer pricing policy. (6 Mark)

**(Total 20 Marks)**

## QUESTION 4

BOK is an autonomous division of Large Plc. BOK carries out large engineering jobs to individual customer specifications. The manager of the division will retire within next year and Henry Femi, the CEO of Large Plc. has used a recruitment agency to identify a suitable successor, Mary Tako. Henry believes that Mary has excellent relevant experience in another company in the country and has offered her a 4-year contract position at BOK. The terms of the offer include a generous compensation package linked to the profit earned by BOK during the 4 years. Henry believes that BOK has been a very successful division and that a high-calibre manager, such as Mary, has great potential to continue to expand that success. In order to impress on Mary on the recent success of BOK, Henry provided her with the following comparative financial data about the recent performance of the division (Table 1):

**Table 1:**

| | **2018** | **2017** |
|---|---|---|
| | ₦ | ₦ |
| Turnover | 27,000,000 | 26,000,000 |
| Net profit | 5,600,000 | 5,200,000 |
| Bad debts | 132,000 | 130,000 |

It can be assumed that the inflation rate in each of the two years was 3% per annum.

Mary indicated that she would need some additional information before deciding on whether to accept the employment offer. The following is an extract from a balanced scorecard (Table 2) which was prepared at Mary's request:

**Table 2:**

| | **2018** | **2017** |
|---|---|---|
| **Customer theme:** | | |
| Number of customers | 120 | 100 |
| Average revenue from each customer, per annum (₦) | 225,000 | 260,000 |
| Market share | 9% | 8% |
| **Internal process theme:** | | |
| Percentage of jobs completed which contained errors | 3% | 4% |
| Average job completion time | 5.5 days | 7 days |

**Learning & growth themes:**

| | | |
|---|---|---|
| Staff turnover rate | 10% | 5% |
| Training expenditure (₦) | 1,000,000 | 1,000,000 |

(a) **Required:**

i. Analyse the change in the financial performance of BOK between 2017 and 2018 using the information provided in Table 1. (3 Marks)

ii. Evaluate the change in the performance of BOK between 2017 and 2018, using the information contained in the balanced scorecard (Table 2).

In addition, discuss the significant reasons why this analysis may be more relevant than your answer to part (ai) in helping Mary to decide whether or not to accept the offer. (13 Marks)

(b) Mary has indicated that she would only be willing to accept the employment offer at BOK if her annual bonuses were to be linked to a defined set of measures from all sections of the unit's balanced scorecard. Henry is resistant to this idea, arguing that profit is the ultimate goal of the organisation and that all bonuses should only be profit-related.

Determine, with reasons, whether Henry should be willing to accede to Mary's request in this regard in order to secure her acceptance of the offer. (4 Marks)

**(Total 20 Marks)**

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

**QUESTION 5**

TK is a company that produces toy television sets targeting children of the elite. The company has two divisions, Division S and Division B.

Division S manufactures components for the televisions and sells components to division B and to external customers. Division B uses five of the components in each of the toy television sets that it manufactures, and sells television sets directly to external customers.

**Division S**

| **Budgeted variable manufacturing cost per component:** | ₦ |
|---|---|
| Direct material | 140 |
| Direct labour | 180 |
| Variable overhead | 120 |

The following information relating to next year is also available:

| | |
|---|---|
| Fixed costs | ₦5,600,000 |
| Production capacity | 175,000 components |
| External demand | 150,000 components |
| Potential demand from Division B | 80,000 components |

The anticipated external market price for a component is ₦500.

| **Division B** | ₦ |
|---|---|
| Sales price | 4,500 |
| **Budgeted variable manufacturing cost per television** | |
| Direct material | 400 |
| Direct labour | 620 |
| Variable overhead | 160 |

In addition to the variable costs above, each toy television set produced needs five components.

Fixed costs are budgeted to be ₦14,600,000 for next year. Annual sales of the toy television sets are expected to be 16,000 units.

**Transfer Pricing Policy**

Transfer prices are set at opportunity cost.

Division S must satisfy the demand of Division B before selling components externally.

Division B is allowed to purchase components from Division S or from external suppliers.

a. Assuming that Division B buys all the components it requires from Division S:

   Prepare a profit statement for each division detailing sales and costs, showing external sales and internal company transfers separately where appropriate. (6 Marks)

b. A specialist external supplier has approached Division B and offered to supply 80,000 components at a price of ₦420 each. The components fulfil the same function as those manufactured by Division S. The manager of Division B has accepted the offer and has agreed to buy all the components it requires from this supplier

   i. Produce a revised profit statement for each division and for the total TK company. (5 Marks)

Division S has just received an enquiry from a new customer for the production of 25,000 components. The manager of Division S requires a total profit for the year for the division of ₦4,500,000.

ii. Calculate the minimum price per component to sell the 25,000 components to the new customer that would enable the manager of Division S to meet the profit target. (4 Marks)

**Note:** This order will have no effect on the divisional fixed costs and no impact on the 150,000 components Division S sells to its existing external customers at ₦500 per component. Division B will continue to purchase the 80,000 components it requires from the specialist external supplier. **(Total 15 Marks)**

## QUESTION 6

"The purpose of management accounting is to provide relevant and reliable information so that managers can make well – informed decisions. The value of management accounting therefore depends on the quality of the information provided and whether this information helps managers to make better decisions."

Therefore, before management accounting information can be useful to managers, it must possess some qualities.

**Required:**

Discuss the essential qualities of a good management accounting information.
**(Total 15 Marks)**

## QUESTION 7

Tetpack Nigerian Limited (TNL) produces various types of packaging products for the food industry. TNL has just introduced a new type of pack and its marketing manager is considering how to penetrate the market with the pack. The following pricing strategies have been suggested.

(i) Market skimming price;

(ii) Market penetration price;

(iii) Full cost plus price;

(iv) Return on investment price; and

(v) Marginal cost plus price

The management accountant has provided the following data about the pack.

- Non-current assets needed for the production of the pack is ₦2,000,000
- Working capital requirements are estimated at ₦400,000
- Expected annual sales volume is 40,000 units

- Variable production costs are ₦60 per unit
- Fixed production costs will be ₦300,000 each year and annual non-production costs will be ₦100,000
- The mark up for the pack will be as follows:
  - If full cost plus price is used, 25%
  - If marginal cost plus price is used, 40%
  - At target return on investment of 10% per year

**Required:**

a. Discuss the above pricing methods and advise when each could be used.
(10 Marks)

b. Calculate what the price of the pack should be if its price is based on:

i. Full cost plus pricing ($1^1/_2$ Marks)

ii. Marginal cost plus pricing ($1^1/_2$ Marks)

iii. Return on investment pricing (2 Marks)

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

Where r = discount rate

n = number of periods

*Discount rate (r)*

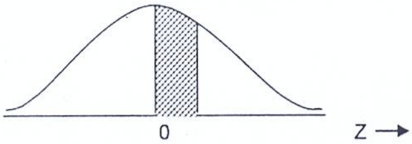
*Periods*

| (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 | 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. **Budgeted profit**

- Budgeted contribution:

| | | ₦000 | ₦000 |
|---|---|---|---|
| Model A | 25,000 × (₦1,000 - 400) = | 15,000 | |
| B | 40,000 × (₦1,250 - 500) = | 30,000 | |
| C | 15,000 × (₦1,500 - 600) = | 13,500 | 58,500 |
| Less fixed costs | | | (12,500) |
| Budgeted profit | | | 46,000 |

**Actual profit**

| | | ₦000 | ₦000 |
|---|---|---|---|
| • Actual contribution | | | |
| Model A | (₦900 - 380) × 14,800 = | 7,696.00 | |
| | B (₦1,000 - 475) × 29,500 = | 15,487.50 | |
| | C (₦1,200 - 570) × 11,700 = | 7,371.00 | 30,554.50 |
| Actual fixed costs (12,500 × 1.05) | | | (13,125.00) |
| Actual profit | | | 17,429.50 |

**Calculation of variances**

i. **Sales Prices Variance** (SPV)

| **Model** | **Actual Qty (units)** | **(AP - SP)** | **Variance** |
|---|---|---|---|
| A | 14,800 | 100(A) | 1,480(A) |
| B | 29,500 | 250(A) | 7,375(A) |
| C | 11,700 | 300(A) | 3,510(A) |
| | | | 12,365(A) |

ii. **Variable cost variance**

| **Model** | **Actual Qty units** | **Savings in variable Cost per unit** | **Variance** |
|---|---|---|---|
| | | **₦** | **₦000** |
| A | 14,800 | 20(F) | 296.00(F) |
| B | 29,500 | 25(F) | 737.50(F) |
| C | 11,700 | 30(F) | 351.00(F) |
| | | | 1,384.50(F) |

- Budgeted sales mix:
  Model A 25/80 x 100 = 31.25%
  B 40/80 x 100 = 50%
  C 15/80 x 100 = 18.75%
- Weighted average contribution per unit:
  (31.25% × ₦600) + (50% ×₦750) + (18.75% × ₦900) = ₦731.25*
  (* Needed in market size and market share variances)

iii. **Sales mix variance**

| Model | AQ in AM (a) units | AQ in SM (b) Units | Std Cont. per unit (c) ₦ | Mix variance (a-b) x (c) ₦'000 |
|---|---|---|---|---|
| A | 14,800 | 17,500 | 600 | 1,620(A) |
| B | 29,500 | 28,000 | 750 | 1,125(F) |
| C | 11,700 | 10,500 | 900 | 1,080(F) |
| | 56,000 | 56,000 | | 585(F) |

**Note:** AQ = Actual quantity, AM = Actual mix
SM = Standard mix
AP = Actual price
SP = Standard price

iv. **Sales quantity variance**

| Model | AQ in SM (a) units | BQ in SM (b) Units | Std Cont. (c) ₦ | Sales Qty variance (a-b) x (c) ₦'000 |
|---|---|---|---|---|
| A | 17,500 | 25,000 | 600 | 4,500(A) |
| B | 28,000 | 40,000 | 750 | 9,000(A) |
| C | 10,500 | 15,000 | 900 | 4,050(A) |
| | 56,000 | 80,000 | | 17,550(A) |

(**Note**: BQ = Budgeted Quantity)

v. **Market size variance**
Actual market size = 200,000
Budgeted market size = 400,000
Budgeted market size percentage = 80/400 = 20%
Variance = (200,000 – 400,000) × 20% × ₦731.25 = ₦29,250,000(A)

vi. **Market share variance**

Actual quantity = 56,000

Standard share of actual market = 20% × 200,000 = 40,000

Variance = (56,000 – 40,000) × ₦731.25 = ₦11,700,000(F)

vii. **Fixed overhead expenditure variance (FOEV)**

5% × ₦12,500,000 = ₦625,000(A)

**Profit reconciliation**

| | ₦'000 | ₦'000 | ₦'000 |
|---|---|---|---|
| Budgeted profit | | | 46,000.00 |
| Selling price variance | | | 12,365.00(A) |
| Variable cost variance | | | 1,384.50(F) |
| Sales mix variance | | 585(F) | |
| Market size variance | 29,250(A) | | |
| Market share variance | 11,700(F) | | |
| Sales quantity variance | | 17,550(A) | 16,965.00(A) |
| Fixed overhead expenditure variance | | | 625.00(A) |
| Actual profit | | | 17,429.50 |

b. **CHANGE IN PRICING STRATEGY**

The obvious costs of the strategy consist of the ₦625,000 additional marketing costs (as shown by the unfavourable FOEV) and the ₦12,365,000 cost of the price reductions (unfavourable SPV). The combined cost of the strategy as indicated by the sum of these two variances, was ₦12,990,000

**ANALYSIS OF OTHER VARIANCES**

However, these costs were partially offset. One offset resulted from the 5% reduction in variable costs (₦1,384,500 favourable variance) which arose because suppliers "agreed" to share in the cost of the price reductions. Also, because the selling price reduction was only 10% for the lowest-contribution product (Model A) compared to 20% for the two higher-contribution products (B and C),the net effect from a customer perspective is that products B and C became relatively less expensive. This is a probable cause of the favourable sales mix variance (₦585,000). Taking these two offsets into account, the net cost of the strategy was ₦12,990,000 – ₦1,398,000 – ₦585,000 = ₦11,007,000

The benefit of the strategy is indicated by the profit from incremental sales that arose as a result of the strategy. At first glance, the strategy appears to have failed because (far from increasing) sales actually diminished, giving rise to the unfavourable sales quantity variance of ₦17,550,000. However, when the SQV is analysed into its market share and market size elements, a different picture emerges. As a result of market share growth (which quite likely resulted from the change in pricing strategy) there were additional sales with a contribution ₦11,700,000. Since this is greater than the cost of the strategy then it can be judged a financial success.

The only variance which can be attributed to luck or uncontrollable factors is the market size variance (₦29,250,000 unfavourable).

**CONCLUSION**
Actual profit (₦17,429,500) was below budgeted profit (₦46,000,000), but this was due to one unfavourable luck factor (market size) which was partly offset by the positive effects of the decision to change the strategy, which was a decision consciously made by the company.

