ICAN

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PATHFINDER

MARCH/JULY 2020 DIET
SKILLS LEVEL EXAMINATIONS

Question Papers

Suggested Solutions

Marking Guides

and

Examiner's Reports

FOREWARD

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

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

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

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

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

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

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

NOTES

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

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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – MARCH/JULY 2020

FINANCIAL REPORTING

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

INSTRUCTION: YOU ARE REQUIRED TO ANSWER FOUR OUT OF SIX QUESTIONS IN THIS PAPER

SECTION A: COMPULSORY QUESTION (40 MARKS)

QUESTION 1

Dangoyaro Plc is a manufacturing company and the summarised financial statements for the year ended September 30, 2019 and the comparative figures for 2018 are as follows:-

	2019	2018
	₦'000	**₦'000**
Revenue	737,500	900,000
Cost of sales	(637,500)	(650,000)
Gross profit	100,000	250,000
Distribution cost	(26,250)	(20,000)
Admin expenses	(122,500)	(97,500)
Investment income	1,250	5,000
Finance cost	(15,000)	(12,500)
Profit/(loss) before taxation	(62,500)	125,000
Income tax at 30% (expense)/relief	10,000	(37,500)
Profit/(loss) for the year	(52,500)	87,500

Statement of financial position as at September 30

	2019	2018
Non–current assets	**₦'000**	**₦'000**
Property plant and equipment	440,000	612,500
Financial assets fair value through profit or loss	60,000	100,000
	500,000	712,500
Current assets		
Inventory & work-in progress	55,000	47,500
Trade receivables	70,000	70,000
Bank	30,000	2,500
	155,000	120,000
Total assets	655,000	832,500

Equity and liabilities		
Equity		
Ordinary share capital of ₦1 each	325,000	300,000
Share premium	25,000	--
Revaluation reserves	--	112,500
Retained earnings	90,000	162,500
	440,000	575,000
Non-current liabilities		
Bank loan	100,000	125,000
Deferred tax	30,000	17,500
	130,000	142,500
Current liabilities		
Payables	85,000	70,000
Current tax payable	--	45,000
	85,000	115,000
Total equity and liabilities	655,000	832,500

The following information was obtained from the chairman's statement in the annual report presented at the Annual General Meeting (AGM) held on December 22, 2019 and in the notes to the financial statements.

(i) Market condition during the year ended September 30, 2019 proved very challenging due largely to difficulties in the global economy as a result of recession, which led to a decline in the share price and property values.

(ii) Dangoyaro plc has not been immuned from these effects and our property have suffered impairment losses of ₦125million in the year. The excess of these losses over previous surpluses has led to a charge to cost of sales of ₦37.5million in addition to the normal depreciation charge.

(iii) There is no addition to or disposal of non-current assets during the year.

(iv) In response to the downturn, the company has made a number of employees redundant, incurring severance cost of ₦32.5million (included in cost of sales), undertaken cost savings in advertising and other administrative expenses.

(v) The difficulty in the credit market has meant that the finance cost of our fixed interest bank loan has increased from ₦12.5million to ₦15million. In order to improve cash flows, the company made a rights issue during the year and reduced the dividend per share by 50%.

(vi) Despite the above events and the associated costs, the board of directors of Dangoyaro Plc believes the company's performance has been quite resilient in these difficult times.

You are required to prepare:

a. An adjusted statement of profit or loss for the year ended September 30, 2019 (without taking into consideration information in the chairman's statement and notes to the financial statements). (5 Marks)

b. Statement of changes in equity for the year ended September 30, 2019. (8 Marks)

c. Statement of cash flows for the year ended September 30, 2019 using indirect method in accordance with provisions of IAS 7. (12 Marks)

d. Analyse and discuss the financial performance and position of Dangoyaro plc as shown by the above financial statements as at September 30, 2019 using the following financial ratios:

    i. Gross profit margin
    ii. Net profit margin
    iii. Return on capital employed (CE = ordinary shares plus reserves)
    iv. Asset turnover
    v. Current ratio
    vi. Quick ratio
    vii. Gearing ratio
    viii. Receivables period
    ix. Inventory period
    x. Payables period

(15 Marks)

(Total 40 Marks)

SECTION B: YOU ARE REQUIRED TO ANSWER ANY THREE OUT OF FIVE QUESTIONS IN THIS SECTION (60 MARKS)

QUESTION 2

a. IFRS 5 sets out requirements that specify the accounting treatment for Non-current Assets Held for Sale and the presentation and Discontinued Operations.

   Required:
   Explain the criteria to be met before assets can be classified as held for sales in accordance with IFRS 5. (5 Marks)

b. Explain the recognition criteria on provisions in accordance with International Accounting Standards (IAS 37) on provisions, contingent liabilities and contingent assets. (5 Marks)

c. What are the disclosure requirements of International Accounting Standards (IAS 37) on provisions. (5 Marks)

d. Explain **FIVE** fundamental principles set out in the ICAN code of ethics.

(5 marks)

(Total 20 Marks)

QUESTION 3

a. International Financial Reporting Standards IFRS 10 - Consolidated Financial Statements states that a parent must prepare consolidated financial statements for the group as a whole.

Required:
Explain the exceptions to this rule according to IFRS 10. (7 Marks)

b. The following information relates to financial statements included in the annual report of Papa Limited and Mama Limited as at December 31, 2018. Papa Limited acquired 80% of the ordinary shares of Mama Limited for ₦1,200m on January 1, 2014:

	Papa Limited ₦'m	Mama Limited ₦'m
Assets		
Non-current assets		
Property, plant and equipment	1,200	900
Investments	1,600	Nil
Current assets		
Inventories	320	300
Trade receivables	240	560
Cash and cash equivalents	40	100
	3,400	1,860
Equity and Liabilities		
Share capital	320	240
Share premium	80	40
Retained earnings	1,180	1,000
Non-current liabilities		
Loan notes	1,200	340
Current liabilities		
Trade payables	620	240
	3,400	1,860

Additional Information provided are:

(i) At the date of acquisition, Mama Limited retained earnings were ₦600m. Non-controlling interest fair value in Mama Limited on the date of acquisition was ₦320m.

(ii) Papa Limited sold goods worth ₦200m to Mama Limited during the year making 25% gross profit margin. 40% of the goods are still included in the inventories of Mama Limited as at December 31, 2018.

(iii) The fair values of the net assets of Mama Limited at the date of acquisition is the same as their carrying amount, with the exception of land and buildings. The cost of these land and buildings is ₦600m and it was estimated to have a fair value of ₦720m.

You are required to:
Prepare the consolidated statement of financial position for the Papa Limited group as at December 31, 2018. (13 Marks)

(Total 20 Marks)

QUESTION 4

a. The Federal Government of Nigeria is committed to improving Medium, Small and Micro Enterprises (MSME) programme. In view of this, the government issued directives to the Central Bank of Nigeria (CBN) to give grants to MSME that has at least 25% local equity participation.

Required:

(i) Explain the **TWO** types of grant/government assistance that are recognised by IAS 20 on accounting for government grants and disclosure of government assistance.

(ii) Outline the **TWO** methods of presenting grant/government assistance that are recognised by IAS 20 - Accounting for Government Grants and Disclosure of Government Assistance. (8 Marks)

b. During the year ended June 30, 2019, Gbogbonise Enterprises having qualified for the 25% local equity participation, received the following grants from Central Bank of Nigeria (CBN).

(i) On September 1, 2018, a grant of ₦1million was received from CBN. The grant was in respect of training casual workers. The training cost incurred by Gbogbonise Enterprises in this respect, was ₦1.75million.

(ii) On November 1, 2018, Gbogbonise Enterprises acquired plant and equipment costing ₦8.75million and received a grant of ₦2.5million from Central Bank of Nigeria (CBN) in respect of the purchase. The plant and equipment which has a residual value of ₦1.25million is depreciated on straight line basis over its useful life of 5 years.

(iii) On June 1, 2019, a grant of ₦2.5million was made by CBN. The grant was in respect of relocation costs that Gbogbonise Enterprises had incurred for movement of its business to a free trade zone allocated to Medium, Small and Micro Enterprises (MSME). The grant is repayable in full unless Gbogbonise Enterprises recruits at least one hundred (100) employees from the free trade zone local area by the end of the month of June, 2019. Gbogbonise is finding it difficult to recruit this number of employee in the local area.

Required:

Prepare extracts of statement of financial position and statement of profit or loss of Gbogbonise Enterprises for the year ended June 30, 2019 using the two methods of presenting grants in the financial statement of business entities. (12 Marks)

(Total 20 Marks)

QUESTION 5

a. IFRS requires several methods for recognising gains and losses on re-measurement of various types of assets recognised by different International Accounting Standards.

Required:

Explain how IFRS requires gains or losses on re-measurement to be dealt with in the financial statements for each of the following type of assets:

i. Financial assets held at fair value under – IFRS 9. (3 Marks)

ii. Property, plant and equipment held under revaluation model of IAS 16.

(2 Marks)

b. The assistant accountant of Gbebody Nigeria Limited after preparing the company's draft statement of profit or loss for the year ended September 30, 2019 and adding the current year's profit to retained earnings extracted a summarised trial balance of the company as at that date are as follows:

	₦'000	₦'000
Retained earnings as at September 30, 2019	-	26,250
Ordinary shares at ₦1 each	-	60,000
Land (₦7.5m) and building at cost	82,500	-
Plant & equipment at cost	87,750	-
Accumulated depreciation at October 1, 2018:	-	
- Building		30,000
- Plant & equipment		51,750
Current assets	60,750	-
Current liabilities	-	57,600
Deferred tax	-	3,750
Current tax	-	1,650
	231,000	231,000

The chief accountant of Gbebody Nigeria Limited on reviewing the draft trial balance discovered that the following information were not taken into consideration by the assistant accountant of the company.

- The price of property has increased significantly in recent years and on October 1, 2018, the directors decided to revalue the land and building.
- The directors accepted the report of an independent valuer who valued the land at ₦12m and the building at ₦58.5million on that date. The remaining life of the building at October 1, 2018 was 15 years. Gbebody Nigeria Limited does not make an annual transfer to retained earnings to reflect the realisation of the revaluation gain, however, the revaluation will give rise to a deferred tax liability. The company income tax rate is 30%.
- Plant and equipment is depreciated at 12½% per annum using reducing balance method. No depreciation has been charged on any non-current assets for the year ended September 30, 2019.

- Provision of ₦3.6million is required for current income tax on the profit for the year to September 30, 2019. The balance on current tax in the trial balance is the under/over provision of tax for the previous year. In addition to the temporary difference relating to the information in the note above. Gbebody Nigeria Limited has further taxable temporary difference of ₦15m as at September 30, 2019.

You are required to prepare:

i. Adjusted retained earnings after taking into consideration the additional information in the notes above. (5 Marks)

ii. The statement of financial position of Gbebody Nigeria Limited as at September 30, 2019. (10 Marks)

(Total 20 Marks)

QUESTION 6

a. The conceptual framework specifies the fundamental reasons why financial statements are produced worldwide which, is to satisfy the requirement of external users.

Required:

Outline **FIVE** types of economic decisions for which financial statements are likely to be used for and identify **TWO** advantages of conceptual framework. (10 Marks)

b. The regulatory body responsible for issuing accounting standards in accordance with local and international regulations in Nigeria is the Financial Reporting Council of Nigeria (FRCON).

Required:

Explain briefly **THREE** main objectives of setting up the Financial Reporting Council of Nigeria (FRCON) and identify **TWO** ethical issues in financial reporting which companies may be sanctioned for by this body.

(10 Marks)

(Total 20 Marks)

SOLUTION 1

(a) **Dangoyaro plc**
Adjusted statement of profit or loss for the year ended September 30, 2019

	N'000
Revenue	737,500
Cost of sales (637.5 – 37.5 – 32.5)	(567,500)
Gross profit	170,000
Distribution cost	(26,250)
Admin expenses	122,500
Finance cost (15 – 2.5)	(12,500)
Investment income	1,250
Net profit before tax	10,000
Income tax at 30% (10m x 30%)	(3,000)
Profit for the year	7,000

(b) **Dangoyaro plc**

Statement of change in equity for the year ended September 30,2019

	Ordinary share capital	**Share premium**	**Revaluation reserve**	**Retained earnings**	**Total**
	₦'000	**₦'000**	**₦'000**	**₦'000**	**₦'000**
October 1, 2018	300,000	--	112,500	162,500	575,000
Profit/Loss for the year	--	--	--	(52,500)	(52,500)
Owners transactions:					
Rights issue	25,000	25,000	--	--	50,000
Revaluation reserve	--	--	(112,500)	--	(112,500)
Dividend paid	--	--	--	(20,000)	(20,000)
	325,000	25,000	Nil	90,000	440,000

(c) **Dangoyaro plc.**

Statement of cash flows for the year ended September 30, 2019

Operating activities	₦'000	₦'000
Profit before tax		(62,500)
Add/Less:		
Finance cost	15,000	
Investment income	(1,250)	
Impairment loss (125,000 - 112,500)	12,500	

Depreciation charge (w1)	47,500	
Loss on fair value of financial assets (100,000 – 60,000)	40,000	113,750
Cash flows from operations before working capital changes		51,250
Working capital changes		
Increase in inventory (55,000 - 47,500)	(7,500)	
Increase in payables (85,000 - 70,000)	15,000	7,500
Finance cost paid		(15,000)
Taxation paid		(22,500)
Net cash flows from operating activities		21,250
Investing activities		
Investment income	1,250	
Net cash flows from investing activities		1,250
Financing activities		
Dividend paid (162,500 – 52,000 – 90,000)	(20,000)	
Proceed from right issue (share 25,000 + prem. 25,000)	50,000	
Repayment of bank loan (125,000 - 100,000)	(25,000)	
Net cash flows from financing activities		5,000
Increase in cash and cash equivalent for the year		27,500
Cash and cash equivalents at start		2,500
Cash and cash equivalents at end		30,000

W1: Schedule of movement in property plant & equipment

	PPE
	₦'000
Cost b/f	612,500
Impairment loss on property	(125,000)
Expected closing balance	487,500
Actual closing balance	440,000
Depreciation charge/loss on fair value	47,500

(d) **Financial performance and position of Dongoyaro plc**

(i) **Profitability**

- Dongoyaro Plc, revenue declined by 18% and its gross profit by 60%. This alone paints the picture of a very challenging trading environment. The results are worsened by ₦37.5million on impairment and ₦32.5million severance cost charged to cost of sales.

- The gross profit percentage is 13.6% compared to 27.8% in year 2018. Similarly, net profit margin also declined from 9.7% to negative 7.1%.

- Even when all the distortion stated in the chairman's statement is not considered the profit performance of the company still declined over the period.

- The decline in ROCE from 15.2% to 11.9% is also an indication of poor efficiency of the utilisation of the company's assets.

(ii) **Liquidity**

- Despite the downturn in trading, Dongoyaro Plc's liquidity position has improved. Both the current ratio and quick ratio improved over the period.

- The actual bank situation improved from ₦2.5million to ₦30million in year 2019.

- The improvement in liquidity position must have been due to the fact that the company made a rights issue to existing shareholders, disposed of some of its financial assets and cut down dividend payments by about 50%.

- Similarly, there was a better working capital management, the company granted less credit period to debtors and deliberately took more credit period from its suppliers while the inventory turnover period was fairly stable over the period.

(iii) Gearing

- The gearing increased over the period by 1%. This was made possible because Dangoyaro Plc repaid part of the loan (i.e ₦25million) during the year and also gave rights Issues, thereby keeping the company's gearing under control.

- In view of the stable gearing, the company is less exposed to creditors but it will be better not to increase the gearing in future due to increasing interest rate as noted in the chairman's statement.

Dangoyaro plc

Computation of relevant accounting ratios for the year 2019 and 2018

		2019	2018
(i)	Gross profit margin = gross profit x 100 / Revenue	100,000 x 100 / 737,500 = 13.56%	250,000 x 100 / 900,000 = 27.78%
(ii)	Net profit margin = Profit after tax x 100 / Revenue	(52,500) x 100 / 737,500 = (7.12)%	87,500 x 100 / 900,000 = 9.72%
(iii)	Return on capital employed (ROCE) = Profit after tax x 100 / Ordinary shares + reserves	(52,500) x 100 / 440,000 = (11.93)%	87,500 x 100 / 575,000 = 15.22%
(iv)	Asset turnover ratio = Revenue / Ordinary shares + reserves	737,500 / 440,000 = 1.68 times	900,000 / 575,000 = 1.57 times
(v)	Current ratio = Current assets / Current liabilities	155,000 / 85,000 = 1.82:1	120,000 / 115,000 = 1.04:1
(vi)	Quick ratio/acid test = Current assets – inventory / Current liabilities	155,000 – 55,000 / 85,000 = 1.18:1	120,000 – 47,500 / 115,000 = 0.63:1
(vii)	Gearing ratio = Long-term debt / Equity x 100 / 1	100,000 x 100 / 440,000 = 22.72%	575,000 x 100 / 700,000 = 24.73%
(viii)	Receivable period = Trade receivable x 365 days / Revenue	70,000 x 365 days / 737,500 = 35 days	70,000 x 365 days / 900,000 = 28 days
(ix)	Inventory days period = Inventory x 365 days / Cost of sales	55,000 x 365 days / 637,500 = 31 days	47,500 x 365 days / 650,000 = 27 days
(x)	Payable payments period = Trade pay. x 365 days / Cost of sales	85,000 x 365 days / 637,500 = 49 days	70,000 x 365 days / 650,000 = 39 days

Examiner's report

The question tests the preparation of final accounts including analysis and adjustments of the financial statements presented at Annual General Meeting (AGM) of an entity.

Majority of the candidates attempted the question and performance was average.
The commonest pitfalls of the candidates are inability to appreciate in question (1a) that the financial statement presented at AGM is the final financial statement

which already incorporated issues mentioned in chairman's statement. Failure of candidates' ability to give correct interpretation to the ratios calculated using other financial statements prepared. Some of the candidates could not correctly prepare the statement of changes in equity.

Candidates are advised to pay more attention to this area of the syllabus as the compulsory questions will always cover this section of the syllabus. Similarly, candidates should make use of the ICAN study texts for better performance in future examinations.