**EXAMINER'S REPORT**

**The question is a compulsory case study question that tests candidates knowledge in the following areas- variance computation and analysis, as well as reconciling budgeted profit with actual profit, It also test candidates ability to evaluate impact of changes in pricing strategy on performance of the company.**

**As a compulsory question, over 90% of the candidates attempted the question but the general average performance of 30% scored above average of the marks allocated the question, which is considered poor.**

**The common pitfall was inability of candidates to compute the relevant variances as well as linking market size and market share variances to sales volume variances.**

**Candidates are advised to utilise the ICAN study pack when preparing for future examination of the Institute.**

**Marking Guide**

| 1) | | Marks | Marks |
|---|---|---|---|
| (a) | Budgeted profit | 3 | |
| | Actual profit | 3 | |
| | Variable cost variance | 2 | |
| | Sales prices variance | 2 | |
| | Sales mix variance | 2 | |
| | Weighted contribution | 1½ | |

| | | |
|---|---|---|
| Sales quantity variance | 2 | |
| Market size variance | 2 | |
| Market share variance | 1½ | |
| Fixed overhead variance | 1 | |
| Profit reconciliation | 5 | 25 |

| | | | |
|---|---|---|---|
| (b) | Comments on combined cost of strategy | 2 | |
| | Analysis of other effects | 2 | |
| | Conclusion | 1 | 5 |
| | | | 30 |

**SOLUTION 2**

a. The following are the benefits of using EVA to measure business performance:

- It aligns interest of shareholders and managers more closely.
- It is a measure of performance.
- Measures creation of value.
- Helps in improving profitability.
- As a long term matrix, management uses it to measure the wealth and value of the business.
- Can be used as a reward scheme.
- It is easy to understand and use.
- Recognises the benefits of activities.
- Helps management in focusing value creation.
- Can be used in investment appraisal.
- Can be used in goodwill and share valuation.

b. **Tees Nigeria Limited**
**Calculation of Economic Profit Using EVA**

| | **Year 1** |
|---|---|
| | **₦000** |
| Profit after tax | 46,200 |
| Add: Interest cost less tax: (₦9,000,00 less 30%) | 6,300 |
| Add: Non-cash expenses | 16,000 |
| NOPAT | 68,500 |

| Capital employed | Year 1 |
|---|---|
| | ₦000 |
| Book value of total assets less current liabilities | 420,000 |
| Non-capitalised leased assets | 24,000 |
| | 444,000 |

WACC = (10% x 60%) + [7% (1 – 0.30) x 40%] = 7.96%.

| EVA | Year 1 |
|---|---|
| | ₦000 |
| NOPAT | 68,500.00 |
| Capital charge: (444,000 x 7.96%) | (35,342.4) |
| Economic value added (estimate) | 33,157.6 |

**EXAMINER'S REPORT**

**The question tests candidates' knowledge of the benefits of economic value added (EVA) and its computation from a given financial statement of a company.**

**This question was well attempted as over 80% of the candidates attempted it.**

**The performance of the candidates was high and encouraging.**

**The common pitfall observed is candidates' failure to compute the weighted average cost of capital (WACC) and the wrong treatment given to non-cash expenses that should be added back to the net profit after tax.**

**It is recommended that candidates should use the ICAN study pack and other relevant texts when preparing for future examination of the institute.**

| **Marking Guide** | | **Marks** | **Marks** |
|---|---|---|---|
| a. | Benefits of EVA, at least 5 points | 10 | 10 |
| b. | Calculation of NOPAT | 3 | |
| | Calculation of capital employed | 3 | |
| | Calculation of WACC | 2 | |
| | Calculation of EVA | 2 | 10 |
| | | | 20 |

## SOLUTION 3

(a)

| Company | Western | Eastern |
|---|---|---|
| ROCE | 20/919.2 = 2.2% | 60/906.432 = 6.6% |
| Pre-tax profit % | 20/400 = 5.0% | 60/440 = 13.6% |
| Asset Turnover | 400/919.2 = 0.435 | 440/906.432 = 0.485 |

(b) **GROSS PROFIT MARGIN OF EASTERN LIMITED**

(i) The value of the group transaction can be identified by comparing the group results with the sum of the two individual company results: the sales value was ₦40m and the cost of sale value was ₦20m thus Eastern Limited made a profit of ₦20m on this transaction which is equal to a gross margin of 50%.

The gross margin on the external sales was ₦100,000 / ₦400,000 = 25%. Thus there is a significant difference in the margins being achieved.

(ii) If the above transaction had not occurred and assuming that Eastern Limited had sold these items using its normal mark-up then the ratios would have been:

| Company | Western | Eastern |
|---|---|---|
| ROCE | 12.94/919.2 = 1.4% | 50/906.432 = 5.5% |
| Pre-tax profit % | 12.94/352.94= 3.7% | 50/400 = 12.5% |
| Asset Turnover | 352.94/919.2= 0.384 | 440/906.432 = 0.485 |

These calculations show that the relative performance of the two companies is significantly different. Further analysis identifies two key reasons for this:

**Gearing**

Western Limited is financed partly by borrowing and partly by equity and the interest charge made by the lenders amounts to a 6.7% return (20/300). This is a significant cost to Western Limited and amounts to a higher return than is being achieved before interest is paid which is 4.4% (40/919.2).

**Non-current asset values**

Although there are differences in the original cost of the non-current asset values (Western Limited is two thirds of Eastern Limited) which reflects the relative sizes of the companies, there is also a difference in the age of the assets which can be identified by the proportion of the non-current assets that has depreciated. Both companies use the same depreciation policy of 20% per annum on a reducing balance basis yet, the non-current asset value of Western Limited has been depreciated by 59.0% of its original cost whereas the non-current asset value of Eastern Limited has been depreciated by 73.8% of its original cost. Thus the non-current assets of Western Limited are newer and because they have a higher net book value, this reduces the apparent Return on Capital Employed (ROCE).

(c) Factors that should be considered when setting the transfer pricing policy are:

- The policy should lead to transfer prices that are fair to both the internal supplier and the internal customer and should provide them both with an incentive to carry out the internal transaction where it is worthwhile from the Group's viewpoint to do so.

- The policy should reflect the capacity constraints and market demand for the item being transferred. Therefore, the transfer price should take account of the supplier's opportunity cost.

- The policy should provide autonomy to both the internal supplier and the internal customer to make their own decisions concerning internal transactions.

- There must be divisional structure.

- Each division must be a profit or investment centre.

- One of the divisions must be willing to transact business with the others.

- The transfer pricing policy must be tax efficient by reducing the overall tax burden of the company.

**WORKINGS**

**Elimination of Group transaction:**

| | | |
|---|---|---|
| Western Limited: Normal mark - up | = 60/400 | = 15% |
| Therefore, cost of sale | = (100 – 15)% | = 85% |

Sales value of goods from Eastern Limited is therefore 40/85 x 100 = ₦47,058,824

The restated Income Statement will now be as follows:

| | Western | Eastern | Peterpan |
|---|---|---|---|
| | ₦000 | ₦000 | ₦000 |
| Revenue | 352,941 | 440,000 | 792,941 |
| Cost of sales | (300,000) | (330,000) | (630,000) |

| | | | |
|---|---|---|---|
| Gross profit | 52,941 | 110,000 | 162,941 |
| Administrative costs | (20,000) | (60,000) | (80,000) |
| Interest payable | (20,000) | - | (20,000) |
| Pre-Tax profit | 12,941 | 50,000 | 62,941 |

**EXAMINER'S REPORT**

**The question tests candidates understanding of transfer pricing between two subsidiaries and the computation and interpretation of financial ratios- return on capital employed (ROCE), asset turnover and profit margin.**

**The question was well attempted by over 80% of the candidates**

**The performance of candidates on this question however was below average.**

**The common pitfalls were the inability of candidates to decipher the treatment to be given to inter-subsidiary sales of ₦20,000,000 which was eliminated from the holding company and also there were confusion as to the variables that should be used in computing ratios like ROCE, asset turnover and profit margin.**

**It is recommended that candidates should in future do enough revision using the Institutes study pack and other recommended relevant texts and manual.**

| **Marking Guide** | | **Marks** | **Marks** |
|---|---|---|---|
| a. | ½ mark each - Calculation of the 3 ratios for each subsidiary | | 3 |
| b. | Calculation of gross profit margin on internal sales | 1 | |
| | Calculation of gross profit margin on external sales | 1 | |
| | Recalculation of the 3 ratios without intra – group transaction | 3 | |
| | 1mark each - Identification of the two reasons for difference in Performance of the two subsidiaries | 2 | |
| | 2 marks each - Discussion of the two reasons identified | 4 | 11 |
| c. | 1 mark each - Identification of the 3 factors in setting transfer Price | 3 | |
| | 1mark each - Discussion of each of the factors | 3 | 6 |
| | | | 20 |

**SOLUTION 4**

a. Turnover:

- Increase: ₦27m/₦26m = 1.04 = 4% increase.
- Exceeds the rate of inflation (3%); indicates some modest growth.

Net profit:

- Increase in absolute terms = ₦400,000
- Increase in % terms = ₦400,000/₦5,200,000 = 7.7%
- Rising faster than sales revenue (and inflation); suggests "real" price increases being achieved (or better cost control)

Bad debts:

- This is a minimal expense and the change between the two years is insignificant. See computation below:

$$\underline{\mathbf{2018}} \qquad\qquad \underline{\mathbf{2017}}$$

$$\frac{₦132{,}000}{₦27{,}000{,}000} = 0.5\% \qquad \frac{₦130{,}000}{₦28{,}000{,}000} = 0.5\%$$

b. General issue: Why Part (aii) analysis is more relevant than Part (ai)

- The usefulness of these indicators is that many of them provide a lead indication of future financial success. This is what is of interest to Mary, since she is considering joining the firm for the first time.
- "Good results" in the lead indicators are likely to lead (after a time) to improved financial performance.
- By contrast the indicators in Table 1 measure financial success in the current period only. They do not (in themselves) provide any indication of future financial success. Given that Mary is only now considering joining BOK it is its future success and potential which are of interest to her, not the past.

Customer knowledge

- "How well BOK dealing with its customers".
- Number of customers: This has increased by 20%. $\left(\frac{120}{100}\right)$ A greater number of customers is (arguably) a good thing in itself because it expands the client base who can potentially be satisfied and therefore become repeat customers in the future.
- Average revenue per customer
  - Change = ₦35,000/₦260,000 = 13.4% reduction.
  - BOK might be reducing its prices to attract more customers, or might not be as successful as in the past in leveraging sales from its client base. This is a potentially negative indicator. The client base is only as valuable as the profit from the sales which can be made to it.

- Increase in market share
  - Total market size:

| 2018 | 2017 | Change |
|---|---|---|
| ₦27m/0.09 = ₦300m | ₦26m/0.08 = ₦325m | 7.7% Decrease |

BOK's modest growth in turnover seems impressive in the context of the shrinking market. BOK is expanding despite very difficult circumstances.

**Internal business processes**

- "The key processes which the business needs to perform well in order to succeed" are the focus of internal business processes.

- Error rates have decreased from 4% to 3%, while at the same time average job completion times have improved from 7 days to 5.5days.

- Clients expect their jobs to be done correctly and on time, and these results indicate that BOK has a strong ability to provide this level of service (which augurs well for BOK's success in attracting new customers and retaining old ones, as indicated by the growing customer numbers).

**Learning and growth**

- The increase in staff turnover is unwelcomed. Generally, recruitment and training of new staff is always expensive and ultimately if not carried-out reduces the productivity level and increases labour costs in the short term.
- The lack of growth in the training expenditure is of concern. Given the large number of new clients and the higher staff turnover, it seems likely that more training is needed. Inadequate expenditure on training is an insidious threat because in the medium term it threatens BOK's ability to maintain its high client service quality levels.

**SIGNIFICANT REASONS THAT WILL SUPPORT MARY'S DECISION TO ACCEPT OFFER:**

From the above evaluations, the information contained in part 2 of the balance scorecard is more beneficial to Mary in making her final decision on whether or not to accept the offer because it gives more clarity on other performance criteria that the financial performance criteria do not disclose such as:

- Increase in number of customers
- Increase in market share and size
- Staff turnover issues
- Growth issues in training expenditure

c. • Yes, Henry should accept this request, Mary is asking to be allowed to embrace responsibility for all of the factors which she controls, not just short term profit, and this attitude is to be welcomed and encouraged.

- Mary's contract is for a 4-year term only. Profits in the first year are likely to be significantly affected by the decisions made by her predecessor, e.g., not to spend more money on training. In this sense profits are not "controllable" by Mary in the short term. She might even be tempted to make up for the shortfall in profits by making dysfunctional decisions which would not affect profits in the short term but would have detrimental consequences in future years.
- By accepting responsibility for a wide range of performance measures. Mary is incentivised not just to pay attention to current profits but to consider what is beneficial for the firm in the long term (e.g., increasing market share, even in ways which do not immediately add to profit). The short duration of her contract might otherwise discourage her from doing this.