Marking guide

		Marks	Marks
a.	Preparation of adjusted statement of profit or loss:		
	- Title of financial statement	½	
	- Determination of gross profit	1½	
	- Determination of profit before tax	2	
	- Determination of profit for the year	1	5
b.	Preparation of statement of changes in equity:		
	- Title of financial statement	½	
	- Determination of changes in ordinary shares	1½	
	- Determination of changes in share premium	1	
	- Determination of changes in revaluation reserve	1½	
	- Determination of changes in retained earnings	2	
	- Determination of total equity	1½	8
c.	Preparation of statement of cash flows:		
	- Title of financial statement	½	
	- Determination of cash flows from operating activities before capital changes	4	
	- Determination of net cash flows from operating activities	2½	
	- Determination of net cash flows from investing activities	1	
	- Determination of net cash flows from financing activities	2	
	- Determination of cash and cash equivalent at year end	1	
	- Workings	1	12
d.	Analysis and discussion of financial performance and position		
	- Any five points on analysis and discussion	7½	
	- Correct calculations of the relevant 10 ratios	7½	15
	Total		**40**

SOLUTION 2

(a) The following are the criteria to be met before assets can be classified as held for sale in accordance with IFRS 5;

i. The asset must be available for immediate sale in its present condition;
ii. Management must be committed to a plan to sell it;
iii. There must be active programme in locating a buyer;
iv. The asset must be marketed at a price reasonable to its current fair value;
v. The sale of the asset is expected to take place within one (1) year from the date of classification;
vi. It is unlikely that a significant change will be made to such plan or that such plan will be withdrawn by the entity; and
vii. The sale of the assets must be highly probable.

(b) Provisions should be recognised when all of the following criteria are met:

i. There is a present obligation arising as a result of past events. This obligation can be either legal or constructive obligation;
ii. It is probable that an outflow of economic benefit will be required to settle the obligation;
iii. The amount of such provision can be reliably estimated; and
iv. If one of the conditions (i) – (iii) above is not met, then the provision cannot be recognised.

(c) The disclosure requirements of IAS 37 on provisions are:

i. The nature of the provision and any uncertainties affecting its outcome.
ii. Additional provisions made in the period, including increase to existing provisions;
iii. The opening and closing balances and the movement in all classes of provisions during the period;
iv. Any assumptions used in recognizing and measuring the provisions;
v. Any reversal made on existing provision during the period; and
vi. The expected timing of any settlement.

(d) Fundamental principles set out in the ICAN code of ethics are:

i. **Integrity**
Professional accountants should be honest and straightforward in their professional and business dealings. They must be seen to be honest. Integrity implies not just honesty but also fair dealings and truthfulness;

ii. **Objectivity**
ICAN 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 skills at such a level that a client or employer receives a competent service, based on current developments in practice, legislation and techniques. They should act diligently and in accordance with applicable technical and professional standards;

iv. **Professional behaviour**
Members must comply with relevant laws and regulations, always behave with courtesy and should avoid any action which can put the profession to disrepute; and

v. **Confidentiality**
Members should not disclose any information of their clients or employers to third parties without the consent of such 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 not be used for the personal advantage of members or third parties.

Marking guide

		Marks	Marks
a.	Criteria for classification of assets as held for sale under IFRS 5:		5
b.	Criteria for recognition of provisions under IAS 37:		5
c.	Disclosure requirements of IAS 37 on provisions:		5
d.	Fundamental principles set out in ICAN code of ethics:		
	- Stating the principles	2½	
	- Explanation of the principles	2½	5
	Total		**20**

Examiner's report

The question tests the following provisions of International Financial Reporting Standards. IFRS 5 – Non-Current Assets Held For Sales and Discontinued Operations, IAS 37 – Provisions, Contingent Liabilities and Contingent Asset, as well as ethical issues in financial reporting.

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

Some candidates could not clearly state the recognition criteria on provisions in accordance with IAS 37 while others could not also state necessary disclosure requirements according to the standard.

Candidates are advised to note that International Financial Reporting Standards will be regularly examined at the skills level of the Institute examinations therefore they should pay attention to all relevant accounting standards at this level.

SOLUTION 3

(a) A parent need not prepare consolidated financial statements if (and only if) it meets all of the following conditions:

(i) The parent is itself a wholly-owned subsidiary.

(ii) The parent is a partially owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about it, and do not object to the parent not to present consolidated financial statements.

(iii) Its securities (either debt or equity) are not publicly traded.

(iv) It is not in the process of issuing its securities in public securities market.

(v) Its ultimate (or intermediate) parent publishes consolidated financial statements that comply with International Financial Reporting Standards.

(b) **Papa Limited**

Consolidated statement of financial position as at December 31, 2018

	₦'m	₦'m
Non-current asset:		
Property, plant & equipment (1,200 + 900 + 120)		2,220
Goodwill (Wk 3)		520
Other investments (1,600 – 1200)		400
Total non-current assets		3,140
Current assets:		
Inventories (320 + 300 – 20)	600	
Trade receivables (240 + 560)	800	
Cash and cash equivalents (40 + 100)	140	
Total current assets		1,540
Total assets		**4,680**
Equity & Liabilities:		
Equity attributable to owners of the parent:		
Share capital		320
Share premium		80
Retained earnings (Wk 6)		1,480
		1,880
Non-controlling interest (Wk 4)		400
Total equity		2,280
Non-current liabilities:		
Loan notes (1,200 + 340)	1,540	
Current liabilities:		
Trade payables (620 + 240)	860	
Total liabilities		2,400
Total equity and liabilities		**4,680**

Working Notes

Wk. 1: Group Structure

Papa Limited ---------------80%--------------- Mama Limited
NCI = 20%

Wk. 2: Net asset of subsidiary

	At Rep. Date	At Acq. Date	Post-Acq.
	₦'m	₦'m	₦'m
Share capital	240	240	-
Share premium	40	40	-
Retained earnings	1,000	600	400
Fair value surplus (720 – 600)	120	120	-
	1,400	1,000	400

Wk. 3: Determination of goodwill on acquisition

	₦'m
Consideration transferred by parent	1,200
	320
	1,520
Net assets of subsidiary at acquisition	(1,000)
Goodwill	520

Wk. 4: Valuation of NCI

	₦'m
NCI at acquisition (Wk. 4)	320
Share of post-acquisition profit (20% x 400)	80
	400

Wk. 5: Unrealised profit

	₦'m
40% x 200 x 25%	20

Wk. 6: Consolidated retained earnings

	N'm
Papa Limited	1,180
Share of post-acquisition profit (80% x 400)	320
Unrealised profit (Wk. 5)	(20)
Consolidated retained earnings	1,480

Examiner's report

The question tests the preparation of the consolidated statement of financial position and exception to rules of preparing consolidated financial statements in accordance with IFRS 10.

Majority of the candidates attempted the question and performance was good.

The commonest pitfall was the inability of the candidates to correctly calculate the goodwill figure in the financial statements.

Candidates are advised to also read widely to have better knowledge of this major section of syllabus.

Marking guide

			Marks	Marks
a.	Exceptions to preparation of consolidated financial statements by parent company:			
	-	Introduction	1	
	-	Any four exceptions to the rule	6	7
b.	Preparation of consolidated statement of financial position			
	-	Title of financial statement	¼	
	-	Determination of consolidated non-current assets	2¼	
	-	Determination of consolidated current assets	3	
	-	Determination of equity	1¼	
	-	Determination of consolidated non-current liabilities	¾	
	-	Determination of consolidated current liabilities	1	
	-	Determination of goodwill on consolidation	2½	
	-	Determination of non-controlling interest	¾	
	-	Determination of consolidated retained earnings	1	
	-	Determination of unrealised profit	¼	13
		Total		**20**

SOLUTION 4

(a)i. Two types of government grant in line with IAS 20 are:

i. **Grant related to assets**: This is a type of grants by government to assist the qualifying companies in the acquisition of a particular asset. It can be accounted for in the statement of financial position, using any of the following two ways:

- Deduct the grant from the original cost of the assets: Under this, the amount of
  government grants received will be deducted from the cost of the assets and the depreciation will be based on the reduced cost.

- Set up grant as deferred income: Under this, the asset will be accounted for as if there were no grants, while the grants will be recognized as an income over the estimated useful life of the asset.

Grants related to income: This is a type of grant by government which is not meant to acquire a particular asset.

It is an income grant to finance the operations of the company.

It is recognised in the income statement in the period received or when deemed to have been received.

ii. The two methods of presenting grants in line with IAS 20 are:

- **Capital approach:** Under this approach, the grants are regarded as financing device and as result credited directly to equity in the statement of financial position. This implies that the grants are not earned, they are incentives without related cost and should not be taken to profit or loss.
- **Income approach:** Under this approach, the grants are regarded as an income and not capital. They are not received from shareholders, hence should not be credited directly to equity.

(b) **Method 1 – (net grants off related expenditure) i.e. capital approach**

(i) **Gbogbonise enterprises statement of financial position (extract) AS AT JUNE 30, 2019**

	₦'000
Non-current assets	
Property plant and equipment. (w1)	5,583
Current liabilities	
Other current liabilities	2,500

(w1)	**Working notes**	**₦'000**
	PPE – Cost (8,750 – 2,500)	6,250
	Accumulated depreciation (8,750 – 2,500) ÷ 5 8/12)	(667)
		5,583

Gbogbonise enterprises

Statement of profit or loss (extract) for the year ended June 30, 2019

	₦'000
Depreciation charged	667
Training (1.75 – 1)	750

Method 2 – Showing grants separately from related expenditure
Gbogbonise enterprises i.e. income approach
Statement of financial position (extract) as at June 30, 2019

	₦'000
Non-current assets	
Property plant & equipment (w2)	7,750
Current liabilities	
Other current liabilities (w3)	4,667

Working Notes:

		₦'000
(w2)	PPE – Cost	8,750
	Accumulated depreciation (8,750 – 1,250) ÷ 5 x 8/12	(1,000)
		7,750
(w3)	**Other current liabilities**	
	Deferred Income relating to Govt. Grant (2,500 – (2,500 ÷ 5 x 8/12)	2,167
	Government grant repayable	2,500
		4,667

Gbogbonise enterprises
Statement of profit or loss (extract) for the year ended June 30, 2019

	₦'000
Depreciation Charged	(1,000)
Training cost grant	(1,750)
Government grant received	1,000
Realisation of deferred govt. grant	333

Note:
Government grant of ₦2.5million in respect of recruitment of employees in free trade zone areas was not accounted for because it has a condition attached to it; and Gbogbonise Enterprises could not meet up the condition hence the grant should not be recognized as stipulated in IAS 20 on accounting for government grants, rather it should be treated as a liability.

Examiner's report

The question tests the provisions and application of IAS 20 – Government Grants and Disclosure of Government Assistance.

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

The commonest pitfall is that candidates have very little knowledge of the standard which, is considered important in view of growth in the MSME sector of the Nigerian economy.

Candidates are therefore advised to pay more attention to the provisions and applications of relevant international accounting standards as well as read financial reporting journals.

Marking guide

			Marks	Marks
a.	Types of government grants and methods of presenting grant/government assistance:			
	-	Stating two types of government grant	1	
	-	Explanation of grants related to assets	1½	
	-	Explanation of grants related to income	1½	
	-	Stating the two methods of presentation of grants	2	
	-	Explanation of capital approach	1	
	-	Explanation of income approach	1	8
b.	Preparation of statement of financial position extract:			
i .	Capital approach			
	-	Presentation of statement of financial position extract	2	
	-	Presentation of statement of profit or loss extract	2	
	-	Workings for PPE and accumulated depreciation	2	6
ii.	Income approach			
	-	Presentation of statement of financial position extract	1	
	-	Presentation of statement of profit or loss extract	2	
	-	Workings for PPE and other liabilities	4	6
		Total		20

SOLUTION 5

(a) (i) **Financial assets held at fair value – IFRS 9**

- Under IFRS 9, financial assets may be held under the 'fair value' or the 'amortised cost' categories. The categorisation is not optional but depends on the type of instrument and the entity's business model for holding it.

  The fair value method is the default and applies to all financial instruments, to which the amortised cost method does not apply.

- Under IFRS 9, gain or losses on re-measurement of such assets are normally taken to profit or loss affecting the retained earnings ultimately. However, there is a limited exception to this rule.

- If the financial assets in question is an equity investment and an election has been made at the date of the purchase, any gain or losses on re-measurement are taken to other comprehensive income and to a separate component of equity.

This election is irrevocable once made; but may be applied or not as decided on the date of purchase.

(ii) **Property plant and equipment under revaluation model - IAS 16**

- Under the revaluation model of IAS 16 revaluation gain or losses are treated differently depending on whether they are originating or reversing.

- An originating gain on revaluation of PPE (means one which is occurring for the first time, and not reversing a previously recognised loss) is recognised through other comprehensive income. This is then taken to a separate component of equity usually called revaluation surplus reserve.

- An originating loss on revaluation is taken to profit or loss as an expense.

- A revaluation gain that is reversing a previously recognised loss is taken to profit or loss as a gain until the effect of the previously recognised loss is completely reversed. This takes into account any difference in depreciation charges arising as a result of the previous loss lowering the depreciable amount. Any gain over and above the amount recognised in profit or loss is treated as an originating gain and taken to other comprehensive income.

- A revaluation loss that is reversing a previously recognized gain is taken to other comprehensive income until the effect of the revaluation gain is reversed. This means in effect that Other Comprehensive Income is charged with the expenses until the accumulated revaluation surplus remaining in equity has been eliminated. Any further loss is treated as an originating loss and taken to profit or loss.

- It should be noted that gains or losses on different assets may not offset against each other. Any reversal must be related to revaluation of the same asset.

(b) **Gbebody Nigeria Limited**

Adjusted retained earnings for the year ended September 30, 2019

	Notes	₦'000
Retained earnings b/f		26,250
Less:		
Depreciation charge on buildings	1	(3,900)
Depreciation charge on plant & equipment	3	(4,500)
Income tax expenses	4	(6,450)
Revised retained earnings for the year		11,400

Gbebody Nigeria Limited

Statement of Financial Position as at September 30, 2019

Non-current assets:	Notes	N'000
Land and building	1	66,600
Plant and equipment	3	31,500
		98,100
Current assets		60,750
Total assets		158,850
Equity and liabilities:		
Ordinary share of ₦1 each		60,000
Retained earning		11,400
Revaluation surplus	2	12,600
Total equity		84,000
Non-current liabilities:		
Deferred tax provision	5	13,650
Current liabilities		57,600
Income tax payables	4	3,600
		74,850
Total equity and liabilities		158,850

Working notes

Wk. 1: Land and building account	**Land**	**Building**	**Total**
	₦'000	**₦'000**	**₦'000**
Cost b/f	7,500	75,000	82,500
Accumulated depreciation b/f	-	(30,000)	(30,000)
Carrying amount b/f	7,500	45,000	52,500
Gain on revaluation	4,500	13,500	18,000
Revalued amount	12,000	58,500	70,500
Current year depreciation (58,500/15years)	-	(3,900)	(3,900)
Carrying amount c/f (SOFP)	12,000	54,600	66,600

Wk. 2: Revaluation surplus account	N'000
Gain on revaluation (Wk. 1)	18,000
Deferred tax provision (18,000 x 30%)	(5,400)
Balance c/f (SOFP)	12,600
Wk. 3: Plant and equipment account	N'000
Cost b/f	87,750
Accumulated depreciation b/f	(51,750)
Carrying amount b/f	36,000
Current year depreciation (12.5% x 36,000)	(4,500)
Carrying amount c/f (SOFP)	31,500
Wk. 4: Income tax expenses	N'000
Current year tax	3,600
Over provision of previous year tax	(1,650)
Increase in deferred tax (Wk. 5)	4,500
SOPL	6,450
Wk. 5: Deferred tax account	N'000
Balance from trial balance	3,750
Deferred tax on revaluation (Wk. 2)	5,400
Deferred tax on others - SOPL (15,000 x 30%)	4,500
Balance c/f (SOFP)	13,650

Examiner's report

The question tests the provisions and application of the following International accounting standards: IFRS 9 – Financial Instruments, and IAS 16 – Property, Plant and Equipment.

Only very few candidates attempted the question and performance was below average.

Most candidates that attempted the question could not correctly explain how gain or losses on re-measurement are dealt with under the above listed accounting standards. Similarly, others could not prepare the adjusted retained earnings as required by examiner.

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

Marking guide

			Marks	Marks
a.	Re-measurement of gains or losses in the financial statements for:			
i.	Financial assets held at fair value under IFRS 9			
	-	Any two correct explanations	3	
ii.	Property, plant and equipment held under revaluation model of IAS 16			
	-	Correct explanations	2	5
b.	Preparation of adjusted retained earnings and statement of financial position			
i.	-	Presentation of adjusted retained earnings	2½	
	-	Workings for income tax expenses	1	
	-	Workings for depreciation charge on land and buildings	1	
	-	Workings for depreciation charge on plant and equipment	½	5
ii.	-	Presentation of statement of financial position	3¾	
	-	Determination of carrying amount of land and building	3¼	
	-	Determination of carrying amount of plant and equipment	1	
	-	Determination of revaluation surplus	1	
	-	Determination of deferred taxation	1	10
		Total		**20**

SOLUTION 6

a. (i) **Types of economic decisions that financial statements may be used for are:**
The Objective of Financial Reporting Council of Nigeria (FRCON)

(i) Decision to buy, hold or sell equity investments.
(ii) Assessment of management stewardship and accountability.
(iii) Assessment of the entity's ability to pay employee, retirement benefits etc.
(iv) Assessment of the amount to lend to an entity and ability to pay back.
(v) Determination of taxation policies by government and other agencies.
(vi) Determination of distributable profit and dividend

(vii) Inclusions in national income statistics
(viii) Regulation of the activities of entity.
(ix) To assist suppliers and other creditors to determine entity's ability to meet current and future obligations
(x) Assessment of going concerns of an entity.

(ii) **Advantages of conceptual framework**
(i) It prevents a situation where accounting standards are being developed on a patchwork basis, hereby preventing contradictions and inconsistencies in basic concepts.
(ii) Standards developed based on conceptual framework will be less open to criticism and political interference.
(iii) It prevents standards from concentrating on a particular area, that is, it ensures uniformity.
(iv) It improves quality of accounting standards.

b. (i) **The Objective of Financial Reporting Council of Nigeria (FRCON)**
(i) Protect investors and other stakeholders' interest;
(ii) Give guidance on issues relating to financial reporting and corporate governance to professionals, institutional and regulatory bodies of Nigeria;
(iii) Ensure good corporate governance practices in the public and private sectors of the Nigeria economy;
(iv) Ensure accuracy and reliability of financial report and corporate disclosure in pursuant to the various laws and regulations currently in existence in Nigeria;
(v) Harmonise activities of relevant professional and regulatory bodies as relating to corporate governance and financial reporting;
(vi) Promote the highest standards among auditors, and other professionals engaged in financial reporting process;
(vii) Enhance the credibility of financial reporting; and
(viii) Improve the quality of accounting and audit services, actuarial valuation and corporate governance standards.

(ii) **Ethical issues**
(i) Engaging a professional suspended by FRCON without the consent of
the council.
(ii) Obstruction of Financial Reporting Council Inspector from doing their work.

(iii) Issue of financial statement which do not comply with relevant financial reporting standard.
(iv) Failure to submit signal financial statements to FRCON within specified period.
(v) Failure of the Chief Finance Officer (CFO) of an entity who is a signatory
to the financial statement to register with FRCON.

Examiner's report

The question tests issues on conceptual framework on financial reporting as well as Financial Reporting Council of Nigeria (FRCON).

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

The main pitfall was the inability of the candidates to identify the ethical issues in financial reporting which companies may be sanctioned for by FRCON.

Candidates are advised to read widely, while also making use of the Institute's study texts for better performance in future examinations.

Marking guide

		Marks
a.	Economic decision that financial statements may be used for:	
i.	Correct listing/identification of decisions	5
ii.	Advantages of conceptual framework:	
	- Correctly listing/identifying advantages	5
bi.	Objective of Financial Reporting Council of Nigeria (FRCON)	
	- Correctly listing/identifying objectives	6
ii.	Ethical issues:	
	- Correctly listing/identifying ethical issues	4
	Total	**20**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – MARCH/JULY 2020

AUDIT AND ASSURANCE

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

INSTRUCTION: **YOU ARE REQUIRED TO ANSWER FOUR OUT OF SIX QUESTIONS IN THIS PAPER**

SECTION A: **COMPULSORY QUESTION** **(40 MARKS)**

QUESTION 1

Mr. Ajibade, a businessman based in the South West region of Nigeria intends to start a new company. The new company, when formed, will focus solely on the production of face masks and alcohol-based hand sanitisers which are needed to prevent the spread of the novel corona virus. This has been incorporated into the draft Memorandum of Association to be submitted to the Corporate Affairs Commission (CAC).

Mr. Ajibade has heard of section 377 of Companies and Allied Matters Act (CAMA) Cap C20 LFN 2004, which offers exemption from an audit if a company qualifies as a small company as per section 351 of the Act. He thinks that when he starts a small company, he will therefore be exempted from statutory audit and so save cost.

Mr. Ajibade has a growth plan for his prospective company. He has also heard that if the company is to grow bigger in the future, he will require more funding in the form of loans from banks and other financial institutions. The banks will require audited financial statements as a prerequisite to granting his company loan facilities. He is therefore, curious to know more about the importance of audited financial statements.

He has approached you for advice.

Required:

Explain to Mr. Ajibade:

a. What qualifies a company as a small company according to CAMA. (6 marks)

b. The benefits and limitations of an audit. (9 marks)

c. The eligibility for qualification as external auditor. (6 Marks)

d. The scope of a statutory audit. (4 Marks)

e. According to ISA 300: *Planning an Audit of Financial Statements*, the objective of the auditor is to plan the audit work so that the audit will be performed in an effective manner.

Required:
Explain the benefits of adequate planning of the audit. (5 Marks)

f. Explain **THREE** risk assessment procedures required by ISA 315: *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.* (10 Marks)

(Total 40 Marks)

SECTION B: YOU ARE REQUIRED TO ANSWER ANY THREE OUT OF FIVE QUESTIONS IN THIS SECTION (60 MARKS)

QUESTION 2

At an inaugural lecture, a professor stated that 'professionals all over the world should be alive to their duties and not breach the ethics of their profession'. As a professional, you attended the inaugural lecture and you are aware that The Institute of Chartered Accountants of Nigeria (ICAN) has "**Accuracy and Integrity"** on its logo, and you also know that professionals should not act contrary to ethical standards and public interest in discharging their duties.

Required:

Explain the following:

a. Professional ethics. (2 Marks)
b. Importance of professional ethics. (5 Marks)
c. Differences between rule based and principle-based professional ethics. (3 Marks)
d. Weaknesses of rule-based professional ethics. (4 Marks)
e. Advantages of principle-based professional ethics. (6 Marks)

(Total 20 Marks)

QUESTION 3

Big Man Nigeria Limited is registered with the Corporate Affairs Commission. The services to be rendered are awaiting regulatory approval. Pending that approval, directors of the company have been funding the operations of the company through the parent company for the past four years. However, the newly appointed chairman of the company's board of directors believes there is the need to organise the company strategically so as to make it more attractive to investors.

Your father's friend, Mr. Ado, has been appointed as the Managing Director of the company, and he is interested in appointing an accountant to keep the books of accounts of the company. The present financial operation of the company does not show a good internal control structure. Added to this, Ado is thinking of recommending to the board of directors the need to appoint an external auditor.

The Managing Director, who is not an accountant, has requested for your advice on the need for an adequate internal control system in a company.

Required:

Explain to Mr. Ado, the following:

a. Meaning of internal control. (4 Marks)

b. Objectives of internal control. (6 Marks)

c. Features of a good internal control system. (4 Marks)

d. Regarding internal control, the responsibilities of:

i. Management; (2 Marks)

ii. Board of Directors; and (2 Marks)

iii. External auditors. (2 Marks)

(Total 20 Marks)

QUESTION 4

During a debate session, there were arguments among the accountancy students of the University of Kunu that the quality of audit work performed recently did not portray accountancy professionals as men of integrity. In their opinion, most financial malpractice committed by members of staff of a company are not detected by the auditors at the time of their audit and this causes corporate failures or leaves the shareholders with little or no return on their investments.

It is obvious that most students are unclear about the various types of audit. They all agreed that an informed person should be invited to educate members of the association on this topic. As an ex-student of University of Kunu, you have been invited to give a talk on various types of audit.

Required:

Explain the following, giving examples to support your answer:

a. Forensic audit (5 Marks)

b. Information systems audit (5 Marks)

c. Compliance audit (5 Marks)

d. Value for money audit (5 Marks)

Total 20 Marks)

QUESTION 5

The Directors of Hallmark Limited have decided that in order to improve its operating efficiency, there is need to increase the working capital of the company. The last audited financial statements of the company were up to September 30, 2018. A prospective investor has decided to perform due diligence on the company before investing a certain amount of money in the business.

The Financial Controller of Hallmark Limited has advised the directors that prior to the due diligence exercise, there might be need to perform assurance services on the company's financial result as the investor may not be willing to accept the last audited financial statements for the due diligence. Your father, who is a director of the company, has approached you as an accountancy student to give more explanations to him on the foregoing.

You are required to explain:

a.	Assurance services	(5 Marks)
b.	The various levels of assurance services	(7 Marks)
c.	The components/elements of an assurance engagement	(8 Marks)
		(Total 20 Marks)

QUESTION 6

In a medium-sized trading organisation, the accountant was given the additional responsibility of pursuing recoveries from debtors. On one occasion, when an insurance claim of ₦1 million was received, the accountant credited it to the account of a debtor to cover up a previous misappropriation of ₦1 million he had recovered in cash from the debtor.

Required:

a. Identify and describe the weaknesses in the internal control system which led to this situation. (10 marks)

b. List **TWO** control objectives and **THREE** control activities that should be put in place for each of the following:

   i. Cash sales. (5 Marks)

   ii. Lodgments into bank. (5 Marks)

(Total 20 Marks)

Solution 1

(a) Mr. Ajibade should note that a company qualifies as a small company as per

section 351 of CAMA CAP C20 LFN 2004, for that year, if the following conditions are satisfied:

i. It is a private company having a share capital;

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

iii. Its net assets value is not more than ₦1 million or such amount as may be fixed by the Corporate Affairs Commissions;

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; and

vi. The directors between them hold not less than 51 per cent of its equity share capital.

(b) The benefits and limitations of audit

(i) The benefits include:

- Enhancement of the credibility of published financial statements;
- Confirmation to management that they have performed their statutory duties correctly;
- Provision of assurance to management that they have complied with non-statutory requirements, such as corporate governance requirements, where these are subject to audit or review;
- Provision of feedback on the effectiveness of internal controls. Where internal controls are weak or inadequate, the auditor will give recommendations for improvement. This will assist management in reducing risk and improving the performance of the company;
- Insistence of potential lenders, such as banks, finance houses; etc that the company should submit audited financial statements as a pre-condition for lending money. Investors and business partners are more persuaded when accounts are audited than when such accounts are unaudited;
- Disagreements in partnerships can better be resolved when accounts are audited;
- Improvements in compliance with laws and regulations are ensured;
- Assisting the management in carrying out risk assessment exercises; and
- Ensuring improvement in the economy, efficiency or effectiveness of operations.

(ii) The limitations include:

- The cost of an audit can be very high. However, if the audit firm is already hired to carry out non-audit work such as accounts preparation or advisory work, the additional cost of an audit may be relatively small;
- There may be disruption to a company's operations during the audit, as some of the company's staff may be required to assist the auditors by answering questions, providing documents and other information;
- Some items in the financial statements might be estimates, which truth and fairness will not be known with certainty until sometime in the future. This means the assurance opinion is ultimately subjective and judgmental;
- Most frauds will include attempts to deliberately conceal the truth or misrepresent information;
- In order to balance cost and efficiency, the auditor routinely uses sampling rather than checking every item;
- Irrespective of how robust a client's systems are, they will always incorporate some degree of inherent limitation; and
- Audit evidence is persuasive rather than conclusive.

(c) The eligibility for qualification of an external auditor

A person to be eligible to become an external auditor must:

i. Be a member of a body of accountants in Nigeria, established by an Act;
ii. Not be an officer or servant of the company;
iii. Not be a person who is a partner of or in the employment of an officer or servant of the company;
iv. Not be a body corporate;
v. Not be a person or firm who or which offers to the company professional advice in a consultancy in respect of secretarial, taxation or financial management; and
vi. Effect registration or clearance from the appropriate regulatory body like Central Bank of Nigeria, Securities and Exchange Commission, relevant to the organisation concerned.

(d) **Scope of statutory audit**

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

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 judgment, including the assessment of the risks of material misstatements in the financial statements, whether due to fraud or error;
iii. In making the risk assessments, the auditor considers internal controls relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control; 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.

(e) **Benefits of adequate planning of an audit**

The objective of the auditor, per ISA 300: *Planning an Audit of Financial Statements* is to plan the audit work so that the audit will be performed in an effective manner.

The benefits of adequate planning include:

i. Assisting the auditor to devote appropriate attention to important areas of the audit;
ii. Assisting the auditor to identify and resolve potential problems;
iii. Assisting the auditor to organise and manage the audit engagement, so that it is performed in an effective and efficient manner;

iv. Assisting in the selection of staff with appropriate experience and the proper assignment of work to them;
v. Allowing for the direction and supervision of staff and review of their work by the auditor; and
vi. Allowing the auditor to identify and focus attention on critical and high risks areas of an audit.

(f) **Three risk assessment procedures required by ISA 315**

ISA 315 requires the auditor's risk assessment procedures to include the following:

i. Inquiries of management and others,that is, asking questions and getting answers. The auditor will ask questions on transactions and balances that are most susceptible to material misstatements;

ii. Analytical procedures, which involve the computation of ratios and trends to identify the existence of unusual transactions or events or amounts, that might have implications for the audit, for example, an analysis of payable days compared to previous years might indicate that the company is having difficulty in paying its debts. As a result, the auditor may plan to do more audit procedures in this area. Information technology may be of use in calculating changes to balances in the financial statements from previous years and graphing trends; and

iii. Observation and inspection include observation of controls in inventory counts, invoices, wages pay out among others and inspecting internal control manuals or business plans.

Examiner's report

The question tests candidates' knowledge on audit planning and control, and risk assessment procedures.

Almost all the candidates attempted the question. They exhibited general understanding of the requirements of the question in parts dealing with "qualification as a small company"; "eligibility for qualification as external auditor"; and "audit planning" consequently, marks were duly earned in these areas, but poor performance was recorded in "benefits and limitations of an audit; "scope of a statutory audit"; and "risk assessment procedures".

The major pitfall was their misinterpretation of the requirements of the question in those concerned parts.

Candidates are advised to pay attention to the requirement(s) of a question before proffering solution.

Marking guide

		Marks	Marks
(a)	Qualifications of a small company		6
(b)	Benefits of an audit	5	
	Limitations of an audit	4	9
(c)	Eligibility for qualification as external audit		6
(d)	Scope of a statutory audit		4
(e)	Benefits of audit planning		5
(f)	Risk assessment procedures		10
			40

Solution 2

a. **Professional ethics**

These are professionally accepted standards of personal and business behaviour, values and guiding principles. Put differently, professional ethics are regulations of a professional body such as ICAN which apply to members generally.

b. **Importance of professional ethics**

Professional ethics will serve the function of providing appropriate avoidance strategies to moral hazards in order to act in the public interest, especially in matters like:

(i) Detecting and reporting any serious misdemeanours or crime;
(ii) Protecting health and public safety;
(iii) Preventing the public from being misled by a statement or action by an individual or an organisation;
(iv) Exposing the misuse of public funds and corruption in government; and
(v) Revealing the existence of any conflict of interests of those individuals who are in positions of power or influence.

c. **Differences between rule-based and principle-based professional ethics**

Rule-based professional ethics are rules issued by a regulatory body of accountants that contain specific rules about how they should act in specific situations.

A principle-based professional ethics for accountants are general principles of ethical behaviour, that require the professional accountant to act in accordance with the principles. The accountant is required to use judgement in deciding whether in each case, a particular course of action is a ''proper'' or "ethical" one.

Both the IFAC and ICAN codes of ethics are principle-based.

d. **Weaknesses of rule-based professional ethics**

These include:

i. It is impossible for rule-based professional ethics to plan for every type of ethical problem that will arise when an ethical decision must be made because circumstances can be complex and varied. It is impossible to make a rule in advance without knowing the exact details of the situation – of what course of action the accountant must take;

ii. Over time, the type of situations (ethical dilemmas) 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 unethical in one country might be perfectly normal and acceptable in another country. A rule book cannot easily make allowances for national and cultural differences in ethical viewpoints.

e. **Advantages of principle-based professional ethics:**

These include:

i. Provision of guidance that can be applied to the infinite variations in circumstances that may arise in practice;
ii. Coping with rapid changes of modern business environment;
iii. Preventing the development of a mechanistic, "box-ticking" approach to decision-making and the use of legalistic loopholes to avoid compliance with guidance;
iv. Focusing on the spirit of guidance and encouraging responsibility and the exercise of professional judgement, which are key elements of professions. On the other hand, supporters of a principle-based approach argue that compliance with such guidance is easier since the requirements are prescriptive and leave little room for misunderstanding;
v. Flexibility for fitting into changing situations and circumstances;
vi. Application of the principles across boundaries;
vii. Enabling the auditor to prove that he has considered and complied with all issues; and
viii. Allowing for specific prohibitions.

Examiner's report

The question tests candidates' knowledge on professional ethics.

About 85% of the candidates attempted the question and the performance was generally good.

The candidates displayed poor knowledge of importance of Professional Ethics and weaknesses of the rule-based professional ethics. It is apparent that candidates did not cover these areas well enough.

Candidates are advised to avoid selective reading, but to cover the entire syllabus very well by making use of ICAN Study Text.

Marking guide

		Marks
(a)	Professional ethics	2
(b)	Importance of professional ethics	5
(c)	Differences between rule-based and principle-based professional ethics	3
(d)	Weakness of rule-based professional ethics	4
(e)	Advantages of principle-based professional ethics	6
	Total	**20**

Solution 3

(a) **Meaning of internal control**

The Committee of Sponsoring Organisations of the Treadway Commission (COSO) describes internal control as follows:

Internal control is a process effected by an entity's board of directors, management and other personnel designed to provide reasonable assurance regarding the achievement of objectives in the following categories:-

i. Effectiveness and efficiency of operations;
ii. Reliability of reporting; and
iii. Compliance with applicable laws and regulations.

(b) **Objectives of internal control**

An internal control system which encompasses the policies, processes, tasks, behaviours and other aspects of a company when taken together;

i. Facilitates effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the company's objectives. These include the safeguarding of assets from inappropriate use or from loss and fraud and ensuring that liabilities are identified and managed;

ii. Helps ensure the quality of internal and external reporting. This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organisation; and

iii. Assists in ensuring compliance with applicable laws and regulations, and also with internal policies in relation to the conduct of business.

(c) The features of a good internal control system include:

i. **Records maintenance** - Keeping appropriate records ensures that documentation exists for each business transaction. Records management involves storing and safeguarding tangible or electronic records;

ii. **Physical and intangible Safeguards** - Safeguards keep unauthorized personnel from accessing valuable company assets. Safeguards are physical, such as locks on doors, or intangible, such as computer software passwords, and are necessary features of an organisation's internal control system. Many business owners instinctively protect inventory, cash and supplies. However, blank cheques, company letterhead and signature stamps are items that require safeguarding but are commonly overlooked;

iii. **Segregation of duties** - An effective system separates authorisation, accounting and custodial functions, for instance, one employee opens incoming mail, a second prepares deposit slips for the daily receipts, while a third deposits receipts in the bank. This type of separation of duties prevents the opportunity of any individual employee from misappropriating incoming funds. This control involves assigning different people the responsibilities of authorising, recording transactions and maintaining the custody of assets. This reduces the likelihood of an employee being able to carry out and conceal errors or fraud;

iv. **Organsation** - There should be an organisational structure in place that defines and allocates responsibility as well as identify lines of reporting;

v. **Personnel** - Recruiting and retaining competent personnel help a business to properly record accounting transactions from year to year by providing consistency. A poorly trained accountant, for example, can make incorrect entries that could be innocent mistakes or could have the appearance of fraud. The functions of each employee are also evaluated to increase efficiency;

vi. **Arithmetic and accounting** - Policies to ensure accuracy of transactions and balances and ensuring true and reliable operating data and financial statements are put in place, and

vii. **Authorisation and approval** – All processes and procedures are to be duly authorised and approved by responsible officials in compliance with company policies and laws of the land.