**EXAMINER'S REPORT**

**This is a question that test candidates knowledge and application of balanced scorecard matrix.**

**Under 50% of the candidates attempted the question.**

**Equally, the performance was below average.**

**The common pitfalls were candidates inability to use the statistics and financial data availed in the question to analyze the company's performance as well as in the interpretation of the balanced scorecard financial and nonfinancial information in determining whether Mary will accept or reject the offer given her.**

**It is therefore recommended that candidates utilize the ICAN study pack and relevant text books when preparing for the Institute future examinations.**

| Marking Guide | | Marks | Marks |
|---|---|---|---|
| (ai) | Growth in turnover | 1 | |
| | Growth in net profit | 1 | |
| | Bad debts | 1 | 3 |
| (aii) | General issue | 2 | |
| | Growth customer | 2 | |
| | Internal business process criteria | 3 | |
| | Learning and growth<br>(Staff turnover/training expenditure) | 3 | |

| | | | |
|---|---|---|---|
| | Significant reasons for Mary's decision to accept the offer | 3 | 13 |
| (b) | Specific relevant reasons Henry | | 4 |
| | | | 20 |

**SOLUTION 5**

| | NOTE | S | B |
|---|---|---|---|
| **Sales** | | ₦ | ₦ |
| Internal | (W1) | 38,500,000 | |
| External | (W2) | 47,500,000 | 72,000,000 |
| | | 86,000,000 | 72,000,000 |
| Variable costs | | | |
| Components | | | |
| Internal | (W3) | - | 38,500,000 |
| External | (W4) | 77,000,000 | |
| Other variables | (W5) | - | 18,880,000 |
| Fixed costs | | 5,600,000 | 14,600,000 |
| Profit | | 3,400,000 | 20,000 |

**Workings**

| | | |
|---|---|---|
| (W1) | 55,000 components at ₦500 opportunity cost | = ₦27,500,000 |
| | 25,000 components at ₦440 marginal cost | = ₦11,000,000 |
| | | ₦38,500,000 |
| (W2) | 95,000 components at ₦500 | = ₦47,500,000 |
| | 16,000 units at ₦4,500 | = ₦72,000,000 |
| (W3) | As per division S internal sales revenue | |
| (W4) | 175,000 components at ₦440 | = ₦77,000,000 |
| (W5) | 16,000 units at ₦1,180 | = ₦18,880,000 |

(b)

(i)

| Sales | Note | S | B | Total |
|---|---|---|---|---|
| | | ₦ | ₦ | ₦ |
| Internal | W1 | - | - | - |
| External | | 75,000,000 | 72,000,000 | 147,000,000 |
| | | 75,000,000 | 72,000,000 | 147,000,000 |
| Variable costs | | | | |
| Components | | | | |
| Internal | | - | - | - |
| External | W2 | (66,000,000) | (33,600,000) | (99,600,000) |
| Other variable | W3 | - | (18,880,000) | (18,880,000) |
| Fixed costs | | (5,600,000) | (14,600,000) | (20,200,000) |
| Profit | | 3,400,000 | 4,920,000 | 8,320,000 |

**Workings**

(W1) 150,000 components at ₦500 market price
16,000 units at ₦4,500

(W2) 150,000 components at ₦440
80,000 components at ₦420

(W3) 16,000 units at ₦1180

(b) (ii)

| | | | |
|---|---|---|---|
| Profit requirement | ₦4,500,000 | | |
| Remaining production capacity | ₦25,000 | = | ₦175,000 – ₦150,000 |
| Additional contribution required | ₦1,100,000 | = | ₦4,500,000 – ₦3,400,000 |
| Contribution per component | ₦44 | = | ₦1,100,000/₦25,000 |
| Contribution per component | ₦440 | | |
| Sell externally per component | ₦484 | = | ₦440 + ₦44 |

**EXAMINER'S REPORT**

**This question test candidates understanding of transfer pricing and its use in computing ideal or minimum price of a product.**

**Over 70% of the candidates attempted this question and performance was high.**

**However, the common pitfall was candidates inability to compute the minimum price of selling 25000 components to the new customer to enable the division meet its profit target.**

**Candidates are advised to use ICAN study manual when preparing for ICAN examination in future.**

**Marking Guide**

| | | Marks | Marks |
|---|---|---|---|
| (a) | Sales | 2 | |
| | Variable cost of components | 2 | |
| | Other variable cost | ½ | |
| | Fixed cost | ½ | |
| | Profit | 1 | 6 |
| (b) | | | |
| i) | Sales | 1½ | |
| | Variable cost of components | 1 | |
| | Others | 1½ | |
| | Profit | 1 | 5 |
| ii) | Calculation of minimum selling price | | 4 |
| | Total marks | | 15 |

**SOLUTION 6**

**MANAGEMENT ACCOUNTING INFORMATION**

Information is only useful to managers if it possesses some essential qualities. These qualities include:

i) **Understandable:** Information should be understandable to the individuals who use it. Therefore, management accounting information must be set out clearly and properly explained;

ii) **Purpose and relevance:** Unless information has a purpose, it has no value at all; therefore, it makes no sense to provide it. Information must be relevant for this purpose;

iii) **Reliable:** Users of information must be able to rely on it for its intended purpose. An unreliable information is not useful. However, information does not have to be 100% accurate to be reliable. In many cases, information might be provided in the form of an estimate or forecast;

iv) **Sufficiently complete:** Information should include all facts necessary for its purpose. At the same time, information in management reports should not be excessive, because important information may be hidden in the unimportant information, and it will take managers too long to read and understand;

v) **Timely:** If information is provided too late for its purpose, it has no value. And with the widespread computerisation of accounting systems, including cost accounting systems, it might be appropriate for up-to-date management accounting information to be available on-line and on demand whenever it is needed;

vi) **Comparable**: In accounting it is often useful to make comparisons, such as current year results with previous years, or comparisons of actual results with planned results. Therefore, to make comparisons possible, information should be prepared on the same basis, using the same methods and the same 'rules';

vii) **Communicated to the right recipient:** Management accounting information should be communicated to the proper recipient. The right recipient is the person with the authority to make a decision on the basis of the facts received and needs the information to make a decision; and

viii) **Cost effective:** Its value must exceed its cost. Management accounting information has a value (if information has no value there is no point in having it) but obtaining it involves a cost. The value of information comes from improving the quality of management decisions. Information is worth having only if it helps to improve management decisions, and the benefits from those decisions exceed the cost of providing the additional information.

**EXAMINER'S REPORT**

**This is a question that test candidates knowledge of qualities of good management accounting information.**

**Nearly 90% of the candidates attempted this question and performance was adjudged very high.**

**The common pitfall was that some candidates mistook the question to mean advantages of management accounting information rather than qualities of good management accounting information.**

**Candidates are advised to take time to decipher the requirements of a question before attempting it. Also, it is recommended that candidates use ICAN study manual when preparing for future ICAN examinations.**

**Marking Guide**

| | | Marks |
|---|---|---|
| 1 mark each | - Identification of each of the qualities | 5 |
| 2 marks each | - Explanation of five of the qualities | 10 |
| Total marks | | 15 |

## SOLUTION 7

**MARKET SKIMMING PRICE**: Market skimming price is a pricing strategy that is used when a new product is introduced to the market with a very high price which is gradually reduced over time to attract more customers. This pricing strategy is normally effective for new "high technology" products such as flat screen television sets, laptops, etc.

However, it is usually a short term pricing strategy that cannot usually be sustained for a long period of time.

It can also be used with a differentiated product of high quality, e.g. cars.

**MARKET PENETRATION PRICE:**
It is an alternative pricing strategy to market skimming pricing strategy when a new product is introduced to the market. Under market penetration pricing strategy, the aim is to introduce the product into the market with a low selling price in order to create a high sales demand as quickly as possible. This can help the company to capture the market before competitors can introduce rival products. This pricing strategy can be used when a company is using a cost leadership strategy, because low price will help a company to obtain a large market share which can further lead to economies of scales and lower costs.

**FULL COST PLUS PRICING**
This involves calculating the full cost of a product and adding a profit margin to arrive at a selling price.

Profit is expressed as either:
- a percentage of the full cost (a profit mark-up) or;
- a percentage of the sales price ( a profit margin)

It is useful when operating on historical basis; for planning purposes, appraisal of divisional performance and stabilising product prices.

**MARGINAL COST PLUS PRICING**
Under this pricing strategy, the marginal cost of the product is calculated and a mark up or profit margin is added to the marginal cost to arrive at the selling price. This is useful in preparing marginal costing statements.

**RETURN ON INVESTMENT PRICING**
This method of pricing strategy is used in a decentralised environment where an investment centre within a company is required to meet a target return on capital employed. Prices are set to achieve a target percentage return on the capital invested.

This is needed in divisional performance appraisal.

(b) FULL COST PLUS PRICE

| | ₦ per unit |
|---|---|
| Variable Cost | 60.00 |
| Fixed Cost (₦300,000 + ₦100,000)/40,000 | 10.00 |
| | 70.00 |
| Mark-up – 25% of cost | 17.50 |
| | 87.50 |

MARGINAL COST PLUS

| | ₦ per unit |
|---|---|
| Variable Cost | 60.00 |
| Mark-up – 40% of variable cost | 24.00 |
| Selling price | 84.00 |

RETURN ON INVESTMENT PRICING:

Target ROI

| | ₦ |
|---|---|
| Non-current assets | 2,000,000 |
| Working Capital | 400,000 |
| Capital employed | 2,400,000 |

Profit required = ₦2,400,000 x 10%
= ₦240,000

Profit required per unit = ₦240,000/40,000
= ₦6.00

| | ₦ |
|---|---|
| | per unit |
| Variable cost | 60.00 |
| Fixed cost (as in full cost plus) | 10.00 |
| | 70.00 |
| | 6.00 |
| Selling price | 76.00 |

**EXAMINER'S REPORT**

**This question test candidates understanding of pricing strategies and methods of product pricing.**

**Over 70 % of the candidates attempted this question and performance was above average.**

**The common pitfall is candidates poor understanding of procedures for the computation of product prices as required in the part (b) of the question. Candidates find it difficult to compute full cost plus price, marginal cost plus price and return on investment price as required in the second part of the question.**

**It is recommended that candidates when preparing for future examination of the Institute, utilize the ICAN study text.**

| **Marking Guide** | | **Marks** | **Marks** |
|---|---|---|---|
| a. | 2 Marks for each of the five methods discussed | | 10 |
| bi. | Computation of full cost plus based price | 1½ | |
| ii. | Computation of marginal cost plus based price | 1½ | |
| iii. | Computation of return on investment based price | 2 | 5 |
| | | | 15 |

# THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

## SKILLS LEVEL EXAMINATION – MAY 2019

## 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**

National Hotel, an investment unit of the Ministry of Tourism and Environment is fifty(50) years old. It has just been restructured from a wholly owned hotel by the government to a private/government partnership. However, being the largest hotel in the country and for security reasons, the government still retains 55% of its equity.

The board of directors of the hotel have recently met and decided to reposition the hotel for better performance.

The board needs external finances to the tune of ₦180 million. This will consist of ₦100 million loan payable over ten years and ₦80 million bank overdraft. All the necessary supports have been given by the government and the private equity holders.

The summarised results relating to the last two financial years are as follows:

| **Income statement**<br>**Year ended 30 September** | **2013** | **2014** |
|---|---|---|
| | **₦'000** | **₦'000** |
| Turnover | 200,000 | 240,000 |
| Cost of sales | (150,000) | (184,000) |
| Gross profits | 50,000 | 56,000 |
| Overhead expenses | (10,000) | (12,000) |
| Profit before tax | 40,000 | 44,000 |

**Statement of financial position:**

| | ₦'000 | ₦'000 |
|---|---|---|
| Non-current assets at cost | 380,000 | 412,000 |
| Less: Depreciation | 138,000 | 106,000 |
| | 242,000 | 306,000 |
| | | |
| **Current assets:** | **₦'000** | **₦'000** |
| Inventory | 14,000 | 60,000 |
| Receivables | 30,000 | 20,000 |
| Balance at bank | 6,000 | - |
| | 50,000 | 80,000 |
| **Current liabilities:** | | |
| Payables | 12,000 | 18,000 |
| Bank overdraft | - | 4,000 |
| | 12,000 | 22,000 |
| Net current assets | 38,000 | 58,000 |
| Total net assets | 280,000 | 364,000 |
| | | |
| **Financed by:** | | |
| Equity | 100,000 | 100,000 |
| Reserves | 160,000 | 204,000 |
| | 260,000 | 304,000 |
| 20% bank loan | 20,000 | 60,000 |
| | 280,000 | 364,000 |

You have been engaged as a consultant to assist the hotel to prepare necessary documents and reports that will enable the hotel achieve its objective.

**Required:**

a. Calculate **six** relevant accounting ratios covering each of the two years: 2013 and 2014 in a tabular form. (12 Marks)

b. Interpret the result of the ratios calculated in (a) above to show the financial performance and position of the entity. (12 Marks)

c. Highlight **four** unfavourable factors about the hotel as revealed by your interpretation. (6 Marks)

**(Total 30 Marks)**

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

**QUESTION 2**

In compliance with the extant directive of the Federal Government that all retiring employees should be documented in the year prior to that in which they are to retire, Hajia Muslima Ladipo applied to be registered in 2016.

She was employed as a junior officer on Grade Level 04 in the Ministry of Goods Exchange & Exhibition on July 1, 1981. She rose through the rank and was finally promoted to chief exhibition officer on salary grade level 14 on January 1, 2016.

The result and letter of her promotion were released in the middle 2016. For documentation, national officers are posted to the nearest cities to their places of work/residence for the exercise. Hajia was therefore documented in Ibadan being the nearest centre to Lagos where her office was situated.

Retiring officers are to produce evidence of employment and retirement at the documentation centre and also be present physically for a biometric process.

Hajia retired from service with effect from June 30, 2017. She complained that she had not received any gratuity and her name was not in the pension register.

**Required:**

a. Identify **four** main objectives of the Pension Reform Act 2014, as it relates to employees. (8 Marks)

b. Explain **three** roles/functions of each of the Pension Fund Administrators and the Pension Fund Custodians. (6 Marks)

c. State whether any of the objectives of the Pension Reform Act has been breached in the case of Hajia Muslima Ladipo. (2 Marks)

d. Identify **four** documents required for proper documentation of a retiring officer under the guidelines issued by the Federal Government. (2 Marks)

e. Identify **two** categories of officers specifically exempted by section 5 of the Pension Reform Act. (2 Marks)

**(Total 20 Marks)**

**QUESTION 3**

The following balances were extracted from the ledger of YOHAFI College of Technology in respect of Senator Momeed Memorial Loan Fund (MMLF) as at31 December 2017

| | DR | CR |
|---|---|---|
| | ₦'000 | ₦'000 |
| Cash | 4,200 | |
| Loan receivable | 158,000 | |
| Investments | 101,000 | |
| Fund balance | | 263,200 |
| | 263,200 | 263,200 |

The following transactions took place in 2018:

(i.) Investment costing ₦30,800,000 were sold for ₦31,900,000;
(ii.) ₦30,700,000 cash was received as the repayment of loans;
(iii.) ₦2,500,000 was received from the family of a former student in full payment of a loan which had earlier been written off;
(iv) ₦41,800,000 was given out as loan during the year;
(v.) A loan of ₦750,000 was written-off as uncollectible; and
(vi.) A sum of ₦3,000,000 cash was received as a gift from a former borrower.

**You are required to:**

a. Open necessary ledger accounts to record above transactions. (13 Marks)
b. Extract a trial balance as at the end of the period. (4 Marks)
c. Prepare a statement of changes in the fund balance. (3 Marks)

**(Total 20 Marks)**

**QUESTION 4**

An anonymous group believed to be members of staff of a Reserve Centre wrote a petition to the Economic and Financial Crimes Commission (EFCC) against Mr. Lagbaja Temedu, the chief executive officer (CEO) of the Maximum Food Reserve Storage Centre. He was alleged to have violated the procurement rules in the award of contract to X-Bar Limited for the supply of twenty (20) SUV vehicles for ₦210million to his department. On getting hint of the petition, the chief executive officer called a meeting of senior members of staff and educated them on contracts awarded by the department. He said that the contract was awarded by a tender's board of the department of which he was the chairman. As for contracts awarded, including the present contract, invitations were published in national newspapers inviting contractors to tender for such supplies. Provision to procure the vehicles was made in the budget approved for the year. He further stated that all laid down procedures had been followed in the award of and payment for this contract.

**You are required to:**

a. State **five** documents that a contractor should possess and forward in bidding for a contract. (5 Marks)

b. Identify **five** basic fundamental principles of procurement in the award of contract in a government department in accordance with Public Procurement Act 2007. (5 Marks)

c. Explain briefly the basic steps to follow as outlined in the Public Procurement Act 2007 for:
   i. Special and restricted methods of procurement (6 Marks)
   ii. Emergency procurement (4 Marks)

**(Total 20 Marks)**

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

**QUESTION 5**

The cost-benefit analysis (CBA) has been described as the most popular technique for investment project appraisal in the public sector, especially in the developing world.

**Required:**

a. Describe the term *cost-benefit analysis* (CBA). (5 Marks)
b. Identify and explain the two methods usually adopted in the evaluation of projects under CBA. (4 Marks)
c. Justify the preference for CBA as a public project appraisal technique. (6 Marks)

**(Total 15 Marks)**

**QUESTION 6**

Public debt management refers to how the central government deals with the adverse economic effect.

**Required:**

a. Describe the term debt conversion (3 Marks)

b. Explain **four** objectives of debt conversion programme in Nigeria (6 Marks)

c. Discuss the problems associated with debt conversion programme in Nigeria (6 Marks)

**(Total 15 Marks)**

**QUESTION 7**

a. Distinguish between net present value (NPV) and internal rate of return (IRR) and state the decision rule under both criteria. (8 Marks)

b. Two projects A and B have initial capital investment of ₦900,000 each. The cash inflows of the two projects are as follows:

| Year | 1 | 2 | 3 | 4 | 5 | 6 |
|---|---|---|---|---|---|---|
| Project A (₦) | 400,000 | 500,000 | 100,000 | 125,000 | 105,000 | 150,000 |
| Project B (₦) | 250,000 | 350,000 | 250,000 | 150,000 | 200,000 | 175,000 |

**Required:**

i. As a financial analyst, calculate the net present value (NPV) of the two projects given a cost of capital of 12%. (6 Marks)

ii. Based on the results obtained in (i), which of the projects should be chosen? (1 Mark)

**(Total 15 Marks)**

**Solution to Question 1**

a. **Relevant ratio**

| **S/N** | **Details** | **Formula** | **2013 N'000** | **2014 N'000** |
|---|---|---|---|---|
| i. | Turnover trends | 2014 – 2013 (turnover) x 100% / 2013 Turnover | N/A | 40,000 X 100 / 200,000 = 20% |
| ii. | Gross profit margin | Gross profit x 100 / Sales | 50,000 X 100 / 200,000 = 25% | 56.000 X100 / 240,000 = 23.33% |
| iii. | Net profit margin | Net profit before tax x 100 / Sales | 40,000 X100 / 200.000 = 20% | 44,000 X 100 / 240,000 = 18.33% |
| iv. | Current ratio | Current assets / Current liabilities | 50,000 / 12,000 = 4.17 : 1 | 80,000 / 22,000 = 3.64 : 1 |
| v. | Quick asset ratio or Acid test ratio | Current assets- inventory / Current liabilities | 50,000-14,000 / 12,000 = 3 : 1 | 80,000-60,000 / 22,000 = 0.91 : 1 |
| vi. | Cost of sales / turnover | Cost of sales x 100 / Sales | 150,000 X 100 / 200,000 = 75% | 184,000 X 100 / 240,000 = 76.67% |
| vii. | Inventory turnover period **or** Inventory turnover | Inventory x 365 days / Cost of sales **or** Cost of sales / inventory | 14,000 X 365 / 150,000 = 34 days **or** 150,000 / 14,000 = 10.7 times | 37,000 X 365 / 184,000 = 73 days **or** 184,000 / 37,000 = 4.97 times |

| | | | | |
|---|---|---|---|---|
| viii. | Receivables collection period **or** Receivables turnover | Receivables x 365 days / Turnover **or** Turnover / Receivables | 30,000 X 365 / 200,000 = 55 days **or** 200,000 / 30,000 = 6.67 times | 20,000 X 365 / 240,000 = 30 days **or** 240,000 / 20,000 = 12 times |
| ix. | Payables payment period **or** Payables turnover | Payables X365 days / Cost of sales **or** Cost of sales / Payables | 12,000 X 365 / 150,000 = 29 days **or** 150,000 / 12,000 = 12.5 times | 18,000 X 365 / 184,000 = 36 days **or** 184,000 / 18,000 = 10.22 times |
| x. | Gearing ratio | Total debt / Total assets | 32,000 / 292,000 = 0.11 : 1 | 82,000 / 386,000 = 0.21 : 1 |
| xi. | Total assets turnover | Turnover X 100 / Total assets | 200,000X 100 / 292,000 = 68.5% | 240,000X 100 / 386,000 = 62.2% |
| xii. | Non-current assets turnover | Turnover X 100 / Total non current assets | 200,000X 100 / 242,000 = 82.6% | 240,000 X 100 / 306,000 = 68.5% |
| xiii. | Return on capital employed | Profit after tax X 100 / Equity funds | 40,000 X 100 / 260,000 = 15.38% | 44,000 X 100 / 304,000 = 14.5% |

b. Interpretation of the accounting ratios

i. The National hotel turnover has increased by 20% from 2013 to 2014. This implies that the turnover is increasing.

ii. Despite the fact that the turnover has increased by 20% between 2013 and 2014, the hotel's profit margin has dropped by 1.7% within the same period. This could be as a result of increase in the cost of sales.

iii. The hotel net profit margin also confirmed a decline by 1.7%, due to increase in cost of sales.

iv. The hotel's liquidity position is good in spite of a decline in trend in the liquidity ratio.

v. There is a significant decline in the acid test ratio due to increase in inventory and current liabilities at the year end.

vi. The cost of sales of the hotel increased by 1.7% between 2013 and 2014. The increase in the cost of sales represents a decline in the profitability.

vii. The hotel's inventory turnover significantly increased by 114.7%. It means inventory stays in the store before it is used for extra 30 days.

viii. The hotel's credit policy is good because the collection period has improved.

ix. The payables payment period has increased from 29 days to 36 days, indicating a better payment policy and financial management.

x. The hotel's total debts to total assets is low but if the financial request from the bank is granted, the situation will become worse and the gearing will become high.

xi. The hotel total assets turnover shows a reduction of 6.% (68.5% - 62 2%) from 2013 to 2014. This implies that the hotel total assets are not been optimised in usage.

xii. The hotel's non-current assets utilisation ratios declined by 4.2% (82.6% - 78.4%) between 2013 and 2014. This ration also confirms that the non-current assets are being under utilised.

xiii. The return on capital employed shows that there is a decline of 0.88% (15.38% - 14 5%) within the two years.

(c) Four unfavourable factors about the hotel as revealed by the interpretation are as follows

i. The hotel's operation is worsening as a result of reduction in its profitability.

ii. The hotel's cost of sales is on the increase and this is affecting its profitability.

iii. There is no justification for piling up inventory, which is 94.7% (114.7% - 20%) higher than the turnover from 2013 to 2014.

iv. The increase in the bank loan exposure by 200% will lead to increase in the hotel capital's gearing if the financial request from the bank is granted.

v. The equity of the hotel remains static and low compared with the level of operation.

**EXAMINER'S REPORT**

**The question tests candidates' knowledge and skills on the calculation and interpretation of accounting ratios.**

**The candidates are also required to comment and interprete the ratios calculated.**

**All candidates' attempted the question and performance was average. The major pitfall was their inability to interpret the accounting ratios and state the unfaviourable factors that affect the organization based on their interpretation.**

**Candidates are advised to make use of the Institute's Study Text and prepare well for future examinations.**

**Marking guide**

| | | Marks | Marks |
|---|---|---|---|
| a. | Any six correct formula @ 1 mark each | 6 | |
| | Any twelve correct ratios @ ½ mark each | 6 | 12 |
| b. | Any six correct interpretations @ 2 marks each | | 12 |
| c. | Any four unfavourable factors @ 1½ mark each | | 6 |
| | **Total** | | **30** |

**Solution 2**

**a. Objectives of the new Pension Reform Act, 2014**

The objectives are as follows:

i. Establish a uniform set of rules, regulations and standard for the administration and payment of retirement benefits for the public service of the Federation, the public service of the Federal Capital Territory, the public service of the State Governments, the public service of the Local Government Councils and the private sector;

ii. Make provisions for the smooth operation of the contributory pension scheme;

iii. Ensure that every person who worked in either the public service of the Federation, the public service of the Federal Capital Territory, the public service of the state governments, the public service of the local government councils and the private sector receives his retirement benefits as and when due; and

iv. Assist improvident individuals by ensuring that they save in order to cater for their livelihood during old age.

(b) **Functions of Pension Fund Administrators**

The Pension Fund Administrators shall carry out the following functions:

(i) Open retirement savings accounts for all employees with personal identity numbers (PIN) attached;

(ii) Invest and manage pension funds and assets;

(iii) Maintain books of accounts on all transactions;

(iv) Provide regular information on investment strategy, market returns and other performance indicators to the Commission and employees or beneficiaries of the retirement savings accounts;

(v) Provide customers' service support to employees, including access to employees' account balances and statements on demand;

(vi) Process the calculations and payments of retirement benefits; and

(vii) Carry out other functions as National Pension Funds Commission may assign from time to time.

**Functions of Pension Fund Custodians**

Section 57 of Pension Reform Act, 2014 states that Pension Fund Custodian shall carry out the following functions:

(i) Receive the total contributions remitted by employers on behalf of the pension fund administrators;

(ii) Notify the pension fund administrators within 24 hours of the receipt of contribution from any employer;

(iii) Hold pension funds and assets in safe custody on trust for the employees and beneficiaries of the retirement savings account;

(iv) Settle transactions and undertake activities related to pension fund investments, including the collection of dividends and related activities;

(v) Provide data and information on investment to the Pension Fund Administrator and the Commission;

(vi) Undertake statistical analysis on the investments and returns on investments with respect to pension funds in its custody and provide data and information to the Pension Fund Administrator and the Commission;

(vii) Execute in favour of the Pension Fund Administrator relevant proxy for the purpose of voting in relation to the investments; and;

(viii) Carry out other functions as may be prescribed by regulations and guidelines issued by the Commission, from time to time.