(d) **Responsibilities in relation to internal control:**

i. **Management** - It is the responsibility of management to establish and maintain internal control. Management ensures the effectiveness of the controls in an organisation and periodically reviews same.

ii. **Board of Directors** – The members are charged with governance of the entity and through its oversight functions on the management, ensure that controls are working as intended and report to that extent in the annual financial statements.

iii. **External auditors** - It is the responsibility of external auditors to assess and evaluate the effectiveness of the internal controls and plan his audit on the basis of his assessment.

Examiner's report

The question tests candidates' knowledge on internal control.

More than 90% of the candidate attempted the question and the performance was average.

The major pitfall of the candidates was their inability to use relevant technical words as stated in the Institute's Study Text in the definition of terminologies.

Candidates should cultivate the habit of making proper use of the Institute's Study Text for future examinations.

Marking guide

		Marks	Marks
(a)	Explanation of internal control		4
(b)	Objective of internal control		6
(c)	Features of a good internal control system		4
(d)	Regarding internal control:		
	i. Management	2	
	ii. Board of directors	2	
	iii. External auditors	2	6
	Total		**20**

Solution 4

(a) **Forensic audit**

Forensic audit is an element in forensic investigations. It refers to the methods and procedures used to obtain audit evidence in a forensic investigation.

Forensic auditing may be defined as the process of gathering, analysing and reporting on data, much of it financial, in the pre-defined context of legal dispute or investigation into suspected irregularities and in some cases, giving preventative advice on this area.

(b) **Information systems audit**

Information systems audit/IT audit is a specific application of one of the key roles of the internal audit functions, which is to assess internal controls. In the case of IT audit, the controls involved are those that operate within the organisation's computer systems. IT systems are key aspects of modern business environment. Assessing and monitoring computer controls is often a key role for the internal auditor. Organisations may employ one or more computer specialists in their internal audit department to perform this role.

(c) **Compliance audit**

Compliance audit is a review performed to ascertain an entity's adherence to regulatory guidelines. The objectives of the auditor according to paragraph 11 of ISA 250 – *Consideration of Laws and Regulations in an Audit of Financial Statements* are to:

i. Obtain sufficient appropriate audit evidence in respect of compliance with those laws and regulations which might be expected to have a direct effect on material amounts and disclosures in the financial statements;
ii. Perform specified audit procedures to help identify such instances of non-compliance; and
iii. Respond appropriately to discoveries of non-compliance or suspected non-compliance.

(d) **Value for money audit**

Value for money (VFM) audit originated in public sector organisations as a way of assessing financial performance. In public sector organisations, conventional profit-based measures are not appropriate because the objectives of these organisations are not usually to make profit. The concept of value for money (VFM) audit has now been widely adopted by commercial organisations as a means of assessing performance on a broader basis than just profit. Value for money, as the term suggests, means getting good value from the money that an entity spends. Value for money is obtained from a combination of the '3 Es' explained as follows;-

- **Economy**
  This means not spending more than is necessary to obtain the required resources;
- **Efficiency**

This means getting a high volume of output from the resources that are used. The efficiency of employees is often referred to as 'productivity'; and

- **Effectiveness**
  This means achieving the objectives of the entity with the resources that it uses. Using resources efficiently has no value if the resources are not used in a way that achieves objectives.

Examiner's report

The question tests candidates' knowledge on these types of audit: forensic; information system; compliance; and value for money.

40% of the candidates attempted the question and performance was below average.

The common pitfall was that candidates could not explain forensic audit and information systems audit.

Candidates should study and prepare well for the examination, covering every part of the syllabus.

Marking Guide

		Marks
(a)	Forensic audit	5
(b)	Information system audit	5
(c)	Compliance audit	5
(d)	Value for money audit	5
	Total	**20**

Solution 5

Hallmark Limited

(a) **Assurance services**

Assurance services are independent professional services usually provided by chartered accountants or any other person under their supervision with the goal of improving or providing information to decision makers and other interested parties to enable them make more informed, and presumably better, decisions on the subject matter.

(b) **The levels of assurance services**

The degree of assurance that can be provided about the reliability of the financial statements of a company will depend on:

i. The amount of work performed in carrying out the assurance process; and
ii. The results of that work.

The resulting assurance falls into one of two categories:

Reasonable assurance - This as high (**but not absolute**) level of assurance provided by the practitioner's conclusion expressed in a **positive form**, for example, "In our opinion the accounts are true and fair". The objective of a statutory audit is to provide reasonable assurance; and

Limited Assurance – This is a **moderate** level of assurance provided by the practitioner's conclusion expressed in a negative form, for example, "Based on our review, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view". The objective of a review engagement is often to provide limited assurance.

c) **The components/elements of an assurance engagement**
These are:

i. **A three party relationship:**
- **Practitioner** – the individual providing professional services that will review the subject matter and provide the assurance, for example, the audit firm in a statutory audit;
- **Responsible party** – the person(s) responsible for the subject matter, for example, the directors are responsible for preparing the financial statements to be audited; and
- **Intended users** - The person(s) or class of persons for whom the practitioner prepares the assurance report, for example, the shareholders in a statutory audit.

ii. **Subject matter** - This is the information such as from the financial statements that has been prepared by the responsible parties for the practitioner to evaluate. Another example might be a cash flow forecast to be reviewed by the practitioner;

iii. **Suitable criteria** - This can be thought of as 'the rules' against which the subject matter is evaluated in order to reach an opinion. In a statutory audit this would be the applicable reporting framework, for example, IFRS and company law;

iv. **Evidence** - Information used by the practitioners in arriving at the conclusion on which their opinion is based. This must be sufficient and appropriate; and

v. **Assurance report** - The report containing the practitioner's opinion, this is issued to the intended user following the collection of evidence.

Marking guide

		Marks
(a)	Assurance services	5
(b)	Various levels of assurance services	3
(c)	Components of an assurance engagement	8
	Total	<u>20</u>

Examiner's report

The question tests candidates' knowledge on Assurance Services.

About 85% of the candidates attempted the question and performance was generally above average.

The common pitfall was the inability of the candidates to define terminologies correctly.

Candidates are advised to make maximum use of the Institute's Study Text and the Pathfinder.

Solution 6

(a) Weaknesses in the internal control system include the following:

i. Lack of segregation of duties that made the accountant to be the only one recovering money from the debtors and handling cash with other functions;
ii. Weakness of reconciliation, absence of reconciliation made it possible for the previous misappropriation to go undiscovered;
iii. Cash collection instead of payment by cheques and bank transfers made it possible for the accountant to misappropriate the cash collected.
iv. Weak organisational structure, adding more responsibility without assessing the impact;
v. Inadequate or lack of credit control policy and processes;
vi. Lack of segregation of duties of collecting, receipting and posting of insurance claims which aided diversion; and

vii. Lack of control of authorisation of transactions. The transactions should be authorised by a superior official.

(b) i. **Cash sales – Control objectives**

These include:

- To ensure that all monies received are recorded;
- To ensure that cash sales are banked into company's bank account; and
- To ensure that monies to which the enterprise is entitled are received.

Cash sales – control activities

These include:

- Cash sales should be restricted to few selected number of employees;
- Cash balance should be locked up in a safe at all times;
- Cash insurance policy should be taken by the company;
- Cash sales should be lodged intact daily with the bank;
- Approved price list should be conspicuously displayed in the sales area;
- Reconciliation of cash sales and balances daily with the bank; and
- Check for evidence that till roll totals or receipts totals are checked against cash received by an authorised person.
- If cash receipts are used they should be pre-numbered, a register of cash sales books should be maintained, used booklets should be returned; and
- A responsible official should sign off cancelled cash sales invoices or receipts.

ii. **Lodgements into bank – control objectives**

These include:

- To ensure all cash sales are lodged into bank intact on daily basis; and
- To ensure that cash sales are reconciled with bank lodgements and balances.

iii. **Lodgements into bank – control activities**

These include:

- Daily reconciliation of cash sales and lodgements into bank account;
- Call over of all cash lodgements by persons other than the cashier;
- Fidelity guarantee should be taken on all staff taking money to the bank;
- Proper safeguards should exist over money held;
- There should be restrictions on individuals authorised to prepare and hold cheques;
- Sales ledger personnel should have no access to the cash or the preparation of the paying slip; and

- Periodical comparison should be made between cash and cheques received and banked.

Examiner's report

The question tests candidates on internal control system.

About 60% of the candidates attempted the question. The understanding shown by the candidates generally was below average.

The common pitfall was poor interpretation of the requirements of the question which occasioned mixing up of the solutions to control objectives and control activities.

Candidates are advised to study well for the examination.

Marking guide

		Marks	Marks
(a)	Weakness of the internal control system		10
(b) i.	Cash sales		
	Control objectives	2	
	Control activities	3	5
ii.	Lodgement into bank		
	Control objectives	2	
	Control activities	3	5
	Total		**20**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – MARCH/JULY 2020

PERFORMANCE MANAGEMENT

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

INSTRUCTION: **YOU ARE REQUIRED TO ANSWER FOUR OUT OF SIX QUESTIONS IN THIS PAPER**

SECTION A: **COMPULSORY QUESTION** **(40 MARKS)**

QUESTION 1

Benco Limited produces two critical components, K and T, both of which are used in petroleum refinery. The components are made by passing each one through two fully-automatic computer-controlled machine lines – A and B – with respective maximum capacity of 13,600 hours and 15,360 hours. The following details are available:

(i) Due to production constraints, the company has decided to produce only oneof the two components, K or T for next period, but not both.

(ii) Market demand is limited to 59,200 units of K and 80,000 units of T.

(iii) Products unit data:

		K	T
Selling price		₦900	₦800
Machine time (hours) -	line A	0.25	0.15
	line B	0.20	0.225
Raw material X (kg)		2	2

(iv) The maximum quantity of material X available is 136,000kg. The material is purchased at ₦50 per kg.

(v) Variable machine overhead for machine line A and line B is estimated at₦500 and ₦600 per machine hour respectively.

(vi) The company operates a JIT system.

Required:

a. Calculate which of the components, K or T, should be produced and sold in the year in order to maximise profits. You should state the number of units to be produced and sold and the resulting contribution. (10 Marks)

b. Benco Limited wishes to consider additional sales outlets which could earn contribution at the rate of ₦400 and ₦600 per machine hour for machine line A and line B respectively. Such additional sales outlets would be taken up only to utilise any surplus hours not required for the production of the components.

   Calculate whether Benco Limited should now produce either component K or T and what quantity to be produced and the resulting contribution. (9 Marks)

c. Suggest ways in which the company may overcome the capacity constraints which limit the opportunities available to it in the year, and indicate the types of costs which may be incurred in overcoming each constraint. (10 Marks)

d. Illustrate the use of opportunity cost in the charging of each of material, labour and overhead elements in comparison with historic absorption cost elements. For each element, you should illustrate your answer with figures of your choice. (11 Marks)

(Total: 40 Marks)

SECTION B: YOU ARE REQUIRED TO ANSWER ANY THREE OUT OF FIVE QUESTIONS IN THIS SECTION (60 MARKS)

QUESTION2

Toby Nigeria Limited is a publishing company established in the early 1970's. The company has recently been taken over by Superior Quality Limited – a multinational company operating in Europe.

Mr. Edet Akpan, a staff of Superior Quality Limited has been sent from the company's headquarters to review, among other things, the budgeting and reporting system used by Toby Nigeria Limited.

During his visit to all the departments, he discovered that monthly budgets are prepared for each department in the company. Upon request, the last budget statement for the School Stationery Production Department (SSP) for period V was presented to him.

The budget statement presented was as follows:

Budget statement for period V

Department: SSP Department

Actual results:	Units produced	45,000
	Labour hours	130,050

	Actual Results ₦'000	Budget ₦'000	Variances ₦'000
Direct materials	907.2	800	(107.2)
Direct Labour	442.8	400	(42.8)
Variable production overhead	284.4	240	(44.4)
Fixed production overhead	212.4	187	(25.4)
Variable admin. overhead	147.6	133	(14.6)
Fixed admin overhead	180.0	160	(20.0)
Total costs	2,174.4	1,920	(254.4)
Sales value of production	2,790	2,480	310
Profit	615.6	560	55.6

Mr. Tola Ademola
School Stationery Manager

Interaction with Mr. Tola Ademola the School Stationery Manager, revealed that the budget statement presented was based on 40,000 units with a standard labour content of 3 hours per unit.

Mr. Akpan observed that Tola was not in any way enthusiastic about the budget system. He saw it as a pressure system imposed by the company's top management to indict some of the managers. He pointed out that the system was hurriedly introduced by High Flyer Consults, about twelve months ago. The consultant never took time to talk to the managers or provide explanation that could assist users to understand the system. The experienced School Stationery Manager was doubtful about the competence of the consultant. He was of the opinion that the system introduced in Toby Nigeria Limited was either a ready-made one developed for another company or that the consultant did not understand the system well enough to give him the needed confidence to educate the users. He concluded by stating that he was sure his department made a loss as against the positive figure recorded in the report and there was the possibility of reporting a loss at another period when profit was actually made. The situation reported above cuts across virtually all the departments and so the need to nip the situation in the bud became very urgent.

The task of making budgeting system more useful and acceptable in a biased environment like this, no doubt, seems difficult therefore, Mr. Akpan has requested from you an advice that will assist him in getting out of the woods.

Required:

a. Redraft the budget statement in a more informative manner. (12 Marks)

b. Discuss the behavioural problems brought out in this situation. (4 Marks)

c. Discuss the steps Mr. Akpan should take to remedy the situation. (4 Marks)

(Total 20 Marks)

QUESTION 3

Sedeco Nigeria Limited manufactures and sells three products Alpha, Beta and Gamma. For sometime now, the company has been concerned about its cost allocation system and has been searching for a more efficient way of cost allocation. The company recently employed a management accountant who informed the management that activity based costing is a more efficient cost allocation system which will also lead to improvement in cost accuracy and reduction.

The management accountant discovered that the company has direct materials, direct labour and five indirect cost pools which represent the five activity areas. The prior product costing system uses the two direct cost categories and a single indirect cost pool where overheads are allocated using direct labour hours.

The following information is provided for the next period.

	Alpha	**Beta**	**Gamma**	**Total**
Production and sales (units)	20,000	12,500	5,000	
Direct material cost	₦250	₦200	₦180	₦8,400,000
Direct labour hours	10	8	4	320,000
Machine hours	5	6	5	200,000
Number of production runs	5	10	25	40
Number of component receipts	15	25	120	160
Number of production orders	15	10	25	50

Direct labour is paid at ₦100 per hour.
Overhead Costs in the period are expected to be as follows:

	₦	**Cost driver**
Set up	1,400,000	Production runs
Machine	9,000,000	Machine hours
Goods inwards	2,800,000	Component receipts
Packaging	2,000,000	Production orders
Engineering	1,800,000	Production orders
	17,000,000	

Also, the company is considering the pricing of the three products because sales prices have remained uncertain as shown in the table below:

Alpha		Beta		Gamma	
Prob.	**₦**	**Prob.**	**₦**	**Prob.**	**₦**
0.6	2,000	0.5	2,000	0.7	1,600
0.3	2,200	0.3	2,200	0.2	1,700
0.1	2,300	0.2	2,250	0.1	1,800

Required:

a. Calculate the unit costs of each product using:

   (i) Prior product costing approach (traditional cost)

   (ii) The Activity Based Costing method (10 Marks)

b. Compute the expected sales prices for the three products and the profit or loss that will arise from the implementation of the ABC costing approach and the traditional costing method. (8 Marks)

c. State reasons why activity based costing approach may be preferred to traditional absorption costing approach in modern manufacturing environment. (2 Marks)

(Total 20 Marks)

QUESTION 4

Ibok Power Nigeria Limited (IPN) is a power utility company providing power distribution services to the public and businesses of Southern Nigeria. The company was formed when the government-owned Power Holding Company of Nigeria was broken up into regional utility companies (one of which was IPN) and sold into private ownership over four years ago.

As a vital utility for the economy of Nigeria, power services are a government-regulated industry. The regulator is principally concerned that IPN does not abuse its monopoly position in the regional market to unjustifiably increase prices. The majority of services (80%) are controlled by the regulator who sets an acceptable return on capital employed (ROCE) level and ensures that the pricing of IPN within these areas does not breach this level. The remaining services, such as provision of metres and contract repairs service, are unregulated and IPN can charge a market rate for these. The regulator calculates its ROCE figure based on its own valuation of the capital assets being used in regulated services and the operating profit from those regulated services.

The target pre-tax ROCE set by the regulator is 6%. If IPN were to breach this figure, then the regulator could fine the company. In the past, other such companies have paid fines amounting to millions of naira.

The board of IPN is trying to drive the performance for the benefit of the shareholders. This is a new experience for many at IPN, who left the public sector four years ago. In order to try to better communicate the objective of maximising shareholders' wealth, the board has decided to introduce economic value added (EVA) as the key performance indicator.

The finance director has provided the following financial information for the year ending 30 September 2018:

Ibok Power Services

	Regulated	**Non-regulated**	**2018 Total**
	₦b	**₦b**	**₦b**
Revenue	138·0	34.5	172.5
Operating costs	115·0	23.5	138.5
Operating profit	23·0	11·0	34·0
Finance charges			11.5
Profit before tax			22.5
Tax at 25%			4.75
Profit after tax			17.75

Capital employed:	**2018**	**2017**
	₦b	**₦b**
Measured from published accounts	328.5	318.5
Measured by regulator (for regulated services only)	389.5	380.5

Notes:

(i) Total operating costs include:

	2018	**2017**
	₦b	**₦b**
Depreciation	29.5	28.5
Provision for doubtful debts	1.0	0·25
Research and development	6.0	–
Other non-cash items	3.5	3.0

(ii) Economic depreciation is assessed to be ₦41.5b in 2018.
Economic depreciation includes any appropriate amortisation adjustments. In previous years, it can be assumed that economic and accounting depreciation were the same.