(c) The objective of Pension Reform Act. 2014 which stipulates that every person who worked in the public service of the Federation, receives his retirement benefits as and when due was breached in the case of Hajia Muslima Ladipo.

(d) **Documents required for proper documentation of retiring officer include the following:**

i. Gazette publication or letter of first appointment;
ii. Gazette publication or letter of confirmation of appointment;
iii. Certified true copy of record of service;
iv. Certified true copy of last three years of personnel emolument records card;
v. Letter of the last promotion;
vi. Current identity cards;
vii. Letter of introduction from the employer conforming that the officer is still in service;
viii. Birth certificate or age declaration affidavit;
ix. Evidence of registration with a PFA; and
x. Other relevant documents as may be required by the Commission, from time to time.

(e) **Exemption from new Pension Reform Act 2014- S 5 (1)**

The categories of persons exempted from the contributory pension scheme are:

i. The categories of persons mentioned in Section 291 of the Constitution of the Federal Republic of Nigeria 1999 (as amended) e.g. judicial officers;
ii. Members of armed forces, the intelligence and secret services of the federation; and
iii. An employee who is entitled to retirement benefits under any pension scheme existing before the $25^{th}$ day of June 2004 and has 3 or less years to retire (i.e. fully funded pension scheme).

**EXAMINER'S REPORT**

**The question tests candidates' knowledge of the provisions of Pension Reform Act 2014, specially: the objectives of the Act; role/functions of Pension Fund Administrators and Pension Fund Custodians; documents required for proper documentation of a retiring officer; and categories of officers exempted by the Act.**

**Majority of the candidates attempted the question and their performance was fair, however, candidates' major pitfall was their lack of understanding of the basic requirements of the question.**

**Candidates are strongly advised to make use of the Institute's Study Text in preparing for future examinations.**

**Marking guide**

| | | Marks | Marks |
|---|---|---|---|
| a. | **Objectives** | | |
| | Four objectives @ 2 marks each | | 8 |
| b. | **Functions of Pension Fund Administrators** | | |
| | Any three functions @ 1 mark each | 3 | |
| | **Functions of Pension Fund Custodians** | | |
| | Any three functions @ 1 mark each | 3 | 6 |
| c. | **Breaching of objective** | | |
| | Identification of the only one objective breached @ 2 marks | | 2 |
| d. | **Documents required for proper documentation** | | |
| | Any four documents @ ½ mark each | | 2 |
| e. | **Categories of persons exempted** | | 2 |
| | Any two categories @ 1 mark each | | |
| | **Total** | | **20** |

**Solution 3**

**YOHAFI College of Technology**
**Senator Momeed Memorial Loan Fund Centre**

(a) (i) **Cash account**

| | **₦'000** | | **₦'000** |
|---|---|---|---|
| Balance b/f | 4,200 | Loan receivable | 41,800 |
| Investment disposal | 31,900 | | |
| Loan receivable | 30,700 | | |
| Bad debt recovered | 2,500 | | |
| Gift: Fund balance | 3,000 | Balance c/d | 30,500 |
| | **72,300** | | **72,300** |
| Balance b/d | 30,500 | | |

(ii) **Loan receivable account**

| | **₦'000** | | **₦'000** |
|---|---|---|---|
| Balance b/f | 158,000 | Cash account | 30,700 |
| Cash account | 41,800 | Bad debt | 750 |
| | | Balance c/d | 168,350 |
| | **199,800** | | **199,800** |
| Balance b/d | 168,350 | | |

(iii) **Investment account**

| | ₦'000 | | ₦'000 |
|---|---|---|---|
| Balance b/f | 101,000 | Investment disposal | 30,800 |
| | | Bal. c/d | 70,200 |
| | **101,000** | | **101,000** |
| Balance b/d | ₦70,200 | | |

(iv) **Fund balance A/C**

| | ₦'000 | | ₦'000 |
|---|---|---|---|
| | | Balance b/f | 263,200 |
| | | Cash account (Gift) | 3,000 |
| | | Investment disposal | 1,100 |
| Bal. c/d | 269,050 | Bad debt recovered | 1,750 |
| | **269,050** | | **269,050** |
| | | Balance b/d | 269,050 |

**Workings**

(i) **Investment disposal account**

| | ₦'000 | | ₦'000 |
|---|---|---|---|
| Investment account | 30,800 | Cash account | 31,900 |
| Profit on disposal | 1,100 | | |
| | **63,800** | | **63,800** |

(ii) **Bad debt recovered account**

| | ₦'000 | | ₦'000 |
|---|---|---|---|
| Loan receivable | 750 | Cash | 2,500 |
| Transfer to fund balance | 1,750 | | |
| | **2,500** | | **2,500** |

(b) **Trial balance as at 31/12/2008**

| | DR ₦'000 | CR ₦'000 |
|---|---|---|
| Cash | 30,500 | |
| Loan receivable | 168,350 | |
| Investment | 70,200 | |
| Fund balance | | 269,050 |
| | **269,050** | **269,050** |

(c) **Statement of changes in the fund balance**

| | ₦'000 | ₦'000 |
|---|---|---|
| Balance b/f | | 263,200 |
| Add: Gift received | 3,000 | |
| Bad debt recovered | 2,500 | |
| Profit on disposal of investment | 1,100 | 6,600 |
| | | 269,800 |
| Less: Bad debt written off | | 750 |
| **Balance carried forward** | | **269,050** |

**Marking guide**

| | Details | Marks | Marks |
|---|---|---|---|
| a. | **Cash account** | | |
| | Ten ticks @ ½ mark each | 5 | |
| | **Loan receivable account** | | |
| | Six ticks @ ½ mark each | 3 | |
| | **Investment account** | | |
| | Four ticks @ ½ mark each | 2 | |
| | **Fund balance** | | |
| | Six ticks @ ½ mark each | 3 | 13 |
| b. | **Trial balance** | | |
| | Four ticks @ 1 mark each | | 4 |
| c. | Statement of changes in fund balance | | |
| | Six ticks @ ½ mark each | | 3 |
| | **Total** | | **20** |

**EXAMINER'S REPORT**

**The question tests candidate's knowledge of fund accounting as it relates to the preparation of ledger accounts and extraction of trial balance.**

**Majority of the candidates attempted the question and their performance was above average. Candidate's major pitfall was lack of understanding of the question's requirements.**

**Candidates are advised to make use of the Institute's Study Text in preparing for future examinations.**

**Solution 4**

(a) **Documents that a contractor should possess and submit in bidding for a contract:**

i. Certificate of incorporation/evidence of registration at the Corporate Affairs Commission (CAC);
ii. Tax clearance certificate covering at least three years preceding the current year;
iii. VAT registration certificate and evidence of payment;
iv. Standard Organisation of Nigeria (SON) Certification;
v. Audited accounts for at least 3years from the current year;
vi. Company profile, organisational structure including names of directors and management team, address of the company and contact details;
vii. Evidence of execution of similar jobs including skill acquisition and experience of personnel;
viii. Bank guarantee or performance bond from an insurance company;
ix. Professional body registration if any, for example, ICAN, COREN, SEC, etc;
x. Details of bankers or financiers and evidence of an existing relationship; and
xi. Any other documents that may be required for the bidding.

(b) **Fundamental principles of public procurement**

All public procurements must be conducted:

i. Subject to prior review of thresholds set by the Bureau;
ii. Based only on procurement plans supported by prior budgetary provisions/appropriations and a "Certificate of `No Objection' to contract award" from the BPP;
iii. By open competitive bidding;
iv. In a transparent, timely and equitable manner which will ensure accountability and conformity with the Act;
v. With the aim of achieving value-for-money and fitness for purpose;
vi. In a manner which promotes competition, economy and efficiency; and
vii. In accordance with the procedures lay down in this Act and as may be specified by the Bureau from time to time.

(c) **Special and restricted methods of procurement**

**Special**

The invitation documents under open competitive bidding:

**Stage one**

i. Shall call upon suppliers or contractors to submit, in the first stage of two-stage tendering proceedings, initial tenders which contain their proposals without a tender price;

ii. May solicit proposals that relate to technical, quality or other characteristics of the goods, works or services as well as contractual terms and conditions of supply and may stipulate the professional competence and technical qualifications of the suppliers or contractors; and

iii. May, in the first stage, engage in negotiations with any supplier or contractor whose tender has not been rejected under an open competitive bidding procedure with respect to any aspect of its tender.

**Stage two**

In the second stage of the two tender proceedings the procuring entity:

i. Shall invite suppliers or contractors whose tenders have not been rejected to submit final tenders with prices on a single set of specifications;

ii. May, in formulating the specifications, delete or modify any aspect of the technical or quality characteristics of the goods, works or services to be procured together with any criterion originally set out in these documents, evaluate and compare tenders and ascertain the successful tender;

iii. May add new characteristics or criteria that conform with this Act;

iv. Shall communicate to suppliers or contractors in the invitation to submit firm tenders, any deletion, modification or addition; and

v. May permit a supplier or contractor who does not wish to submit a final tender to withdraw from the tendering proceedings.

**Restricted tendering**

Subject to the approval by the Bureau, a procuring entity may for reasons of economy and efficiency engage in procurement by means of restricted tendering on the following conditions:

i. Goods, works or services are available only from a limited number of suppliers or contractors;

ii. Time and cost required to examine and evaluate a large number of tenders is disproportionate to the value of the goods, works or services to be procured;

iii. Procedure is used as an exception rather than norm; and

iv. Procuring entity shall cause a notice of the selected tendering proceedings to be published in the procurement journal.

ii. **Emergency procurement**

An entity may, carry out an emergency procurement on the following steps:

i. In an emergency situation, a procuring entity may engage in direct contracting of goods, works and services;

ii. All procurements made under emergencies shall be handled with expedition but along principles of accountability, due consideration being given to the gravity of each emergency; and

iii. Immediately after the cessation of the situation warranting any emergency procurement, the procuring entity shall file a detailed report thereof which the Bureau will verify same and if appropriate issue a Certificate of 'No Objection'.

**EXAMINER'S REPORT**

**The question tests candidates' knowledge and understanding of provisions of Public Procurement Act, 2007; specifically on the documents to be submitted by a contractor in bidding for a contract and the fundamental principles in the award of contracts. It also tests the basic steps to follow for specific and restricted method of procurement and emergency procurement.**

**Many candidates attempted the question and the performance was average. Candidates' major pitfall was their lack of understanding of the requirement of the question.**

**Candidates are advised to make use of the ICAN Study Text as well as relevant texts for future examinations.**

**Marking guide**

| | | Marks | Marks |
|---|---|---|---|
| a. | **Documents that a contractor should submit in bidding for a contract** | | |
| | Any five documents @ 1 mark each | | 5 |
| b. | **Fundamental principles of public procurement** | | |
| | Any five fundamental principles @ 1 mark each | | 5 |
| c. i | **Special and restricted methods of procurement** | | |
| | **Special -stage one** | | |
| | Any three steps @ ½ mark each | 1½ | |
| | **Special -stage two** | | |
| | Any three steps @ ½ mark each | 1½ | |
| | **Restricted** | | |
| | Any three steps @ 1 mark each | 3 | 6 |
| c. ii. | **Emergency** | | |
| | Any two steps @ 2 marks each | | 4 |
| | **Total** | | **20** |

**Solution 5**

(a) **Cost-benefit analysis**

(i) It is the attempt to compare the total social costs and benefits of an activity usually expressed in money terms.

(ii) The costs and benefits concerned include not only direct pecuniary costs and benefits, but also externalities, meaning external effects not traded in markets.

(iii) The external effects include external costs such as pollution, noise and disturbance to wildlife and external benefits such as reductions in travelling time or traffic accidents.

(iv) Cost-benefit analysis often resorts to the use of shadow prices to evaluate benefits and costs that are qualitative and without market values.

(v) If total social benefits of an activity exceed total social costs, a public project is justifiable, otherwise the project is socially unprofitable.

(vi) Cost-benefit analysis can be used in the allocation of resources among the three-tiers of government and can help to predict whether the benefits of a policy outweigh its costs (and by how much), relative to other alternatives.

(b) **Methods of evaluation of projects**

The two methods are as follows:

(i) **Benefits/Costs comparison**

This method compares estimated benefits and costs of project to be taken. The decision criterion is that if benefits are greater than the costs of a project, it should be accepted for implementation; otherwise, it should be rejected.

(ii) **Benefit/Cost ratio**

This method assesses estimated benefits as a ratio of estimated cost. The decision rule is that if the ratio is greater than one (1), the project should be accepted, otherwise, it should be rejected.

(c) **Justification for CBA**

The justification for CBA as a public project appraisal is informed by the following considerations:

(i) The monopolistic power of government over vital or strategic public projects. These are public goods, which are open to use by all members of society, and are really expensive for individuals to provide. The CBA provides the framework for determining the viability of such investments;

(ii) The fact that public projects are such that they have non-marketed costs and benefits which need to be measured and evaluated for relevant public investment decisions;

(iii) The CBA is an appraisal technique designed to capture in a more comprehensive manner externalities (both external costs and benefits) usually identified with public projects; and

(iv) In a situation where service-oriented goal public projects is involved (e.g defence, education and health programmes), CBA is a viable option for appraising such project.

**EXAMINER'S REPORT**

**The question tests candidates' knowledge and understanding of cost-benefit-analysis (CBA) and its relevance as a tool for project appraisal.**

**Few candidates attempted this question and the performance was below average. The poor performance of some of the candidates was a result of their inability to understand methods of project evaluation and justification for cost benefit analysis tested in parts (a) and (c) of the question.**

**Candidates are advised to make use of standard texts and ICAN Study Text to have more understanding, especially on the methods used for evaluation of public sector projects.**

**Marking guide**

| | | Marks | Marks |
|---|---|---|---|
| a. | **Cost-benefit analysis** | | |
| | Any five features @ 1 mark each | | 5 |
| b. | **Methods of evaluation of projects** | | |
| | i. Benefit/Cost comparison @ 2 marks | 2 | |
| | ii. Benefit/ Cost ratio @ 2 marks | 2 | 4 |
| c. | **Justification for CBA** | | |
| | Any three justifications @ 2 marks each | | 6 |
| | **Total** | | **15** |

**Solution 6**

(a) **Debt conversion**

It is a system by which countries with excessive debt exchange part of their debt obligations for:

i. Equity- Debt for equity swap
ii. Cash- Debt for cash
iii. Debt- Debt -for -debt swap
iv. Export-Debt -for -export swap

These arrangements for settling outstanding debt obligations may be beneficial for both debtor and creditor nations, depending on the terms of agreement and the prevailing environment of the debtor nations.

(b) **Objectives of debt conversion programme**

The Debt Conversion Programme (DCP) was introduced in July, 1988, with the following objectives:

i. Reduction of Nigeria's external debt by reducing foreign currency denominated debt, in order to alleviate the debt service burden;
ii. Improvement of economic environment in order to attract foreign investment;

iii. Serving as additional incentive to prevent capital flight;

iv. Stimulating employment opportunities and investment in areas, which are of significance to the local industries;

v. Encouragement of the creation and development of export oriented industries, thereby diversifying the export base of the economy; and

vi. Increasing the access to appropriate technology, external market and other benefits associated with foreign investments.

(c) **Problems of debt conversion (DCP) programme in Nigeria**

The problems identified include:

i. Because most debt conversion transactions involve the release of local currency, there could be unplanned increase in money supply, thus leading to inflation and exchange rate pressure;

ii. Debt conversion programmes offer opportunities for 'round tripping'. It involves the commission of a part or all of the redemption proceeds in the foreign exchange in the parallel or official market, for exportation immediately or at a later date.

This style has ominous implication for the exchange rate stability;

iii. Danger of non-additionality of resources/investment in the sense that investment through a debt conversion programme may merely substitute for direct investment that would have entered the country on its own even in the absence of a conversion; and

iv. Debt conversion programme tends to increase fears about the possibility of radical change in the structure of business ownership in favour of foreigners.

**EXAMINER'S REPORT**

**The question tests candidates' understanding of public debt management as it relates to objectives and problems associated with debt conversion in the country.**

**Few candidates attempted the question and the overall performance was poor. Majority of them lacked proper understanding of the requirements of the question. In most cases they discussed the problems of borrowing rather than the problems associated with debt conversion in the country.**

**Candidates are advised to study thoroughly the question in terms of its requirements so as to identify relevant points. They should also consult ICAN Study Text and other relevant materials on public debt for better understanding for future examinations.**

**Marking guide**

| | | Marks |
|---|---|---|
| a. | **Debt conversion** | |
| | Explanation of the concept with reference to any one of the examples | 3 |
| b. | **Objectives of debt conversion** | |
| | Any four objectives @ 1½ marks each | 6 |
| c. | **Problems of debt conversion** | |
| | Any four problems @ 1½ marks each | 6 |
| | **Total** | **15** |

**Solution 7**

a. **Net present value (NPV)**

This method refers to the equivalents in present value terms of the cash inflows and outflows from a project when discounted at a particular or given cost of capital. The appropriate discount rate chosen is one firm's or entity's opportunity cost of capital, which is equal to the required rate of return.

The formula for the computation of Net Present Value is:

$$NPV = \frac{C_1}{(1+K)} + \frac{C_2}{(1+K)} + \frac{C_3}{(1+K)^3} \cdots + \frac{Cn}{(1+K)^n} - C_0$$

Where C series represent cash inflows,

'K' the opportunity cost of capital,

Co is the initial cost of the investment and

'n' the project's expected life.

**Decision rule**

The decision criterion is that a project is acceptable if it has a positive NPV, and rejected, if it has a negative NPV. In total, the present value of cash inflows should be greater than that of cash outflows. The positive nature of the net present value pre-supposes the potential increase in consumption made possible by the investment, valued in present day terms. For mutually exclusive projects, they would be ranked. The one with the highest net present value is selected.

**Internal rate of return (IRR)**

The approach is also known as "discounted cash flow yield." The "internal rate of return" is the discount rate, which when applied, gives zero net present value. It can be found by either drawing a "present value profile" or graph, or mathematically through linear interpolation, using the formula stated thus:

$$\text{IRR*} \quad = \quad R1 + P\frac{(R2 - R1)}{P + N}$$

Where:

IRR = the Internal Rate of Return

$R1$ = positive rate

$R2$ = negative rate

$P$ = positive net present value (NPV)

$N$ = negative net present value (NPV)

**Decision rule**

In using the internal rate of return model, the 'decision rule' is to accept the project appraised where the calculated rate is greater than the entity's cost of capital. The project with the highest percentage of internal rate of return is picked where two or more mutually exclusive investments are being considered.

b. i. **Calculation of the net present value of the two projects**

| | | Project A | | Project B | |
|---|---|---|---|---|---|
| Years | DF 12% | CF | PV | CF | PV |
| | | ₦ | ₦ | ₦ | ₦ |
| 0 | 1.0000 | (900,000) | (900,000) | (900,000) | (900,000) |
| 1 | 0.8929 | 400,000 | 357,160 | 250,000 | 223,225 |
| 2 | 0.7972 | 500,000 | 398,600 | 350,000 | 279,020 |
| 3 | 0.7118 | 100,000 | 71,180 | 250,000 | 177,950 |
| 4 | 0.6355 | 125,000 | 79,438 | 150,000 | 95,325 |
| 5 | 0.5674 | 105,000 | 59,577 | 200,000 | 113,480 |
| 6 | 0.5066 | 150,000 | 75,990 | 175,000 | 88,655 |
| | | **NPV** | **141,945** | | **77,655** |

ii **Decision**

Based on the results obtained in (bi) above, project A should be selected because it gives the higher NPV of ₦141,945

**EXAMINER'S REPORT**

**The question tests candidates' knowledge of capital investment appraisal as it relates to net present value (NPV) and internal rate of return (IRR).**

**Majority of the candidates attempted the question and their performance was above average. Candidates' major pitfall was their inability to give a correct formula of IRR and NPV in part (a) of the question.**

**Candidates are advised to consult standard texts and ICAN Study Text to have more understanding, especially on the methods used for evaluating public sector projects for future examinations.**

**Marking guide**

| | | Marks | Marks |
|---|---|---|---|
| a. | **Net present value (NPV)** | | |
| | Explanation of the net present value (NPV) @ 2 marks | 2 | |
| | Decision @ 2 marks | 2 | |
| | **Internal rate of return (IRR)** | | |

| | | | |
|---|---|---|---|
| | Explanation of the internal rate of return (IRR) @ 2 marks | 2 | |
| | Decision @ 2 marks | 2 | 8 |
| b.i. | **Calculation of the Net present value of the two projects** | | |
| | Heading | ¼ | |
| | Calculation of distance factor | | |
| | 7 ticks @¼ | 1³/4 | |
| | **Net present value (NPV) of project A** | | |
| | 8 ticks @ ¼ mark each | 2 | |
| | **Net present value (NPV) of project B** | | |
| | 8 ticks @ ¼ mark each | 2 | 6 |
| | **Project selection** | | |
| | Correct decision @ 1 mark | | 1 |
| | **Total** | | **15** |

# THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA
# SKILLS LEVEL EXAMINATION – MAY 2019

## MANAGEMENT, GOVERNANCE AND ETHICS

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

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

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

**QUESTION 1**

a. You have just been contracted by UBC Plc to prepare a business plan on the company's intended investment in the manufacture of GSM phones in the country. The following is a summary of the brief given to you and your own research:

b.

- UBC Plc is a multinational conglomerate involved in the manufacture and distribution of computer hardware accessories, networking hardware and allied products. With experience spanning four decades in the industry, the company's products enjoy a lion share of the market. As part of its diversification strategy aimed at sustaining its competitive advantage, the company intends to start the production of GSM phones, targeting the mass market in the country.

- The company plans to control at least 40% of the low end GSM phone market in the country in the next five years.

- UBC Plc possesses the requisite human resources and physical facilities necessary for the successful takeoff and growth of the new venture. The company also intends to leverage on its extensive distribution network for its IT products covering major cities within the West African sub-region to distribute its new GSM phones.

- The company also has modern equipment which can easily be converted into the production of GSM phones at little cost without significantly affecting the current production levels of other products. When this is done, the equipment will be able to produce more than 5 million GSM phones per annum.

- While the company intends to expand its production capacity radically within the first few years of manufacturing GSM phones, it is still struggling to cope with the country's incessant electric power failure which has made the company to rely almost exclusively on the use of generators to power its equipment. This constitutes the bulk of its overhead costs.

- The firm has signed a Memorandum of Understanding with a group of reputable firms abroad, which guarantees steady supply of all required components and inputs.

- The current value of the annual GSM phone demand in the country is estimated at ₦520 billion. Estimated demand growth rate is put at 5%. There is currently no local producer, as all of the GSM phones in the market are imported. However, there is currently a large number of local firms that act as distributors to foreign producers.

- Except for regulations aimed at ensuring that only high quality products are manufactured, there are currently no legal restrictions on local production of GSM phones. Furthermore, to encourage manufacturing, the government offers tax holidays to all manufacturers in the first five years of operation.

- Estimated cost per unit of GSM phones designed for the mass market in the country is put at ₦8,000 while the current average price stands at ₦10,000.

**Required:**

a. From the given scenario provide:

(i) A business environment analysis using SWOT and PESTEL analyses. (10 Marks)

(ii) A competitive analysis using the Porter's Five Forces Model. (15 Marks)

b. Advise on Kant's categorical imperative. (5 Marks)

**(Total 30 marks)**

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

**QUESTION 2**

The Code of Corporate Governance in Nigeria states that "the Board of Directors may establish a Risk Management Committee to review the adequacy and effectiveness of risk management and controls at least annually and the Board has responsibility to report on the effectiveness of the controls to shareholders".

a) In line with the requirements above, discuss the elements of a risk management system. (8 Marks)

b) (i) Advise an executive director on the functions of the Board Committee in relation to enterprise risk management. (6 Marks)

(ii) Extract from the Turnbull Report, the **SIX** (6) categories of risk common to business. (6 Marks)

**(20 Marks)**

**QUESTION 3**

a. Distinguish FIVE (5) types of risk that a Risk Manager is expected to oversee. (5 Marks)

b.

i) Draft a recommendation on the steps to be taken by a company in the implementation of a Corporate Social Responsibility (CSR) policy. (12 Marks)

ii) Present 'Sustainable Development' in a way that highlights its importance to society. (3 Marks)

**(Total 15 Marks)**

**QUESTION 4**

Drewal and Taiwo jointly established a plastic company after a long period of economic recession. The Board of Directors is in the process of drawing out the corporate code of ethics for the company. Advise it on:

a) The nature of a corporate code of ethics . (2 Marks)

b) **THREE** basic reasons for developing a company's code of ethics. (6 Marks)

c) Any **FIVE** general provisions that a corporate code of ethics should specify. (5 Marks)

d) **FOUR** provisions or statements the corporate code of ethics should have in respect of employees and any **THREE** in respect of customers. (7 Marks)

**(Total 20 Marks)**

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

**QUESTION 5**

Shacks Limited is a company involved in the production of radio cassettes and photographic films. In the past two decades, the company had the greatest share of the market for these products. However, technological advancements resulting in the development of DVDs and digital photographs have greatly eroded the competitiveness of the company. To reposition Shacks Limited and make it more competitive, the management is considering concentric diversification as the strategy to pursue.