(iii) Tax is the cash paid in the current year (₦4.5b) and an adjustment of ₦0·25b for deferred tax provisions. There was no deferred tax balance prior to 2018.

(iv) The provision for doubtful debts was ₦2.25b on the 2018 statement of financial position.

(v) Research and development is not capitalised in the accounts. It relates to a new project that will be developed over five years and is expected to be of long-term benefit to the company. 2018 is the first year of this project.

(vi) Cost of capital of IPN

Equity	16%
Debt (pre-tax)	5%

(vii) Capital structure of IPN 40% Equity
60% Debt

Required:

a. Evaluate the performance of IPN using EVA. (13 Marks)

b. Assess whether IPN meets its regulatory ROCE target and comment on the impact of such a constraint on performance management at IPN.
(7 Marks)
(Total 20 Marks)

QUESTION 5

Olascom Nigeria Limited has two operating divisions, Western division and Eastern division that are treated as profit centres for the purpose of performance reporting.

Western division makes two products, Tot and Tal. Tot is sold to external customers for ₦310 per unit. Tal is a part-finished item that is sold only to Eastern division.

Eastern division can obtain the part-finished item from either Western division or from an external supplier. The external supplier charges a price of ₦275 per unit.

The production capacity of Western division is measured in total units of output of Tot and Tal. Each unit requires the same direct labour time. The costs of production in Western division are as follows:

	Tot	Tal
	₦	₦
Variable cost	230	240
Fixed cost	95	95
Full cost	325	335

Required:

a. What is an optimal transfer price? (4 Marks)

b. What would be the optimal transfer price for Tal if there is spare production capacity in Western division? (4 Marks)

c. What would be the optimal transfer price for Tal if Western division is operating at full capacity due to a limited availability of direct labour, and there is unsatisfied external demand for Tot? (7 Marks)

d. Discuss two methods that can be used to evaluate performance of divisions that operate as investment centres, (5 Marks)

(Total 20 Marks)

Question 6

"Performance management incorporates activities that aim to ensure that goals are consistently met in an effective and efficient manner. In order to achieve this, management requires reliable systems to support them in decision making".

Required:

Explain, with examples, the common types of information that are required by various levels of management for effective decision making, stating the qualities needed to classify such information as good. **(20 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:

$$Y = a + bX$$

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

$$a = \frac{\sum y}{n} - \frac{b\sum x}{n}$$

Coefficient of determination (r^2)

$$r^2 = \frac{(n\sum XY - \sum x\ \sum Y1)^2}{(n\sum X^2 - (\sum X)^2\ (n\sum y^2 - (\sum X)^2}$$

The Miller-Orr Model

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

Annuity Table

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

Where r = discount rate

n = number of periods

Discount rate (r)

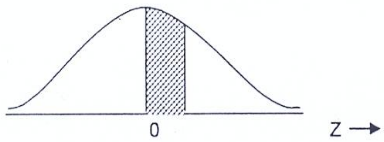
Periods

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

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

NORMAL DISTRIBUTION

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



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

a) Maximum production of each product is as follows:

	K (Units)		T (Units)
Machine line A limitation (13,600 ÷ 0.25)		(13,600 ÷ 0.15)	90,666
Machine line B limitation (15,360 ÷ 0.20)	76,800	(15,360 ÷ 0.225)	68,266
Material X limitation (136,000 ÷ 2)	68,000	(136,000 ÷ 2)	68,000
Maximum sales	59,200		80,000

Given the various limitations, the maximum that can be produced of each of the components is the lowest under each component, i.e. 54,400 units of K and 68,000 units of T.

The contribution per unit of output is:

Variable costs:

	K		T
	₦		₦
Material X (2kg × ₦50)	100	(2kg × ₦50)	100
Machine line A (0.25 × ₦500)	125	(0.15 × ₦500)	75
Machine line B (0.20 × ₦600)	120	(0.225 × ₦600)	135
	345		310
Selling price	900		800
Contribution	555		490

The maximum possible contribution from each of the components will be:

K 54,400 × ₦555 ₦30,192,000

T 68,000 × ₦490 ₦33,320,000

The company should therefore produce and sell 68,000 units of component T, giving total contribution of ₦33,320,000.

b) The spare machine capacity assuming that 54,400 units of K and 68,000 units of T are produced is as follows:

	Machine A (Hours)		Machine B (Hours)
Production of 54,400 of K: 13,600 – (54,400 × 0.25)	0	[15,360 – (54,400 × 0.20)]	4,480
Production of 68,000 of T: 13,600 – (68,000 × 0.15)	3,400	[15,360 – (68,000 × 0.225)]	60

The revised contributions are:

	K		T
	₦		₦
Original contribution			
	30,192,000		33,320,000
Sales from unused capacity of machine A	0	(3,400 × ₦400)	1,360,000
Sales from unused capacity of machine B x ₦600)	2,688,000	(60 ×₦600)	36,000
Revised contribution	32,880,000		34,716,000

The above figures indicate that component T should still be sold when an alternative sales outlet exists.

c) In order to overcome the capacity constraints, the following alternative courses of action should be considered:

i) Hire additional machinery to meet short-term demand and evaluate purchase of additional machinery if the shortage of capacity is expected to continue in the long term. However, cost of financing the additional machinery needs to be considered.

ii) Increase output per machine hour by more efficient operating or increasing machine speeds. However, additional costs and lost output might arise from machine breakdowns.

iii) Increase machine capacity by introducing additional shifts. This will lead to increased shift and overtime payments and may also result in machine breakdowns arising from more intensive use of machinery.

iv) Sub-contract production but this will lead to increased costs and possibly lost sales arising from inferior quality products, late delivery, etc.

v) Seek alternative supplies of Material X since it is a limiting factor. Care should be taken to ensure that any additional purchase and delivery costs do not exceed the contribution from increased sales.

vi) Outsource production capacity of excess demands. Quality of the outsourced products, cost and delivery time should be considered.

d) The opportunity cost approach requires the calculation of the net cash flows which will arise from pursuing a particular course of action.

i) Materials cost: Consider a situation where materials which originally cost ₦1,000 is in store and has a replacement cost of ₦1,500. The material is not currently used as part of normal production and if not used on a

specific contract now being quoted for, half would be sold as scrap for ₦75 and the remainder disposed of at a cost of ₦50.

The original cost of ₦1,000 is past expenditure and is irrelevant to future decisions. The replacement cost of ₦1,500 is irrelevant since the material will not be replaced. The opportunity cost to be charged to the contract is

		₦
	Scrap value foregone	75
Less:	Disposal cost forgone	50
		25

ii) Labour cost: Consider a situation where the company's policy is to retain workers at a basic wage of ₦1,600 per week. If not used on the contract (10 workers for four days), they will be used on general duties which would otherwise have been undertaken by an outside services agency at a cost of ₦36,000. The contract under review will require overtime which would not otherwise have been worked at a cost of ₦2,000.

In this case, the basic wage of ₦1,600 × 10 men × 4 days = ₦64,000 will be paid whether or not the contract is accepted. If the contract goes ahead, the company will have to spend ₦36,000 on the external service work plus make overtime payments of ₦2,000 to the workers on the contract.

The opportunity cost to be charged to the contract is therefore ₦36,000 + ₦2,000 = ₦38,000.

iii) Overhead: There are many illustrations which may be used in respect of overhead cost. Once again the important factor is to determine whether additional (incremental) expenditure will occur because of the contract.

Consider machinery to be used on the contract to which the following information applies for the period of the contract:

	₦
Depreciation provision	1,000
Routine maintenance cost	4,000 (25% due to the contract)
Special tooling cost	3,500
Power cost	5,000

The depreciation provision is simply an allocation of a past (sunk) cost and will not affect cash flows whatever decision is made. The routine maintenance which is due to the contract is the relevant cost i.e. 25% × ₦4,000 = ₦1,000. The special tooling cost is incremental i.e. it is avoidable if the contract does not proceed. The power cost is also a variable cost.

The opportunity cost to be charged to the contract is therefore ₦1,000 + ₦3,500 + ₦5,000 = ₦9,500

Examiner's report

Being a compulsory question, the question tests candidates' understanding of computing maximum contribution in a situation where there are three but single based limiting factors. The question also tests the utilisation of surplus hours in production of products.

The question was virtually attempted by all the candidates. The major pitfall is that most candidates failed to distinguish the requirement of the question as testing individual limiting factor by proceeding to use linear programming approach due to the three limiting factors that ordinarily should have been evaluated individually.

It is advised that candidates should, in future examinations, read the Institute's study text manual so as not to be caught in the web of such self inflicted confusion.

Marking guide

DECISION MAKING			Marks	Marks
(a)	- Computation of maximum production of each product		2	
	- Variable cost and contribution of each unit of product		3	
	- Maximum contribution		2	
	- Decision on contribution and quantity		3	10
(b)	- Computation of excess machine hours		4	
	- Computation of revised contribution		4	
	- Decision on excess machine hours		1	9
(c)	- Overcoming the capacity constraint (any 4 points at 2½ marks per point)			10
(d)	- Material expenses (cost):			
	- Opportunity cost		2	
	- Historical cost		1	
	- Illustration		½	3½
	- Labour cost:			
	- Opportunity cost		2	
	- Historical cost		1	
	- Illustration		1	4
	- Overhead cost:			
	- Opportunity cost	2		
	- Historical cost	1		
	- Illustration	½	3½	11
	Total:			**40**

SOLUTION 2

TOBY NIGERIA LIMITED

(a) **Budget statement for Period V**

Department: SSP Department

Particular	Flexed Budget ₦	Actual Result ₦	Variances ₦
Sales	2,790,000	2,790,000	0
Less Variable costs;			
Direct material	900,000	907,200	(7,200)
Direct labour	450,000	442,800	7,200
Variable production overhead	270,000	284,400	(14,400)
Variable Administration overhead	149,625	147,600	2,025
Total variable costs	1,769,625	1,782,000	(12,375)
Contribution	1,020,375	1,008,000	(12,375)
Fixed costs;			
Production overhead	187,000	212,400	(25,400)
Administration overhead	160,000	180,000	(20,000)
Total fixed overhead	347,000	392,400	(45,400)
Net Profit	673,375	615,600	(57,775)

Notes/Workings

Budget Result Basis: Units = 40,000

Labour (Hrs) = 40,000 units × 3.00

= 120,000 hours

Actual result basis:

Units = 45,000

Budgeted Labour (hours) = 120,000/40,000 × 45000 = 135,000

Actual Labour (hours) = 130,500 hours

Direct materials = $\frac{₦800{,}000}{40{,}000\text{units}} \times 45{,}000\text{units}$ = ₦900,000

Direct Labour = $\frac{₦400{,}000}{120{,}000 \text{ hrs}} \times 135{,}000\text{hrs}$ = ₦450,000

Variable Overhead = ₦240,000 + ₦133,000 = ₦373,000

$\frac{₦373{,}000}{120{,}000 \text{ hrs}} \times 135{,}000\text{hrs}$ = ₦419,625

Sales value = $\frac{₦2{,}480{,}000}{40{,}000 \text{ units}} \times 45{,}000$ = ₦2,790,000

(b) Behavioural problems in the situation

- The budgetary process here is not participatory.
- The approach applied here discouraged initiative and that was why users misunderstood the objective of the system.
- They saw the system as a penny-pinching control activity rather than a positive and beneficial one.

- The Budget system was imposed on users. This created resentment and negative reactions;
- Users did not understand the system and so system was unacceptable to them;
- The implementation of the budget resulted in the stifling of motivation;
- Users did not see the system as a neutral and objective one; and
- The goals of users were at variance with those of the organisation (goal incongruence).

(c) Mr. Akpan is advised to take the following steps:

- Call a meeting of all managers and heads of department where he will disabuse their minds on the acquired negative and contradictory attitude;
- Cancel the present system and initiate a new system that involves full participation of the budget holders;
- Communicate the objectives of the company and the usefulness of a budget system to all users. All the benefits derivable therefrom should be clearly and distinctly highlighted; and
- The new process of budget preparation and subsequent performance evaluation should be carried out in such a manner as to motivate managers and staff i.e. it should be participatory and should also encourage initiative and responsibility.

Marking guide

	BUDGETING	Marks	Marks
(a)	- Budget statement	11	
	- Workings	1	12
(b)	- Behavioural problems in budgeting		4
(c)	Advice to remedy the problems		4
	Total:		**20**

Examiner's report

The question testes candidates' ability to prepare budget statement used in flexible budgeting approach as well as computation of variances from such statements.

The question was attempted by many candidates.

The common pitfall is the inability of candidates to re-prepare the budget statement using the flexed quantity of 45,000 units.

It is advised that candidates should, in future examinations of the Institute, endeavour to study the Institute's text manual on the subject as well as other recommended text books.

SOLUTION 3

SEDECO Nigeria Limited

a) (i) **SEDECO NIGERIA LIMITED**
Unit Cost of Product using prior costing approach

	Alpha	Beta	Gamma
	₦	₦	₦
Direct Materials	250.00	200.00	180.00
Direct labour	1,000.00	800.00	400.00
Overhead Costs	531.25	425.00	212.50
Total Cost per unit	1,781.25	1,425.00	792.50

(ii) **SEDECO NIGERIA LIMITED**
Unit Cost of Products using the ABC Approach

	Alpha	Beta	Gamma
	₦	₦	₦
Direct Materials	250.00	200.00	180.00
Direct labour	1,000.00	800.00	400.00
Overhead Cost	303.88	393.80	1,200.00
Total Cost per unit	1,553.88	1,393.80	1,780.00

b) (ii) Computation of Expected Sales Prices

Product Alpha		Expected Outcome
Probability	₦	₦
0.6	2,000	1,200
0.3	2,200	660
0.1	2,300	230
Expected sales price		2,090

Product Beta		Expected Outcome
Probability	₦	₦
0.5	2,000	1,000
0.3	2,200	660
0.2	2,250	450
Expected sales price		2,110

Product Gamma		Expected Outcome
Probability	₦	₦
0.7	1,600	1,120
0.2	1,700	340
0.1	1,800	180
Expected sales price		1,640

(ii) **Profit or loss performance using traditional costing approach**

	Alpha	Beta	Gamma	Total
	₦	₦	₦	₦
Sales price	2,090.00	2,110.00	1,640.00	
Direct material	250.00	200.00	180.00	
Direct labour	1,000.00	800.00	400.00	
Overhead cost	531.25	425.00	212.50	
	1,781.25	1,425.00	792.50	
Profit / (Loss)	308.75	685.00	847.50	
Units produced /sold	20,000	12,500	5,000	
Total Profit/(Loss)	₦6,175,000	₦8,562,500	₦4,237,500	₦18,975,000

(iii) **Profit or Loss Performance using ABC Approach**

	Alpha	Beta	Gamma	TOTAL
	₦	₦	₦	₦
Selling price	2,090.00	2,110.00	1,640.00	
Direct material	250.00	200.00	180.00	
Direct labour	1,000.00	800.00	400.00	
Overhead	303.88	393.80	1,200.00	
	1,553.88	1,393.80	1,780.00	
Profit /(Loss)	536.12	716.20	(140.00)	
Units sold	20,000	12,500	5,000	
Total profit/(Loss)	₦10,722,500	₦8,952,500	(₦7,000,000)	₦18,975,000

(c) Reasons why activity -based costing approach is preferred to traditional absorption costing approach include:

- Unlike in the past, information processing cost is not high, hence a more sophisticated cost system can be utilised to analyse and allocate current overhead costs that are now more dominant than direct costs.

- ABC approach relies on a greater number and variety of a second stage cost drivers unlike the traditional costing system which is simplistic and possesses a lot of distortions.

- Traditional costing approach uses only volume-based cost drivers on the assumption that a product's consumption of overhead resources is directly related to the number of units produced. Some overheads are related to non-volume-based cost drivers and as such, ABC abhors generalisation but encourages the appropriate cost driver relating to the activity to be used in overhead allocation.

- Costs reflect the complexity and diversity of production as a result of realistic bases of absorption
- It provides more accurate cost per unit
- It aids cost control
- It focuses attention on real nature of cost behaviour
- It provides a reliable indication of long run variable product cost
- It can be used for both service and product costing
- It can be applied to all overhead cost.

Workings:

Computation of overhead using direct labour hour:

- Total overhead cost ₦17,000,000
- Total Direct labour hour 320,000 hours
- Overhead rate per hour = $\frac{₦17{,}000{,}000}{320{,}000}$ = ₦53.125

Computation of overhead cost using ABC Approach

	Alpha	Beta	Gamma
• Set up Cost			
Alpha 5× 35,000 =	175,000		
Beta 10 × 35,000 =		350,000	
Gamma 25 × 35,000 =			875,000
• Machine			
Alpha 100,000 x 45 =	4,500,000		
Beta 75,000 x 45 =		3,375,000	
Gamma 25,000 x 45 =			1,125,000
• Goods Inwards			
Alpha 15 × 17,500 =	262,500		
Beta 25× 17,500 =		437,500	
Gamma 120 × 17,500 =			2,100,000
• Packaging			
Alpha 15 × 40,000 =	600,000		
Beta 10 × 40,000 =		400,000	
Gamma 25 × 40,000 =			1,000,000
• Engineering			
Alpha 15 × 36,000 =	540,000		

Beta 10 × 36,000 =		360,000	
Gamma 25 × 36,000 =			900,000
Total Overhead	₦6,077,500	₦4,922,500	₦6,000,000

	Alpha	Beta	Gamma
Total Overhead	₦6,077,500	₦4,922,500	₦6,000,000
Total units produced	20,000	12,500	5,000
Overhead Per unit	₦303.875	₦393.80	₦1,200

Cost
Machine

Alpha $\frac{100,000}{200,000} \times 9,000,000 = ₦4,500,000$

Beta $\frac{75,000}{200,000} \times 9,000,000 = ₦3,375,000$

Gamma $\frac{25,000}{200,000} \times 9,000,000 = ₦1,125,000$

Set up Cost = $\frac{₦1,400,000}{40}$ = ₦35,000 per set up run

Goods inward = $\frac{₦2,800,000}{160}$ = ₦17,500 per receipt

Packaging = $\frac{₦2,000,000}{50}$ = ₦40,000 per order

Engineering = $\frac{₦1,800,000}{50}$ = ₦36,000 per order

Computation of Expected Sales Prices

Project Alpha

Prob.	₦	Expected Outcome ₦
0.6	2,000	1,200
0.3	2,200	660
0.1	2,300	230
		2,090

Project Beta

Prob.	₦	Expected Outcome ₦
0.5	2,000	1,000
0.3	2,200	660
0.2	2,250	450
		2,110

Product Gamma		Expected Outcome
Prob.	₦	₦
0.7	1,600	1,120
0.2	1,700	340
0.1	1,800	180
		1,640

Examiner's report

This question tests candidates understanding of ABC approach to overhead absorption vis-a-vis traditional absorption costing method.