(a) Explain the term 'diversification strategy'. (5 Marks)

(b) From the given scenario, advise the management of Shacks Limited on the key factors that indicate preference for concentric diversification strategy. (10 Marks)

**(Total 15 Marks)**

**QUESTION 6**

The need for transparency and disclosure in financial markets is recognised in codes and statements of principles of corporate governance.

a) Advise the Board of a company on the importance of 'Transparency and disclosure' in corporate governance. (5 Marks)

b) Present the principles of disclosure and communication of information in Corporate Governance in a lucid manner that will be comprehensible to a new Board member. (10 Marks)

**(15 Marks)**

**QUESTION 7**

a. In an attempt to establish the link between culture and ethics as well as between culture and social responsibility, advise a set of management trainees on:

   i. The role of culture in an organization or company. (2 Marks)

   ii. Outline any **FOUR** of the **SIX** inter-related elements of culture suggested by Johnson and Scholes in their idea of the cultural context of ethics. (8 Marks)

b. Since business entities operate within society, the professional accountant is required to know the theories on the responsibilities of a business entity towards the society in which it operates.

   Analyse the stakeholder theory of corporate governance and advise on any **TWO** considerations underpinning this theory. (5 Marks)

**(Total 15 Marks)**

## SOLUTION 1

a.

### (i) Business environment analysis using SWOT

The SWOT analysis provides a framework for assessing both the internal and external environments.

**Strengths**

- These are the attributes within the internal environment that can provide competitive advantage to a firm.

  From the given scenario, the following constitute the strength of UBC Plc in respect of GSM mobile phone production:

- Requisite human resources for the GSM mobile phone manufacturing business.

- An extensive distribution network for its current products which can be leveraged on to gain access into the GSM mobile phone market.
- Modern equipment that can easily be converted to the production of GSM mobile phones. These equipment are adequate for effective take-off of the proposed business.

- Experience spanning over decades in the manufacturing of computer hardware accessories, networking hardware and allied product. This may be to its advantage because there is no indication of any competitors with such technological experience.

**Weaknesses**

- These are challenges associated with the internal environment.
- They could hinder the success of the proposed business or inherent limitations/constraints which create strategic disadvantages
- They are identified so that the firm can put in place measures to address them.
- For UBC Plc, it is still battling with alternative source of energy in its manufacturing process.
- The use of generators to power its equipment will definitely increase overhead cost.

**Opportunities**

- These are factors in the external environment that could positively affect the success of the proposed business.
- They are usually beyond the control of the entity.

- They are favourable conditions which enable organisations to consolidate and strengthen its strategic position.
- For UBC Plc, the signing of a Memorandum of Understanding with a group of reputable firms abroad will enhance steady supply of all required components and inputs.
- In addition, there is a potential growth in demand (5%) when compared to the present estimated value of N520billion.
- With the strength of core competence, UBC Plc has the opportunity for a higher market share.
- There is also no legislation which decreases the need of the company's product.
- There is a tax advantage to encourage UBC Plc profitability.

**Threats**

- These are factors in the external environment that can negatively affect the success of the proposed business.
- They are usually beyond the control of the entity.
- This is an unfavourable condition in any organisation environment which creates risk for, or causing damage to the organisation.
- The likely threat facing UBC Plc is the country's incessant electric failure which has made the company to rely on use of generator.

**Business environment analysis using PESTEL**

- **Political Environment**: These are political factors that could affect the level of competitiveness of a business. They include the ability of government to provide enabling environment by way of security for business activities.
  UBC plc is fortunate because there is no political instability that could disturb its business operation.

- **Economic environment**: This deals with market forces of price supply and demand. It includes all economic influences and changes in economic factors that could have some influence on the future prospect of the business.

**From the given scenario:**

The five-year tax holiday to new entrants constitutes an opportunity for the proposed business.

The size and growth rate of the GSM phone market is also an economic factor that is an opportunity for the business. From the given scenario, the market is at the growth stage of the product life cycle. Also, there exists a gap between demand and supply of the product.

For UBC Plc, the present price of GSM stands at 10,000 Naira and any force to bring down the price may not go down well with the company, given an estimated cost price of ₦8000 per unit. UBC plc may employ cost leadership strategy in order to maintain its strategic position.

- **Social Environment**: This describes the socio-cultural influences in the environment where the business operates. It includes attitudes, customs, etc.

  **From the given scenario**: there are no identifiable socio-cultural factors that can impact the business.

- **Technological Environment**: This consists of the scientific and technological resources available to an organisation.

  **From the given scenario:** the information about the technological environment suggests that it is suitable for manufacturing GSM phones. For instance, that the available modern equipment could easily be converted into the production of GSM phones is an added advantage for profitability.

- **Ecological Environment**: This comprises of environmental factors that have important influence on strategic planning and decision making of the business.

  **From the given scenario:** There is no information on this factor.

- **Legal Environment**: This is made up of laws and regulations that affect an entity.

  **From the given scenario:** The legal environment is good for UBC Plc. For example, there is no legal requirement for the local production of GSM phones.

  In addition to this, the Government offers tax holiday to all manufacturers in the first 5 years. However, UBC Plc needs to maintain high quality product as required by regulations.

(ii) Competitive Analysis using Porter's **five** Forces Model

The model examines FIVE factors that explain the strength and nature of competition in an industry.

- **Threat from Potential Entrants**
  This indicates that the higher the threat of new entrants, the higher the degree of competition in the market.

  The strength of this threat is determined by the strength of barriers to entry into the market. When barriers are low, firms in the market will keep prices low thereby increasing the degree of competition in the market.

Factors that create barrier to entry include economies of scale, capital investment requirement, access to distribution channels, time to become established, switching costs and government regulations.

**From the given scenario:** there are no clear barriers to entry. As such, one might expect the level of competition in the GSM mobile phones market to be high.

However, the capital intensive nature of the industry may discourage competitions with UBC Plc.

- **Threat of Substitute Products**
  This threat comes from the level of ease with which customers can switch to other products. When this threat is high, the level of competition in the market will also be high.

  **From the given scenario:** There are existing brands of GSM phones in the market to which customers could switch fairly easily. Therefore, this threat will further strengthen the level of competition in the market.

  Although UBC Plc may be seen as the expected sole producers of GSM, there are a large number of local firms that act as distributors for foreign producers.

  When there are substitute products, for UBC Plc to remain in the market as indicated (i.e., with 40% of market share), it should undertake a product differentiation strategy so as to create a unique attractiveness to customers.
- **Bargaining Power of Suppliers**
  Where suppliers have considerable power, they may decide to raise prices. This could reduce the profitability of the business thereby making it more competitive.

  **From the given scenario:** The company has signed an MOU with a group of suppliers to guarantee continuous availability of inputs. No information is provided on the strength of these suppliers.

  Generally, the bargaining power of suppliers is strong where there are only a small number of suppliers to the market, where the suppliers' product is an important component in the end product or when the supplier can easily integrate forward, and enter the market as competitors.

- **Bargaining Power of Customers**
  Powerful customers could demand lower prices or improved product quality as a condition for buying, thus driving up the degree of competition.

The strength of buyers is determined by the volume of their purchases.

**From the given scenario:** the strength of buyers could be said to be weak due to their large number.

However, from another perspective, the power is high since there are substitutes from foreign products. UBC Plc should as much as possible, make its products different from the foreign products to break the bargaining power of buyers.

- **Competitive Rivalry**
  Strong competition forces rival firms to offer their products to customers at lower prices and this keeps profitability low.

  One key factor that determines the strength of competitive rivalry is the number of competitors. The higher the number of rival firms, the higher the degree of competition.

  **From the given scenario:** There are many local distributors of GSM phones. This will make the level of competition in the industry to be high.

b. Kant's categorical imperative could be expressed as follows:

- Act so that you can ensure that the principle for your action becomes a universal law.
- This means judging whether an action is moral by asking what would happen if everyone behaved in exactly the same way.
- Act so that you treat other people as an end in themselves, never as a means to an end only.
- Do unto others as you will want them to do unto you.

**EXAMINER'S REPORT**

**Part (a) of this compulsory question is scenario-based. It is in two parts. Part (i) test candidates' ability to evaluate a business environment using SWOT and PESTEL analyses, while part (ii) tests the candidates' ability to use Porter's five forces model to analyse competition in the market.**

**Part (b) tests candidates' understanding of Kant's categorical imperative in ethics.**

**More than 95% of the candidates attempted the question, but performance was below average as less than 30% of candidates scored 50% of the marks allotted.**

**The common pitfalls were the inability of candidates to distinguish between analyses of the internal and external environments and relating them to facts in the scenario. Some candidates also did not understand Kant's categorical imperative.**

**It is recommended that candidates should pay attention to the fine details of the elements of this subject and relate them to practical situations as envisioned in the scenario to ensure a better performance in future.**

| | | Marks | Marks |
|---|---|---|---|
| | **Marking Guide** | | |
| a. i | SWOT ANALYSIS | | |
| | INTRODUCTION OF SWOT ANALYSIS | 1 | |
| | 2 points under STRENGTHS - 2 x $^1/_2$ | 1 | |
| | 2 points under WEAKNESSES - 2 x $^1/_2$ | 1 | |
| | 2 points under OPPORTUNITIES - 2 x $^1/_2$ | 1 | |
| | 2 points under THREATS - 2 x $^1/_2$ | 1 | |
| | PESTEL | | |
| | Political Environment | 1 | |
| | Economic Environment | 1 | |
| | Social Environment | $^1/_2$ | |
| | Technological Environment | 1 | |
| | Ecological Environment | $^1/_2$ | |
| | Legal Environment | 1 | 10 |
| | PORTER'S FIVE FORCES MODEL | | |
| ii. | | | |
| | Threat from potential entrants | 3 | |
| | Threat of substitute products | 3 | |
| | Bargaining power of suppliers | 3 | |
| | Bargaining power of customers | 3 | |
| | Competitive rivalry | 3 | 15 |
| b. | KANT's CATEGORICAL IMPERATIVE | | |
| | 2 points x 2$^1/_2$ marks per points | | 5 |
| | | | 30 |

**SOLUTION 2**

a. **Elements of a risk management system**

i) Similar to the elements of internal control system.

ii) There should be a culture of risk awareness within the company.

iii) Managers and employees should understand the risk appetite of the company and know that excessive risks are not justified by the quest for higher profits.

iv) There should be a system for identifying, assessing and measuring risks. When risks have been measured, they can be prioritised for control or containment.

v) There should be an efficient system of communicating information about risk and risk management to managers and the Board of Directors.

vi) Strategies and risks should be monitored to ensure that strategic objectives

vii) are achieved within acceptable levels of risk.

b (i) The functions expected of a Board Committee in enterprise risk management include:

- **Risk Identification**: Identifying and assessing risks, and reporting to the Board.
- **Formulate possible business risk management strategies:** For recommendation to the Board.
- **Design and Implement Internal Controls:** Agree on programmes for the design and implementation of internal controls.
- **Risk Monitor**: Monitor the effectiveness of risk management throughout the company (both business risk management and the control of internal risks) and report to the Board.
- **Review Risk Management Structure:** To review the adequacy and effectiveness of risk management and controls at least annually.
- **Risk assessment**: Analyse risks and consider their likelihood and impacts as a basis for determining how they should be managed.
- **Control activities**: Evolve policies and procedures that help to ensure the risk responses are effectively carried out.
- **Information and communication**: Ensure that information related to risks is identified, captured and communicated in a form and time frame that enables people to carry out their responsibilities.

(ii) Categories of risks common to many types of business identified in Turnbull Report are:

(iii) **Market risk**: This is the risk arising from changes in market price of key items, such as the price of key commodities.

Market prices can go up or down, and a company can benefit from a fall in raw material price or incur a loss form a rise in prices.

**Credit risk**: This is the risk of losses from bad debts or by customer's failure in the settlement of their debts. The size of the credit risk depends on the amount receivables owed to the company.

**Liquidity risk:** This is the risk that the company will be unable to make payment to settle liabilities when payment is due. It occurs when a company has no money in the bank or is unable to borrow money quickly, etc.

**Reputation Risk:** It is the risk that a company's reputation with the general public or the reputation of its product brand will suffer damage.

**Legal risk:** This is the risk of losses arising from failure to comply with laws and regulations, and also the risk of losses from legal actions and law suits.

**Technological risk**: This is the risk that could arise from changes in technology or inadequacies of technological systems in use. When a major technological risk occurs, companies might have to make a decision on whether or not to adopt the new technology.

**Health, safety and environmental risk:** This relates to the health and safety of employees, customers and the general public. Environmental risks relate to damage to the environment in the short, medium or long term.