The question was attempted by most candidates.

Performance was however average.

The common pitfall is the wrong computation of fixed overhead absorption rate using direct labour hours.

It is suggested that candidates should endeavour to use ICAN Study manuals in future examinations.

Marking guide

ACTIVITY BASED COSTING		Marks	Marks
(a)i	- Unit cost computation (Traditional Cost Method)	3	
ii	- Units Cost Computation (ABC Approach)	3	
	- Workings	4	10
(b)i	- Computation of expected sales prices	1½	
ii	- Computation of profit (Traditional Costing)	3¼	
iii	- Computation of Profit (ABC Approach)	3¼	8
(c)	Reasons why ABC approach is preferred to the traditional approach		2
			20

SOLUTION 4

(a)

NOPAT		₦ Billion
Profit After Tax		17.75
Add: Interest after tax (11.5 x 0.75)		8.625
Add: Non cash item		3.5
Add: deferred tax		0.25
Add: Research and Development	6.00	
Less amortisation	(1.2)	4.80
Add provision for doubtful debt		1.00
Add depreciation	29.5	
Less economic depreciation	(41.5)	(12.00)
		23.925

Weighted Average Cost of Capital

WACC = [0.16 x 0.4] + [0.05[1-0.25] × 0.6

= 6.4% + 2.25%

= 8.65%

Computation of capital employed:	₦ Billion
Initial capital employed	318.50
Add: Non-Cash item	3.00
Provision for doubtful debt	1.25
	322.75

EVA:	₦ Billion
NOPAT	23.925
Less: Capital charges [8.65% × 322.75]	(27.918)
	(3.993)

The EVA produced negative ₦3.993 Billion, this shows that the business is not creating adequate values for the owners.

(b) **Regulatory ROCE**

Target 6%

Ibok $\frac{\text{Operating profit}}{\text{Capital employed}} \times \frac{100}{1} = \frac{23.0}{389.5} \times \frac{100}{1} = 5.90\%$

- The company is within the allowed return on capital employed by the regulator. There is only a minimal scope for increase in the profitability of this aspect of the business as the maximum operating profit that the regulator would allow on ₦389.5m of capital employed is ₦23.37m.

- The company should seek to increase its non-regulated activities as these are generating much higher operating profit margins – 32% compared to 17% (regulated). It could use the regulated activities as a reliable source of cash profit to reinvest in expansion of the more profitable non-regulated areas.

- The implications for performance management are the need to control costs within regulated activities so that the regulator cannot argue that the company is overcharging its customers in order to drive profit growth. This can be done through tight observance of budgets and seeking cost savings through efficiency improvements. Targets based on minimising variances and innovation in cost cutting would be appropriate.

- Within the non-regulated areas, a more entrepreneurial approach can be taken. Performance management in these areas will focus more on growing revenues by expanding markets (taking a larger share of the national market) and improving profit margins. As already noted, growth by acquisition of suitable unregulated businesses using the cash generated by the regulated activities would be a possible course of action. Targets based on revenue growth and innovating in new business areas with high profit margins would be appropriate.

- Creation of additional value will be discouraged. However, if the additional value created could outweigh the penalty, the management should drive more returns.

- The ROCE set by the regulator may not provide adequate values for the shareholders.

Examiner's report

The question tests candidates understanding of Economic Value Added (EVA) as a measure of divisional and firm performance. Very few candidates attempted the question.

The performance was however poor. The pitfall was candidates' inability to compute Net Operating Profit after Tax (NOPAT) due to poor understanding of the adjustments that needed to be made as well as incorrect computation of the initial capital employed.

Candidates are advised to use the Institute's text manual extensively when preparing for future ICAN examinations.

Marking guide

	EVA COMPUTATION	Marks	Marks
(a)	- Computation of NOPAT	6	
	- Computation of WACC	1	
	- Computation of Capital employed	2	
	- Computation of EVA	2	
	- Decision on EVA	2	13
(b)	- Computation of regulatory ROCE	3	
	- Decision on regulated services	2	
	- Impact on Constraints on Performance Management	2	
			7
	Total:		**20**

SOLUTION 5

OLASCOM NIGERIA LIMITED

(a) An optimal transfer price (or range of transfer prices) is a price for an internally-transferred item at which:

i. the selling division will want to sell units to the other profit centre, because this will add to its divisional profit;

ii. the buying division will want to buy units from the other profit centre, because this will add to its divisional profit; and

iii. the internal transfer will be in the best interests of the entity as a whole, because it will help to maximise its total profit.

(b) When Western division has spare capacity, its only cost in making and selling extra units of Tal is the variable cost per unit of production, ₦240. Eastern division can buy the product from an external supplier for ₦275.

It follows that a transfer that is higher than ₦240 but lower than ₦275, for additional units of production, will benefit both profit centres as well as the company as a whole. (It is in the best interests of the company to make the units in Western division at a cost of ₦240 than to buy them externally for ₦275.)

		₦
Variable Cost	=	240
Opportunity Cost	=	0
Optimal Transfer	=	240

(b) When Western division is operating at full capacity and has unsatisfied external demand for Tot, it has an opportunity cost if it makes Tal for transfer to Eastern division. Tot earns a contribution of ₦80 per unit (₦310 – ₦230). The minimum transfer price that it would require for Tal is:

		₦
(c)	Variable cost of production of Tal	240
	Opportunity cost: lost contribution from sale of Tot	80
	Minimum transfer price to satisfy Western division	**320**

Eastern division can buy the product from an external supplier for ₦275, and will not want to buy from Western division at a price of ₦320. The maximum price it will want to pay is ₦275.

The company as a whole will benefit if Western division makes and sells Tot.

It makes a contribution of ₦80 from each unit of Tot.
If Western division were to make and sell Tal, the company would benefit by only ₦35. This is the difference in the cost of making the product in Western division (₦240) and the cost of buying it externally (₦275).

The same quantity of limited resources (direct labour in Western division) is needed for each product, therefore the company benefits by ₦45 (₦80 – ₦35) from making units of Tot instead of units of Tal.

On the basis of this information, the transfer price for Tal should be ₦320 as long as there is unsatisfied demand for Tot. At this price, there will be no transfers of Tal.

(d) Two methods of evaluating the performance of divisions that operate as investment centres are:

i. Residual income: This is described as the difference between the absolute profit on investment and the imputed cost of capital of the organization. Residual income is calculated by deducting an amount for imputed interest (also called notional interest) from the accounting profit for the division.

The interest charge is calculated by applying a cost of capital to the division's net investment (net assets).

One reason for using residual income instead of ROI to measure a division's financial performance is that residual income has a money value, whereas ROI is a percentage value. A company may prefer to measure performance in money terms. In most other respects, however, residual income is similar to ROI as a measure of divisional performance.

ii. Return on investment: Return on investment (ROI) is a measure of the return on capital employed for an investment centre. It is also called the accounting rate of return (ARR).

It is often used as a measure of divisional performance for investment centres because:

- the manager of an investment centre is responsible for the profits of the centre and also the capital invested in the centre, and
- ROI is a performance measure that relates profit to the size of the investment.

iii. Absolute Profit: Absolute profit can be used as a measure of performance and investment centre. This is calculated as selling price less cost.

iv. Economic Value added (EVA): EVA can be used as a performance evaluation tool for divisional managers. Using EVA encourages divisional managers to maximize the wealth of the division.
EVA can be computed thus:
EVA = Net Operating Profit after Tax (NOPAT) minus [weighted average cost of capital (WACC) X Initial capital employed].

Examiner's report

The question tests candidates understanding of transfer pricing, the computation of ideal transfer price in situation of unlimited spare capacity and limited spare capacity as well as parameters for measuring the performance of investment centres.

Many candidates attempted the question due to its outlook which appears simple.

The performance of candidates is above average.

It is hereby recommended that candidates, in future examinations should continue to revise ICAN text manual.

Marking guide

	OPTIMAL TRANSFER PRICE	**Marks**
(a)	- Explanation of an optimal transfer price (selling division/buying division/company)	4
(b)	- Computation of optimal transfer price in situation of spare capacity	4
(c)	- Computation of optimal transfer price in situation of limited spare capacity	7
(d)	- Two methods of divisional performance evaluation (any 2 methods at 2½ marks for a method)	5
	Total:	**20**

SOLUTION 6

Levels of Management

Management may be classified into three levels:
Strategic management;
Tactical management; and
Operational management.

These three classifications are based on the types of decision that are taken by management at each level. For decisions at each level of management, a different type of information is required.

Strategic information is required at strategic management level. The characteristics of strategic information may be summarised as follows:

It is information about the organisation as a whole, or a large part of it.
It is in a summary form, without too much detail.
It is generally relevant to the longer term.
It is often forward-looking.

The data that are analysed, to provide the strategic information come from both internal and external sources.

It is often prepared on an 'ad hoc' basis, rather than in the form of regular and routine reports.

It may contain information of qualitative and quantitative nature.

There is often a high degree of uncertainty in the information. This is particularly true when the information is forward-looking (for example, a forecast) over a number of years in the future.

Tactical information is used to decide how the resources of the organisation should be used, and to monitor how well they are being used. It is useful to relate tactical information to the sort of information that is contained in an annual budget. A budget is planning at a tactical management level, where the plan is expressed in financial terms.

The general features of tactical information are as follows:

It is information about individual departments and operations.
It is in summary form, but at a greater level of detail than strategic information.

It is generally relevant to the short-term and medium term.

It may be forward-looking (for example, medium-term plans) but it is often concerned with performance measurement. Control information at a tactical level is often based on historical performance.

The data that are analysed to provide the information come from both internal and external sources, but most of the information come from internal sources.

It is often prepared on a routine and regular basis (for example, monthly or weekly performance reports).

It consists mainly of quantified information.

There may be some degree of uncertainty in the information. However, as tactical plans are short-term or medium-term, the level of uncertainty is much less than for strategic information.

Operational information is the day to day (routine) information needed for control purposes. It may also be needed by employees, to process transactions in the course of their regular work.

The general features of operational information are as follows:

It is normally information about specific transactions, or specific jobs, tasks, daily workloads, individuals or work groups. (It is 'task-specific'.)

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

It is generally relevant to the very short-term.

It may be forward-looking (for example, daily plans) but it is often concerned with transactions, procedures and performance measurement at a daily level.

The data that are analysed to provide the information comes almost exclusively from internal sources.

It is often prepared frequently, as required for daily operational needs (routine in nature).

It consists mainly of quantified information. Most of this information is 'factual' and is not concerned with uncertainty.

Qualities of Good Information

The qualities of good information include:
Relevance- It must have purpose and use.
Reliability - It must be accurate and complete for its intended purpose
Timely – It must be available as and when required.
It must attract user confidence and realistic.
It must be valuable and cost efficient – Cost and benefit.
It must be accurate.
It must be readily accessible.
It must be addressed to right recipient.

Examiner's report

The question tests candidates' understanding of performance and management systems as it relates to Management levels, information expectation at those levels and the qualities of good information.

Most of the candidates attempted the question. Performance in this question was high.

Certain pitfalls were however noticed in candidates inability to show the qualities expected of good information.

It is however advised that candidates should, in preparing for future examinations of the Institute, study and understand the Institute's text manuals extensively to achieve greater success.

Marking guide

	Marks	Marks
- Types of management level		
(3 levels at 1 mark per level listed)		3
- Management Information types		
(listing of 3 information types	3	
Correct explanation of 3 information types at 2 marks each)	6	9
- Quality of information		
(4 points at 2 marks per point)		8
Total:		**20**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – MARCH/JULY 2020

PUBLIC SECTOR ACCOUNTING & FINANCE

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

INSTRUCTION: **YOU ARE REQUIRED TO ANSWER FOUR OUT OF SIX QUESTIONS IN THIS PAPER**

SECTION A: **COMPULSORY QUESTION** **(40 MARKS)**

QUESTION 1

In the year 2000, Amotekun State of Nigeria established two State Universities, namely Amotekun State University (ASU) and Amotekun State University of Education (ASUE), to cater for the indigenes of the state. The following information relates to each of the universities:

a. The Bursar of Amotekun State University, Oke-Mosan, delegated the preparation of Non-current assets schedule to be included in the final accounts of the University for the year ended December 31, 2018 to one of the Deputy Bursars in the Bursary Department.

   In the discharge of the assignment, the Deputy Bursar reviewed the following documents:

   - International Public Sector Accounting Standards (IPSAS).
   - Previous year's financial report.
   - Non- current assets register.
   - Valuation reports etc.

He was able to obtain the following information:

(i)

Details	Cost/fair value as at December 31, 2017	Accumulated depreciation/ amortisation	Estimated life span/lease period
	₦'000	₦'000	Years
Land & building	500,000	50,000	50
Furniture & fittings	180,000	72,000	10
Office equipment	130,000	65,000	8
Plant & machinery	190,000	95,000	10
Motor vehicles	500,000	200,000	5
Computer equipment	160,000	80,000	10
Equipment on lease	105,000	42,000	5

(ii) It is the policy of the University to charge a full year's depreciation on assets irrespective of the month of purchase or revaluation during the year while no depreciation is charged on asset disposed off during the year.

(iii) Equipment on lease are depreciated equally over the period of the lease.

(iv) Land and buildings were professionally revalued during the year by Parisco & Associates, a firm of Chartered Surveyors and Valuers and approved by the State Ministry of Works and Housing. The valuation which was based on open market value produced a revaluation surplus of ₦150,000,000 over the carrying amount as at January 1, 2018.

(v) The University (ASU) purchased plant and machinery which was imported from United Kingdom at a cost of ₦430,500,000. Installation and transportation costs to the University amounted to ₦20,500,000.

(vi) The Deputy Bursar that prepared the non-current assets schedule last year classified some of the computer equipment purchased on May 15, 2017, costing ₦26,000,000 as office equipment, a reclassification is required in the current year.

(vii) Office furniture and fittings costing ₦12,250,000 were disposed of during the year for ₦11,500,000, which resulted to a profit of ₦750,000.

(viii) The University (ASU) entered into an equipment lease agreement with Ode Finance Limited; the terms and conditions of the finance lease are as follows:

Principal sum	-	₦45,000,000
Lease period	-	5 years
Lease rentals	-	₦10,000,000 p.a.

(ix) During the year, the University acquired a fleet of vehicles at the cost of ₦50,000,000. The State Government financed this acquisition.

Required:

i. In accordance with IPSAS 13, identify **FIVE** features of a finance lease. (5 Marks)

ii. Prepare the non-current assets schedule of Amotekun State University suitable for publication. (15 Marks)

b. Amotekun State University of Education, Ode, was the second university established by the Amotekun State of Nigeria. The government, as a mark of its commitment towards the survival of this young institution, has continued to support the University Senate in all its efforts. At the last meeting of the stakeholders, held at the state hotel, Igbo, on June 30, 2019, the Bursar presented the following financial statements for discussion and approval:

Amotekun State University of Education

Statement of Financial Position as at December 31, 2018

	Notes	2018 ₦'000	2017 ₦'000
Non-current assets	1	95,242,700	75,323,734
Construction in progress		410,000	410,000
Library development fund		48,228	41,910
Total		**95,700,928**	**75,775,644**
Current assets:			
Inventory		2,847,224	569,032
Account receivables		3,313,006	1,574,072
Cash and bank	2	6,216,222	991,922
Total current assets		**12,376,452**	**3,135,026**
Current liabilities:			
Payables:			
Short term loan		-	163,880
Consultants		205,368	4,129,410
Others		6,634,714	9,314,402
Total current liabilities		**6,840,082**	**13,607,692**
Net current assets		**5,536,370**	**(10,472,666)**
Total net assets		**101,237,298**	**65,302,978**
Net assets/equity:			
State government capital grant	3	97,872,742	72,429,500
Operating surplus/(deficit)		3,364,556	(7,126,522)
Total net assets/equity		**101,237,298**	**65,302,978**

The following notes form an integral part of these accounts.

Amotekun State University of Education
Statement of financial performance for the year ended December 31, 2018

Income:	**Notes**	**2018 ₦'000**	**2017 ₦'000**
State government: Recurrent grant	3	42,400,000	22,192,548
Internally generated revenue		4,420,324	2,627,140
Miscellaneous income		552,202	438,418
Total income		**47,372,526**	**25,258,106**
Expenditure:			
Academic and administrative expenses		27,636,154	22,646,910
Depreciation		9,245,294	9,737,718
Total expenditure		**36,881,448**	**32,384,628**
Operating surplus/(deficit)		10,491,078	(7,126,522)
Accumulated surplus/(deficit) b/f		3,364,556	(7,126,522)
Accumulated surplus/(deficit) c/f		**13,855,634**	**(14,253,044)**

The following notes which form an integral part of the accounts, were also provided

1 Non-current assets

Cost	**Land and building ₦'000**	**Plant and machinery ₦'000**	**Total ₦'000**
As at January 1	53,560,628	31,500,824	85,061,452
Additions	10,844,670	18,319,590	29,164,260
As at December 31	64,405,298	49,820,414	114,225,712
Depreciation			
As at January 1	2,944,230	6,793,488	9,737,718
Charges in the year	2,511,888	6,733,406	9,245,294
As at December 31	**5,456,118**	**13,526,894**	**18,983,012**
Carrying amount Dec 31	58,949,180	36,293,520	95,242,700
Carrying amount Jan 1	**50,616,398**	**24,707,336**	**75,323,734**

2

Cash and bank:	2018 ₦'000	2017 ₦'000
Ijebu Bank Plc	1,279,314	258,752
Egba Bank Plc	3,777,680	645,648
OkeMosan Microfinance Bank	477,350	-
Cash in hand	681,878	87,522
Total	**6,216,222**	**991,922**

The Oke-Mosan Microfinance Bank balance in 2018 represents the 'short term loan.

3 State Government Grants

Grants:	2018 ₦'000	2017 ₦'000
Capital grants	21,292,294	71,429,500
Special grants	4,150,948	1,000,000
Sub-total	**25,443,242**	**72,429,500**
State government recurrent grants	42,400,000	22,192,548
Total	**67,843,242**	**94,622,048**

The Chairman of the Governing Council, who incidentally is a chartered accountant, observed that the financial statements appeared incomplete because no statement of cash flows was prepared.

Required:
Prepare, a statement of cash flows for Amotekun State University of Education for the year ended December 31, 2018, using the direct method in accordance with IPSAS 2.

(20 Marks)
(Total 40 Marks)

SECTION B: YOU ARE REQUIRED TO ANSWER ANY THREE OUT OF FIVE QUESTIONS IN THIS SECTION (60 MARKS)

QUESTION 2

IPSAS 3 - Accounting policies, changes in accounting estimates and errors, outlines criteria for selecting and changing accounting policies among other purposes.

Required:

a. Explain what constitute changes in accounting policies under the standard. (4 Marks)

b. Outline **THREE** disclosure requirements in the standard:

   (i) When initial application of IPSAS 3 is made and has effects on current, prior or future period.

   (ii) When voluntary changes in accounting policy is made and has effects on current, prior or future period. (6 Marks)

c. Expenditure assignment refers to division or sharing of expenditure, regulatory and tax functions or responsibilities among multi-levels of governments in a federation. Identify and explain **FIVE** challenges prevalent on expenditure assignment. (10 Marks)

(Total 20 Marks)

QUESTION 3

National Chart of Accounts (NCOA) shows the complete list of budget and Accounting items for General Purpose Financial Reporting System (GPFS) and budgeting.

Required:

a. Identify **FOUR** characteristics of National Chart of Accounts. (4 Marks)

b. Discuss the **SIX** structures of the National Chart of Accounts for budgeting. (6 Marks)

c. Discuss **FIVE** problems associated with debt conversion programme in a country. (10 Marks)

(Total 20 Marks)

QUESTION 4

A responsible government will ensure transparency and accountability in its governance and reduce corruption by establishing and empowering some agencies to eliminate economic saboteurs. An example of such agencies in Nigeria is the Economic and Financial Crimes Commission (EFCC).

a. State **FIVE** responsibilities of EFCC as enshrined in Part II of the Act that established the Commission. (5 Marks)

b. Identify **FIVE** punishments the Code of Conduct Tribunal can impose if it finds a public officer guilty of contravention of any of the provisions of the Code of Conduct Tribunal for public officers. (5 Marks)

c. Debt burden transfer is justified as a matter of inter-generational equity. Discuss **THREE** methods of debt burden transfer. (6 Marks)

d. State **FOUR** requirements of revenue bonds. (4 Marks)

(Total 20 Marks)

QUESTION 5

a. Major towns and cities in Ibadan State which is one of the states in the South West of the country are maintained by local government councils, which are funded through allocations from the federation account, states accounts and internally generated revenue. The local government councils submit budgets each year, which forms the basis of the funds received.

Matanmi local government council, one of the local government councils, in Ibadan State, provides you with the following information as part of the 2019 budget preparation.

Overheads

Overhead costs are budgeted on an incremental basis, taking the previous year's actual expenditure and adding a set percentage to allow for inflation. Adjustments are also made for known changes. The details for these are:

Overhead cost	2019 cost ₦'000	Known changes	Inflation adjustment between 2019 and 2020
Property cost	420,000	None	+11%
Personnel cost	350,000	Note 1 below	+0%
Stationery	125,000	Note 2 below	+10%

Note 1: One new staff member will be added to the payroll, this will cost ₦300,000 in 2020

Note 2: A move towards the paperless office is expected to reduce stationery costs by 20% in 2020.

Road repairs

In 2020, it is expected that 200 kilometers of road will require maintenance but a contingency of an extra 10% has been agreed.

In 2019, the average cost of a road repair was ₦1,500,000 per kilometer, but this did not include any cost effects of extreme weather conditions. The following probability estimates have been made in respect of 2020:

Weather type predicted	Probability	Increase in cost
Good	0.7	0
Poor	0.1	+10%
Bad	0.2	+20%

Inflation on road maintenance costs is expected to be 10% between 2019 and 2020.

New roads

New roads are budgeted on a zero-based basis and will have to compete for funds along with other capital projects such as hospitals and schools.

Required:

Calculate the overheads and road repairs budgets for year 2020.

(10 Marks)

b. The goods and services produced in every society can be classified into public and private goods.

Required:
Identify and explain **TWO** sub-divisions and **THREE** characteristics of public goods. (10 Marks)
(Total 20 Marks)

QUESTION 6

a. Privatisation may be defined as the transfer of asset, business, industry, or service from public to private ownership and control.

Required:
Identify and explain **FOUR** methods of privatisation. (10 Marks)

b. The customs and excise authority is one of the key border agencies in any country.

Required:
Explain the terms 'excise' and 'customs duties' and identify how each is used to influence economic behaviour.
(10 Marks)
(Total 20 Marks)

SOLUTION 1

a.

i. In accordance with IPSAS 13, the following are the features of a finance lease:

- Ownership is transferrable to the lessee.
- Risks and rewards incidental to ownership reside with the lessee.
- Option to purchase the asset at a lower value than the fair value.
- The lease term is for the major part of the economic life of the assets even if ownership is not transferred.
- At the inception of the lease, the present value of the minimum lease payments amounts substantially to at least, the fair value of the leased assets.
- The lease assets are of such a specialised nature that only the lessee can use them without major modifications.
- The lease assets cannot easily be replaced by other assets.
- If the lessee can cancel the lease, the losses associated with the cancellation are born by the lessee.
- The lessee has the ability to continue the lease for a secondary period at a rent substantially lower than the market rent.
- Gains or losses from the fluctuations in the fair value of the residual assets should accrue to the lessee.

ii. **Amotekun State University**

Non- current asset schedule

	Total	Land & Build.	Furniture & Fittings	Office Equip.	Plant & Mach.	Motor vehicle	Equip. on lease	Computer Equip.
Cost	**₦'000**	**₦'000**	**₦'000**	**₦'000**	**₦'000**	**₦'000**	**₦'000**	**₦'000**
At 1-1-2018	1,765,000	500,000	180,000	130,000	190,000	500,000	105,000	160,000
Additions	546,000	-	-	-	451,000	50,000	45,000	-
Revaluation	100,000	100,000	-	-	-	-	-	-
Reclassification	-	-	-	(26,000)				26,000
Disposal	(12,250)	-	(12,250)	-	-	-	-	
At 31-12-2018	**2,398,750**	**600,000**	**167,750**	**104,000**	**641,000**	**550,000**	**150,000**	**186,000**
At 1-1-2018	604,000	50,000	72,000	65,000	95,000	200,000	42,000	80,000
Charged for the year	265,808	13,333	16,775	13,000	64,100	110,000	30,000	18,600
Disposal	(1,500)	-	(1,500)	-	-	-	-	-
Reclassification	(650)	-	-	(3,250)	-	-	-	2,600
At 31-12-2018	**867,658**	**63,333**	**87,275**	**74,750**	**159,100**	**310,000**	**72,000**	**101,200**
Carrying amount								
At 31 – 12 – 2018	**1,531,092**	**536,667**	**80,475**	**29,250**	**481,900**	**240,000**	**78,000**	**84,800**
At 31 – 12 – 2017	**1,161,000**	**450,000**	**108,000**	**65,000**	**95,000**	**300,000**	**63,000**	**80,000**

Workings:

i. Revaluation of land and buildings

	₦'000
Carrying amount at January 1 2018 (₦500,000 – ₦50,000)	450,000
Add: Revaluation surplus on carrying amount at January 2018	150,000
New value at December 31 2018	600,000
Less: Opening value	500,000
Revaluation surplus	**100,000**

ii. Depreciation

	Years
Number of years land and buildings had been depreciated before valuation	5
Remaining useful life of land and buildings (50 – 5)	45
Depreciation per annum for the remaining 45 years (₦600,000,000/45)	**₦13,333,333**

iii. Depreciation on leased equipment

	₦'000
Depreciation on old equipment (₦105,000/ 5)	21,000
Depreciation on new equipment (₦45,000/ 5)	9,000
Total	**30,000**

iv. Depreciation on asset disposed

	₦'000
Sales proceed	11,500
Less: Profit	750
Carrying value	10,750
Cost of furniture and fittings	12,250
Depreciation on asset disposed	**1,500**

b. **Amotekun State University of Education**

Statement of cash flows for the year ended December 31 2018

	2018	
Cash flows from operating activities	**₦'000**	**₦'000**
Receipts		
Grants from state government:		
- Capital		21,292,294
- Special		4,150,948
- Recurrent		42,400,000
Internally generated revenue		4,420,324
Miscellaneous income		552,202
Payments:		
Inventories	(2,278,192)	
Receivables	(1,738,934)	
Short-term loan	(163,880)	
Consultants	(3,924,042)	
Others	(2,679,688)	
Academic and administrative expenses	(27,636,154)	(38,420,800)
Net cash flow from operating activities		**34,394,878**
Cash flows from investing activities		
Purchase of Non- current assets	(29,164,260)	
Library Development Fund	(6,318)	
Net cash flow from investing activities		**(29,170,578)**
Cash flow from financing activities		
Net cash flow from financing activities		-
Net increase/(decrease) in cash and cash equivalents		5,224,300
Cash and cash equivalents at January 1, 2018		991,922
Cash and cash equivalents at December 31, 2018		**6,216,222**

Examiner's report

The question tests candidates' knowledge on finance lease and ability to prepare non-current assets schedule in part (a) of the question, while part (b) tests candidates' knowledge on the preparation of statement of cash flows using direct method.

As a compulsory question, all the candidates attempted the question and their performance was below average.

The commonest pitfalls were the inability of the candidates to differentiate between the features of finance and operating lease. Candidates were unable to incorporate the additional information given in the notes to the question in the preparation of non-current assets schedules and also failure to differentiate between the preparation of statement of cash flows using direct and indirect method.

Candidates are advised to have adequate knowledge of relevant provisions of International Public Sector Accounting Standards (IPSAS) for better performance in the Institute's future examinations.

Marking guide

		Marks	Marks
a. i	**Identification of features of finance lease**		
	Any five features		5
a. ii	**Non- current asset schedule**		
	Correct title	¼	
	Calculation of cost as at 31st December 2018	4½	
	Calculation of depreciation as at 31st December 2018	5¼	
	Calculation of carrying amount as at December 31, 2017	2	
	Calculation of cost as at December 31, 2018	2	
	Workings		
	Calculation of revaluation surplus on cost land & building	¼	
	Calculation of depreciation per annum for the remaining 45 years onland & building	¼	
	Calculation of depreciation per annum depreciation on leased equipment	¼	
	Calculation of depreciation on asset disposed off during the year	¼	15
b.	**Cash flow statement**		
	Correct title	1	
	Calculation of net cash flow from operating activities	13	
	Calculation of net cash flow from investing activities	3	
	Calculation of net cash flow from financing activities	-	
	Calculation of Net increase/(decrease) in cash and cash equivalents	1	
	Calculation of Cash and cash equivalents at January 1 2018	1	
	Calculation of Cash and cash equivalents at December 31 2018	1	20
	Total		**40**

SOLUTION 2

a. According to IPSAS 3, the following constitute changes in accounting policy:

(i) A change from one basis of accounting to another basis of accounting; and

(ii) A change in the accounting treatment, recognition or measurement of a transaction, event or condition within a basis of accounting.

b. The IPSAS 3 requires the following disclosures:

(i) When the initial application of IPSAS is made and has effects on current, prior or future periods;

- The title of the standard;
- When applicable, an event of transitional provision;
- The nature of the change in accounting policy;
- When applicable, a description of transitional provision;
- When applicable, the transitional provisions that might have an effect on future periods; and
- Others are the amount of adjustments by line item affected and if retrospective application is impracticable, the circumstances for that, how and from when the change applied.

(ii) When a voluntary change in accounting policy is made and has effects on current, prior or future periods.

- The nature of the change in accounting policy;
- The reasons why applying the new accounting policy provides a more reliable and relevant information;
- For current and prior periods; present to the extent practicable the amount of the adjustment for each financial statement line items affected;
- The amount of the adjustments relating to periods before those presented to the extent practicable**; and**
- If retrospective application is impracticable, the circumstance for the application, how and from when the change applied.

c. **Identification and challenges prevalent on expenditure assignment.**

(i) **Lack of formal assignment**: The absence of a formal assignment of responsibilities among the multi-levels of government is a common problem with expenditure assignment.

A formal assignment of responsibilities contributes to the stability of the system of intergovernmental finances. From a fiscal management perspective, a formal expenditure assignment also introduces an important element of certainty for budget planning at all levels of government.

(ii) **Inefficient assignments**: Another common problem in the assignment of expenditure responsibilities is the inefficiency of the assignments. First is the issue of capital expenditure responsibilities. The problem has been the assignment of all capital expenditure responsibilities at the central level, independently of the level of government responsible for the provision of the services associated with the capital infrastructure.

(iii) **Ambiguity in certain assignments**: Despite the ambiguity in assignments, there are few open conflicts or disputes that have taken place between the central and state governments in terms of assignment of expenditure responsibilities. For example, there are arguments on whose responsibility it is to maintain internal security in Nigeria when the police is under the control of the central while the governors have little or no control over the police.

(iv) **Co-sharing of responsibilities**: The co-sharing of responsibilities within a particular public service is likely to cause confusion leading to inefficiencies. In the case of education, it would appear to be for the most part a local (or state) activity, many key decisions in educational policies are carried out at the central level in many countries. For example, the Ministry of Education may be responsible for the construction of school buildings, curriculum design, teacher training, and design and production of textbooks.

(v) **Conflict of responsibilities:** The co-sharing or fragmentation of responsibilities within a particular public service has the disadvantage that it is likely to cause confusion leading to inefficiencies.

Examiner's report

The question tests candidates' knowledge of IPSAS 3- Accounting policies, changes in accounting estimates and errors. Part (a) of the question requires candidates to explain the constituents of changes in accounting policy as stipulated by the standard, while part (b) requires the candidates to outline disclosure requirements stated in the standard. Part (c) of the question tests the challenges prevalent on expenditure assignment.

Few candidates attempted the question and performance was below average.

The commonest pitfalls were the inability of the candidates to explain what constitute changes in accounting policies and the disclosure requirements of the standard. They also lack the knowledge of expenditure assignment as a mechanism used in managing and sharing resources by the government in a federation.

Candidates are advised to have adequate knowledge of relevant provisions of IPSAS and making use of Pathfinder and Study Text of the Institute for better performance in the Institute's future examinations.

Marking guide

		Marks	Marks
a.	**Changes in accounting policies**		
	Explanation of the two circumstances that can constitute changes in accounting policies		4
b.	**Disclosure requirements**		
	(i) Any three disclosure requirements when initial application of IPSAS 3 is made	3	
	(ii) Any three disclosure requirements when voluntary changes in accounting policy is made	3	6
c.	**Identification and explanation of challenges prevalent on expenditure assignment**		
	Identification of five challenges.	5	
	Explanation of five challenges identified	5	10
	Total		**20**

SOLUTION 3

a. The characteristics of National Chart of Accounts (NCOA) are as follows:

(i) The NCOA was designed after due consultations with all the local government councils, states and Federal Government of Nigeria in consideration with their peculiar needs;
(ii) It must be expandable/flexible;
(iii) Each item has a unique code;
(iv) It is used for both budgeting and accounting;
(v) It must comply with IPSAS cash and accrual basis;
(vi) It must comply with Government Financial Statistics(GFS)2001; and
(vii) It must be in compliance with Classification by Functions of Government (COFOG).

b. The six structures of the National Chart of Accounts for budgeting are as follows:

(i) **Administrative segment:** The Administrative segment assigns responsibility for each transaction whether revenue centre (receipt) or cost centre (payment).
(ii) **Economic segment:** Every receipt must be from a particular source e.g. Contractor Registration Fee. Likewise, every expense must be on a particular item or object e.g. Purchase of drugs and medical supplies.
(iii) **Functional segment:** Functional classification categorizes expenditure according to the purposes and objectives for which they are intended. Functional classification or Classification by Functions of Government (COFOG) is defined as a detailed classification of the functions, or socio-economic objectives, that general government units aim to achieve through various kinds of outlays.

Functional classification organises government activities according to their broad objectives or purposes (for example, education, social security, housing, etc.). Government expenditure is measured according to internationally recognised functional categories. A functional classification is especially useful in analysing the allocation of resources among sectors. Functions and sub-functions will be assigned at the point of budget and planning for every transaction or initial setup.

(iv) **Programme segment:** The programme classification identifies various set of activities to meet specific policy objectives of the government e.g. Pre-primary education, poverty alleviation and food security.

(v) **Funds segment:** The fund segment addresses the "Financed by" element of a transaction. Fund refers to the various pool of resources for financing government activities. It will fast track the implementation of IPSAS particularly with respect to the full disclosure of government revenue including external assistance.