**Business probity risk:** This is the risk of losses from a failure to act honestly.

**EXAMINER'S REPORT**

**This question tests candidates' understanding of risk management with respect to elements of risk management system, role of board committee and Turnbull report on categories of risks.**

**More than 60% of the candidates attempted this question with less than 50% of them scoring 50% of the marks allotted.**

**The common pitfall was the inability of candidates to identify the elements of a risk management system and the role of board committee in risk management.**

**Candidates are advised to study the various components of the subjects when preparing for future examinations.**

| | **Marking Guide** | Marks | Marks |
|---|---|---|---|
| a. i | ELEMENTS OF A RISK MANAGEMENT SYSTEM | | |
| | 4 points x 2 marks each | | 8 |
| b. i | FUNCTIONS OF THE BOARD COMMITTEE | | |
| | 6 points x 1 mark each | 6 | |
| ii | Categories of Risk | | |
| | 6 points x 1 mark each | 6 | 12 |
| | | | 20 |

**SOLUTION 3**

**a.**

Five types of risk to be overseen by a Risk Manager:

i. **Financial or Treasury risk**: This is the risk of financial consequences on any financial transaction. For example, a company that sells its product on credit may be exposed to financial risk. This type of risk, if unchecked, may lead to liquidity risk.

ii. **Operational risk**: This is the risk that deals with the internal operations of the organization. For example lack of effective internal control will lead to operational risk.

iii. **Compliance risk**: This risk relates to obeying the laws and regulations.

iv. **Health and safety risk:** These are risks affecting the employees in carrying out their day to day activities. Poor working conditions will lead to health and safety risk.

v. **Information system and information technology:** These are the risks associated or connected with international network e.g. Computer viruses, network risk of hackers, etc.

vi. **Insurance**: This is the likelihood that an insured event will occur.

vii. **Human Resources:** This is also called peoples' risk. It includes company culture, talent shortages and retention, incompetence, employee performance, unethical behaviour, low morale, grievances and disputes, excessive absenteeism, sabotage, work place violence and non-compliance standards, rules, regulations and laws.

**b.**

i. The steps to be taken into consideration by a company to implement a Corporate Social Responsibility (CSR) policy are:

- It should decide its code of ethical values and possibly publish these as a code of ethics.
- It should establish the company's current position with regards to its CSR values and decide the position it would like to reach in the future.
- The company should develop realistic targets and strategies for its CSR policy which should be appropriately implemented.
- Key stakeholders in the company should be identified, especially those whose views the company wishes to influence (e.g. employees, pressure groups, customers, etc.)
- The company's CSR achievements should be communicated to key stakeholders.
- The company's CSR achievements should be monitored, and actual achievements compared with (1) the targets and (2) the CSR achievements of similar companies (including business competitors).

**ii. Sustainable Development:**

i. This is a dynamic process which enables all people to realise their potentials and improve their quality of life in ways which simultaneously protect and enhance the earth's life support system.

OR

ii. A development that meets the need of the present without compromising the ability of future generations to meet their own needs.

**EXAMINER'S REPORT**

**The question tests candidates' understanding of the role of a risk manager, implementation of a corporate social responsibility policy and the concept of sustainable development.**

**More than 80% of the candidates attempted this question and performance was above average as more than 60% of the candidates scored above 50% of the marks allotted.**

**The few candidates that did not perform well, did not understand the implementation of corporate social responsibility policy.**

**Candidates should develop skills to apply knowledge to practical situations**

| **Marking Guide** | | Marks |
|---|---|---|
| a. | TYPES OF RISK | |
| | 5 points x 1 mark each | 5 |
| b. i. | STEPS TO BE TAKEN TO IMPLEMENT CSR | |
| | 6 points x 2 marks each | 12 |
| ii. | SUSTAINABLE DEVELOPMENT | |
| | Definition of sustainable development | 3 |
| | | 20 |

**SOLUTION 4**

a) A corporate code of ethics is:

i. A code of ethical behaviour, a formal written statement, issued by the Board of Directors of a company and made available to all employees.

ii. The decisions and actions of all employees in the company must be guided by the code.

b) The three basic reasons for developing a company's code of ethics are:

i. **Managing for compliance:** To ensure that all its employees comply with relevant laws and regulations, and conduct themselves in a way that the public expects.

For example, companies providing a service to the general public need to ensure that their employees are polite and well-behaved in their dealings with customers.

ii. **Managing stakeholder relations:** A code of ethics can help to improve and develop the relations between the company and its stakeholders, by improving the trust that 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 (openness and transparency) and on respecting the rights of stakeholders.

iii. **Creating a value-based organisation:** A company might recognise 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. (It could be argued that an ethical company, like a well-governed company, is more likely to be successful in business in the long term. However, there is no firm evidence to prove this point, and it is therefore a matter of opinion.)

c) **A code of conduct should specify the following:**

i. Compliance with local laws is essential;
ii. Employees should comply with the policies and procedures of the company;
iii. Any employee who fails to comply with the company's code of conduct will face disciplinary action;
iv. An overview of business conduct;
v. The need to protect the company's reputation
vi. Acting at all times with integrity;
vii. Protecting the environment;
viii. The 'pursuit of excellence';
ix. Respect for the individual;
x. The code must specify dealing with each stakeholder; and
xi. Fair dealing with competitors.

c) **For the employees**, a code of ethics might include statements about:

**i.** Human rights, including the right of all employees to join legally-authorised organisations such as a trade union or political party;
**ii.** Equal opportunities for all employees, regardless of gender, race, ethnic origin, religion, age, disability or sexual orientation;
**iii.** Refusal to tolerate harassment of employees by colleagues or managers;
**iv.** Concern for the health and safety of employees;
**v.** Respect for the privacy of confidential information about each employee; and
**vi.** Company policy on giving or receiving entertainment or bribes.

**For the customers**, a code of ethics might include statements about:

i. Fair dealing with customers;
ii. Product safety and/or product quality;
iii. The truthfulness of advertisements; and
iv. Respect for the privacy of confidential information about each customer.

**EXAMINER'S REPORT**

**The question tests candidates' understanding of elements of code of corporate governance.**

**About 80% of the candidates attempted this question. Performance was average as about 50% of the candidates scored 50% of marks allotted.**

**The common pitfall was the inability of candidates to state elements of corporate code of ethics in respect of employees and customers.**

**Candidates are advised to develop skills that will enable them relate their knowledge to practical situations.**

| **Marking Guide** | | Marks | Marks |
|---|---|---|---|
| (a) | CORPORATE CODE OF ETHICS | | |
| | Nature of corporate code of ethics | | 2 |
| (b) | REASONS FOR CODE OF ETHICS | | |
| | Managing for Compliance | 2 | |
| | Managing shareholder relations | 2 | |
| | Creating a value based organisation | 2 | |
| | | | 6 |
| (c) | GENERAL PROVISIONS OF A CODE OF ETHICS | | |
| | 5 points x 1 mark each | | 5 |
| (d) | PROVISION FOR EMPLOYEES AND CUSTOMERS | | |
| | 4 provisions for employees x 1 mark each | 4 | |
| | 3 provisions for customers x 1 mark each | 3 | 7 |
| | | | 20 |

**SOLUTION 5**

(a) Diversification is a growth strategy which involves entering into a new market or industry in which a business was not operating before. It might involve creating a new product for that market. There are two types of product diversification.

- Concentric Diversification: This means that the new product market area is related to the entity's existing products and markets.
- Conglomerate Diversification: This means that the new product market area is not related in any way to the firm's existing products and markets.

(b) Shacks Ltd might realise its objectives through concentric diversification if the following considerations were present:

(i) The choice of a new business must be one whose technologies and products complement its present business. This is not clearly stated in the scenario.

(ii) Concentric Diversification as a strategy would be successful only when the entity leverages on existing competencies and capabilities by expanding into businesses where these same resource strengths are Key Success Factors (KSF) and valuable competitive assets.

(iii) When diversification into closely related businesses opens avenue for reducing costs.

(iv) When it has a powerful and well known brand name that could be transferred to the products of other businesses and thereby used as a lever for driving up sales and profit of such businesses.

**EXAMINER'S REPORT**

**This question tests candidates' understanding of diversification as a growth strategy.**

**Most of the candidates attempted this question with performance being slightly above average.**

**The common pitfall was the inability of candidates to justify the adoption of concentric diversification strategy from the facts in the scenario.**

**Candidates are admonished to develop skills of applying knowledge to situations, which distinguishes examination at this level from those of the foundation level.**

| **Marking Guide** | | Marks | Marks |
|---|---|---|---|
| (a) | DIVERSIFICATION | | |
| | Definition of diversification | 2 | |
| | Concentric diversification | $1^1/_2$ | |
| | Conglomerate diversification | $1^1/_2$ | 5 |
| (b) | Factors supporting concentric diversification | | |
| | 4 factors x $2^1/_2$ marks each | | 10 |
| | | | 15 |

**SOLUTION 6**

a) **Transparency** in stock and other financial markets means that information about conditions in the markets is clear and well understood.

Transparency exists when investors understand the financial situation of companies and their future plans as well as prospects, which is important for them to make well-informed investment decisions.

**Disclosure** means making information available so that there is transparency. Companies have the main responsibility for disclosure in the stock markets.

The Code of Corporate Governance in Nigeria states that companies should engage in increased disclosure beyond the statutory requirements of Companies and Allied Matters Act. The board should be guided by the principle of timely, accurate and continuous disclosure so as to give a balanced and fair view of the company including non-financial matters.

b) Principles of disclosure and communication of information on governance.

i. **Information should be reliable:**
Reliable information is such that is sufficiently accurate for investors to trust when making investment decisions.

ii. **Information should be understandable:**
One of the criticisms of International Financial Reporting Standards IFRS) is that financial reporting in accordance with IFRS could be very complex, and some investors might not understand properly the information therein.

iii. **Information should be timely:**
'Timely' often means 'communication as soon as possible'. Information should be made available to all investors as soon as possible after it becomes 'public'.

iv. When information is disclosed by companies, it should be equally available to all investors.
Information should be made available through convenient channels of communication. Companies should be encouraged to make information available in electronic form to investors who want to receive it in that form.

v. Opportunities for insider dealing for exploiting confidential information to make a personal profit should be reduced.

**EXAMINER'S REPORT**

**This question tests candidates' understanding of the underlying principles of transparency and disclosure, and disclosure and information in corporate governance.**

**About 80% of the candidates attempted this question. Performance was below average as many candidates could not relate the underlying principles to corporate governance.**

**It is recommended that candidates should pay attention to the principles underpinning the concept of corporate governance.**

| **Marking Guide** | | Marks | Marks |
|---|---|---|---|
| (a) | TRANSPARENCY AND DISCLOSURE | | |
| | Definition of transparency | 3 | |
| | Definition of disclosure | 2 | 5 |
| (b) | PRINCIPLES OF DISCLOSURE AND COMMUNICATION | | |
| | 5 principles x 2 marks each | | 10 |
| | | | 15 |

**SOLUTION 7**

**a**

i) Companies (and other entities) develop their own culture, which is the set of shared beliefs, attitudes, norms, values and behaviour found among employees of an organization.

**Culture helps an organization:**

- To develop attitudes and habits that are unique to the organisation. The individuals who work in a company often develop cultural attitudes and habits that are unique to that company. Even global companies, in which employees do not share the same language or live in the same geographical area, could develop a culture of shared beliefs and attitudes.
- In shaping ethical beliefs and attitude of all employee of an organization.
- To succeed.
- To deal with problems that the organization faces internally and in its external environment.

ii) The cultural web consists of six inter-related elements of culture within an organisation:

- **Routines and rituals.** Routines and rituals are 'the ways things are done around here'. Individuals get used to established ways of doing things.

- **Stories and myths.** Stories and myths are used to describe the history of an organisation, and to suggest the importance of certain individuals or events. They are passed by word of mouth and they help to create an impression of how the organisation got to where it is, and it usually is difficult to challenge established myths and consider a need for a change of direction in the future.

- **Symbols.** Symbols could become a representation of the nature of the organisation. Examples of symbols include a company car or helicopter, an office or building, a logo or a style of language.

- **Power structure.** Organisations are influenced by the individuals who are in a position of power. In many business organisations, power is obtained from management position.
  However, power could also come from personal influence or experience and expertise.

- **Organisation structure.** The culture of an organisation is affected by its organisation and management structure. Hierarchical and bureaucratic organisations might find it particularly difficult to adapt to change and are often conservative in their outlook.

- **Control systems.** Performance measurement and reward systems within an organisation establish the views about what is important and what is not so important. Individuals focus on performance that earns rewards. For example, it has been suggested that cash bonus systems help to create the profit-driven culture in investment banks.

b. The stakeholder theory of corporate governance holds that a company's directors owe a duty to all major stakeholders in the company, including employees, customers, communities and society as a whole.

   The considerations are:
   i. All individuals have a basic moral right to be treated by business entities in a way that respects their interests and concerns.
   ii. Employees should not be treated simply as a means of achieving the end of higher company profits.

**EXAMINER'S REPORT**

**The question tests candidates' understanding of the impact of culture on an organisation and the stakeholder theory of corporate governance.**

**About 70% of the candidates attempted this question.**

**Performance was below average as less than 35% of the candidates scored up to 50% of the marks allotted.**

**The common pitfalls were lack of understanding of the cultural context of ethics and the principles underpinning stakeholders theory.**

**Candidates are advised not only to study the concepts of strategic management, but also their underpinning principles.**

**Marking Guide**

| | | Marks | Marks |
|---|---|---|---|
| (a) | ROLE OF CULTURE IN AN ORGANISATION | | |
| (i) | Role of culture | 2 | |
| (ii) | Interrelated elements of culture | | |
| | 4 points x 2 marks each | 8 | 10 |
| | | | |
| (b) | STAKEHOLDER THEORY OF CORPORATE GOVERNANCE | | |
| | Definition of stakeholder theory of corporate governance | 2 | |
| | Considerations underpinning stakeholders theory | | |
| | 2 points x $1^1/_2$ marks each | 3 | 5 |
| | | | 15 |