(vi) **Geographic segment:** It addresses the location/station element of every transaction. It is for location or physical existence of transaction so that an analysis of government budget and expenditure along the various geo political zones, states, and local government councils in the country can be done. The use of geographic codes will make it easier for agencies with oversight function like monitoring and evaluation mandates to locate projects across the country.

c. The problems associated with debt conversion programme in a country are as follows:

(i) **Inflation.** From the discussion on the types of debt, there is an obvious fact that debt conversion transactions involve the release of domestic currency. As a consequence, there is the possibility of an unplanned increase in money supply thereby leading to inflationary pressure.

(ii) **Round tripping**: Debt conversion offers opportunity for round tripping which involves the conversion of redemption proceeds into foreign currency either in the official foreign exchange market or parallel market for exportation immediately or at a later date. This problem has serious implications not only for foreign exchange rate but also for balance of payment position.

(iii) **Degree of additionality**: This represents the capacity of debt equity swaps to attract foreign equity investment and flight capital into the country which otherwise would not have come in. Thus the advantages associated with debt conversion depend on the degree of additionality in the absence of which the exercise results only in minima benefit to the economy.

(iv) **Fear of foreign domination:** Debt conversion programmes tend to increase fear about the possibility of a radical change in the structure of business ownership in favour of foreigners. Such fears tend to generate political sensitivity about the programme.

(v) **Effective transactions exchange rate:** The transactions effective exchange rate is determined by a combination of factors such as discounted purchase price of the debt, tax or conversion charges among others. The transaction's effective exchange rate must be sufficiently attractive to the investors in order to make debt conversion worthwhile. On the other hand, an excessively attractive transaction's exchange rate would constitute a loss to the economy, as it will amount to subsidising inefficiency.

Examiner's report

Parts (a) and (b) of the question test the candidates' knowledge of the characteristics and structure of National Chart of Accounts (NCOA) respectively while part (c) asks the candidates' to discuss problems associated with debt conversion programme in a country.

Few candidates attempted the question and performance was below average.
The commonest pitfalls were the inability of the candidates to identify the characteristics and features of National Chart of Accounts (NCAO); and problems associated with debt conversion programme.

Candidates are advised to have adequate knowledge of relevant provisions of National Chart of Accounts (NCAO) and other regulations relating to public sector account for better performance in the Institute's future examinations.

Marking guide

		Marks	Marks
a.	**Characteristics of National Chart of Accounts**		
	Identification of four characteristics		4
b.	**Structure of National Chart of Accounts:**		
	Identification of six structures	3	
	Explanation of six structures identified	3	6
c.	**Identification and explanation of problems associated with debt conversion programme**		
	Identification of five problems	5	
	Explanation five problems identified	5	10
	Total		**20**

SOLUTION 4

a. According to Part II of the Act 2002, the responsibilities of the Commission are as follows:

(i) The enforcement and the due administration of the provisions of the Act.

(ii) The investigation of all financial crimes which include advance fee fraud, money laundering, counterfeiting, illegal charge transfers, futures market fraud, fraudulent encashment of negotiable instruments, computer credit card fraud, contract scam, etc.

(iii) The co-ordination and enforcement of all economic and financial crime laws and enforcement functions conferred on any other person or authority.

(iv) The adoption of measures to eradicate economic and financial crimes.

(v) The adoption of measures to identify, trace, freeze, confiscate or seize proceeds derived from terrorist activities, economic and financial crime related offences or the properties, the value of which corresponds to such proceeds.

(vi) The adoption of measures which includes coordinated, preventive and regulatory actions, introduction and maintenance of investigative and control techniques on the prevention of economic and financial related crimes.

(vii) The facilitation of rapid exchange of scientific and technical information and the conduct of joint operations geared towards the eradication of economic and financial crimes.

(viii) The examination and investigation of all reported cases of economic and financial crimes with a view to identifying individuals, corporate bodies or groups involved.

(ix) The determination of the extent of financial loss and such other losses by government, private individuals or organisations.

(x) Collaboration with government bodies both within and outside Nigeria, carrying on functions wholly or in part analogous with those of the Commission concerning:

- The identification and determination of the whereabouts and activities of persons suspected of being involved in economic and financial crimes;
- The movement of proceeds or properties derived from the commission of economic and financial and other related crimes;
- The exchange of personnel or other experts;
- The establishment and maintenance of a system for monitoring international economic and financial crimes in order to identify suspicious transactions and persons involved;
- Maintaining data, statistics, records and reports on persons, organisations, proceeds, properties, documents or other items or assets involved in economic and financial crimes; and
- Undertaking research and similar works with a view to determining the manifestation, extent, magnitude and effects of economic and financial crimes and advising government on appropriate intervention measures for combating same.

(xi) Taking charge of, supervising, controlling, coordinating all the responsibilities, functions, activities relating to the current investigation and prosecution of all offences connected with or relating to economic and financial crimes, in consultation with the Attorney General of the Federation.

(xii) Carrying out such other activities as are necessary or expedient for the full discharge of all or any of the functions conferred on the Commission under the Act.

b. The following are the punishments, which the Code of Conduct Tribunal shall impose if it finds a public officer guilty of contravention of any of the provisions of the code of conduct for public officers, viz:

(i) Vacation of office or seat in any legislative house;

(ii) Disqualification from membership of a legislative house and from holding any public office for a period not exceeding ten years;

(iii) Seizure and forfeiture to the state, any property acquired in abuse or corruption of office;

(iv) Penalties that may be imposed by any law where the conduct is also a criminal offence; and

(v) Prosecution of the public officer punished in a court of law.

c. The three methods of debt burden transfer are as follows:

(i) **Transfer through reduced capital formation**: The decision of government to withdraw money from the economy will cause a reduction in the level of disposable income, which invariably may affect consumption, or capital formation. In the first case, the welfare of the present generation as measured by consumption is reduced while the income of the future generation will be unaffected. In the second case, the consumption welfare of the present generation is untouched whereas the future generation will inherit a small capital stock and thus enjoy a lower income. In this sense the future generation is burdened.

(ii) **Transfer through generation overlap:** Capital formation is the only way through which burden transfer between generations can occur. Assume the existence of two generations with generation one living from years 1 to 50 and generation two lives from 25 to 75. If generation one is requested to pay one million naira needed to finance a public project with a useful life of 50 years, generation one will do so at the cost of reducing its own consumption by this amount. Only in years 25 to 50 will it be possible to collect taxes of ₦500,000 from generation two in order to refund generation one. In this way, generation one while initially assuming the entire burden can transfer part onto generation two.

(iii) **Transfer with external debt**: In this case, there is no need for generation one to reduce its expenditure. Both consumption and capital formation in the private sector can remain intact as the resources needed for the public outlay are obtained abroad. Loan finances now impose a burden on generation two not only with reduced capital formation but with responsibility to servicing the foreign debts. Taxes must be paid to finance interest paid to foreigners rather than to domestic holders of the debt. This foreign debt burden replaces the loss of capital formation which generation two would have suffered had there been domestic loan finance and a resulting reduction in capital formation.

d. The requirements for revenue bonds are as follows:

(i) Identification of government's authority to borrow and the type of activities to which the enabling legislation applies.

(ii) General grant of power to acquire, construct, improve or extend the special improvement to issue revenue bonds and pledge same for the payment of these bonds.

(iii) Requirement that the issuing body should establish sufficient charges or rates to operate and maintain the projects and meet principal and interest payments as scheduled.

(iv) Guarantee that the revenue bonds have all the qualities of a negotiable instrument under the appropriate law of the State.

(v) Provisional design to secure the successful operation of the project.

(vi) Remedies to be initiated where there is default.

Marking guide

		Marks	Marks
a.	**Responsibilities of EFCC**		
	Stating of five responsibilities	5	
b.	**Imposition of punishments by Code of Conduct Tribunal on public officers.**		
	Identification of five punishments to be imposed	<u>5</u>	10
c.	**Discussion of method of debt burden transfer**		
	Identification of the three methods of debt burden transfer	1½	
	Explanation of the three methods identified	<u>4½</u>	6
D	**Requirements of revenue bonds**		
	Stating of the four requirements revenue bonds		<u>4</u>
	Total		**<u>20</u>**

Examiner's report
Parts (a) and (b) of the question test candidates' knowledge of functions and punishments to be imposed on public officer by the two agencies of government, while part (c) and (d) test the issue of debt burden transfer and requirements of revenue bond.

Few candidates attempted the question and performance was above average.
The commonest pitfalls were the inability of the candidates to identify the methods of debt burden transfer and the requirements of revenue bonds.

Candidates are advised to have adequate of EFCC Act, 2002 and Code of Conduct Tribunal for better performance in the Institute's future examinations.

SOLUTION 5

a. **Matanmi Local Government**

Calculation of overheads cost and road repairs budgets

(i) Overhead costs budget for 2020:

	₦'000
Property cost (₦420million x 1·11)	466,200
Personnel cost (₦350million +₦300,000)	350,300
Stationery (₦125million x 0.8 x 1.10)	110,000
Total	**926,500**

(ii) Road repair budget for 2020

Type of weather	**Calculation**	**₦'000**
Good	200 x 1,500,000 x 1·0 x 0·7	210,000
Poor	200 x 1,500,000 x 1·1 x 0·1	33,000
Bad	200 x 1,500,000 x 1·20x 0·2	72,000
Sub total		**315,000**
Inflation factor	0.10 x 315,000	31,500
Total		**346,500**

b. **(i)** Public goods can be sub-divided into the following:

- **Pure public goods**- They are goods that are perfectly non-rival in consumption and non-excludable. Defence and street lightings are good examples of pure public goods

- **Quasi-public goods**- These are goods that possess some characteristics of both private and public goods. They are partially non-rivalrous and partially non-excludable. Examples include roads, tunnels and bridges. Markets for these goods are considered to be inefficient. For example, private enterprise could provide some bridges, roads and tunnels if a charging system could be applied which solves the free rider problem.

- **Merit goods**- The concept was introduced in economics by Richard Musgrave as a commodity, which is judged to be of immense value to an individual or society and one should have on the basis of need, rather than ability and willingness to pay. Merit goods are those goods and services that the government believes people will under-consume, and which ought to be subsidised or provided free at the point of use so that consumption does not depend primarily on the ability to pay for the goods or services. Education and healthcare are good examples of merit goods.

(ii) The characteristics of public goods are as follows:

- **Non-rival consumption-** Generally public goods refer to those goods whose consumption is not in rival relationship. This implies that consumption by one individual will not cause a decline in the benefit that will accrue to other consumers of the same goods. For example, government policy of providing street lightings on roads, defence and adequate policing to make the society crime-free will become beneficial to everyone. It does not matter whether or not everybody is a tax payer. Therefore consumption of public goods is not competitive.

- **Non-excludability-** Another remarkable feature of public goods is the non-applicability of exclusion principle. Since everyone consumes from the same source of supply, once provided for one individual the same quantity and quality becomes available to everyone. Divisibility of output into smaller units to meet individual's demand is not desirable even if were feasible. Therefore, consumption of public goods is not dependent upon payment thereby giving room for 'free riders'. The non-excludability condition makes provision of public goods through the market mechanism impossible.

- **Zero marginal cost-** Public goods are characterised by the existence of zero or near zero marginal cost. This means that increase in demand may not necessarily force government to increase supply at least in the short run. Hence there is no extra cost incurred by the additional demand. For example, increase in the number of vehicles plying a road may not necessitate immediate expansion of the road. Similarly, additional vehicle passing over a bridge is without any additional cost to the society.
- **Equality of sum of marginal benefits with marginal cost-** The marginal cost is usually a measure of benefit (utility/satisfaction) derived by consumers from consumption. In the case of public goods it is the sum of the marginal benefits derived by each individual that should equal marginal cost. This is so since all consumers consume from the same source of supply.

Examiner's report

Part (a) of the question tests candidates' knowledge of the preparation of overhead costs and road repair budgets of a local government authority while part (b) tests candidates' knowledge on subdivisions and characteristics of public goods.

Few candidates attempted the question and performance was below average.

The commonest pitfalls were the inability of the candidates to incorporate the incremental basis parameters namely inflationary adjustment, contingency plan and the probability alignment with cost increase in calculating the overheads and road repairs budget. Also they were unable to identify the subdivisions and characteristics of public goods.

Candidates are advised to have adequate skill of preparing budgets for public sector entities and study more on public goods. The Pathfinder and Study Text of the Institute are relevant learning materials on this aspect of the syllabus.

Marking guide

		Marks	Marks
a.	Correct title	1½	
	Overhead costs for the 2019 budget:		
	Calculation of overheads budget for 2019	3½	
	Road repair budget		
	Calculation of road repairs budget for 2019	5	10
b.	**Public goods**		
	Identification of two sub-divisions of public goods	1	
	Explanation of two sub-divisions of public goods with one example	3	
	Identification of three characteristics of public goods	1½	
	Explanation of three characteristics of public goods with one example	4½	10
	Total		**20**

SOLUTION 6

a. The following are the methods of privatisation:

(i) **Full privatisation** implies complete divestment by the government of the ownership and control of the designated enterprises. Examples of enterprises with full privatisation include Flour Mills of Nigeria Plc., United Bank for Africa Plc., etc.

(ii) **Partial privatisation** means that the government will sell only a part of its interest in equity in the designated enterprises in order to inject profit motive into the business. Example here includes Bank of Industry (BOI)

(iii) **Full Commercialisation** means that the government would cease to grant subventions as such companies would be allowed to charge economic tariffs for services provided. The government still owns all the equity holdings. Example here includes Nigeria Ports Authority (NPA).

(iv) **Partial commercialisation**, the enterprises will continue to enjoy some support from the government towards operating cost and future capital investment. The whole equity holdings still belong to the government.

b. (i) **Excise:** This is a tax levied on certain goods and commodities produced or sold within a country and on licenses granted for certain activities. It is a per-unit tax imposed before the purchase price for specific items by the government. It is an inland tax. Examples are taxes imposed on cigarettes, alcohol, gambling, etc.

Influence on economic behaviour

- The government generates revenue as excise are imposed to discourage consumption of certain commodities;
- Increase in excise duties may result to job losses;
- It is regressive in nature because an increase in excise duty will affect the poor than the rich; and
- Sellers cannot always calculate and collect the exact fraction of tax applicable on all commodities that they sell, hence they tend to charge more than necessary.

(ii) **Custom Duties:** These are taxes levied on goods as they cross a designated border – taxable items at the border. Taxes levied on imported items.

Influence on economic behaviour

The following activities influence the country's economic behaviour:

- **Trade facilitation-** Trade facilitation means making Customs procedures more efficient to enable lower trade transaction costs for businesses. Trade procedures include the activities, practices and formalities involved in collecting, presenting, communicating and processing data and other information required for the movement of goods in international trade.

  Trade facilitation will lead to the following advantages

  - Significantly lower trade costs, especially reducing time;
  - Bring about significant increases in the volume of trade;
  - Allow for increases in government revenue and collection efficiency; and

- Generally contributes to welfare improvements and economic growth.

- **Revenue collection**-An increase in custom duties will make funds available for development purposes that will accelerate economic growth. From the findings, customs duty would increase the revenue base of government and make funds available for development purposes that will accelerate economic growth.
- **Social protection-** Social protection includes functions such as counter-terrorism and interdicting the movement of illicit goods such as narcotics and counterfeits. Customs can contribute to economic competitiveness by protecting society with respect to national security and deterring the cross-border trade in dangerous and unsafe products.

Examiner's report

Part (a) of the question tests candidates' knowledge of methods of privatisation while part (b) asks the candidates to identify and explain the terms "excise" and customs duties" and how each is used to influence economic behaviour.

Most of the candidates attempted the question and their performance was below average.

The commonest pitfalls were the inability of the candidates to identify and explain methods of privatisation. Majority of the candidates mixed up the meaning of excise duty to be export duty and could not explain how each of them is used to influence economic behaviour.

Candidates are advised to extend their study towards issues relating to privatisation and various taxes that are imposed by government. The Pathfinder and Study Text of the Institute are relevant learning materials on this aspect of the syllabus.

Marking guide

		Marks	Marks
a.	**Identification and explanation of methods of privatisation**		
	Identification of four methods of privatisation	4	
	Explanation four methods identified	6	10
b.	**Explanation and identification on how excise and custom duties is used to influence economic behavior**		
	Identification of the terms excise and custom duties	5	
	Explanation on how excise and custom duties is used to influence economic behaviour.	5	10
	Total		**20**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – MARCH/JULY 2020

CORPORATE STRATEGIC MANAGEMENT & ETHICS

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

INSTRUCTION: YOU ARE REQUIRED TO ANSWER FOUR OUT OF SIX QUESTIONS IN THIS PAPER

SECTION A: COMPULSORY QUESTION (40 MARKS)

QUESTION 1

Air Spirit Limited, a leading aviation company in Nigeria, is involved in passenger and cargo airline business. The company was established in 1980 and since inception, it has maintained leadership in the passenger airline business in Nigeria. The company has been able to leverage on experience, leading to efficiency in its operations which competitors have not been able to replicate. Hence, it has assumed cost leadership position in the industry. The firm currently pursues a low-price strategy and offers the lowest fare for all categories of flights (economy, business and first class) in the market and its cargo services. Service quality of Air Spirit is adjudged by the flying public as second to none in terms of quality, efficiency and safety with customer benefits rated above those of its rivals.

As a growth strategy, the company plans to expand its product offerings to include chartered flights. Target market includes politicians, businessmen and high net worth individuals. It is estimated that the chartered flights market is growing at 10% annually. Also, the chartered flights market is currently serviced by only one company; Royal Airlines Limited, which covers only the Lagos-Abuja route. Set up cost is high, thereby providing a barrier for new entrants. The company hopes to leverage on existing competencies in the passenger and cargo market to build the best chartered flights company in the country within the next three years, offering excellent services and benefits that would be difficult to replicate by competitors. It has built a strong relationship with aircraft suppliers and maintenance contractors. This will facilitate easy access to needed inputs. It hopes to commence operations across several routes, most of which are not currently serviced by its competitor. The company believes that the capabilities obtained from the passenger and cargo airline business will enable it to offer the lowest fare in the chartered flights industry.

Required:

a. From the scenario above, use the Bowman's Strategic Clock to analyse the effectiveness of the current strategy of Air Spirit Limited in the passenger airline business. (22 Marks)

b. Using Porter's Five Forces model, advise the management of Air Spirit Limited on the level of competition in the chartered flights market. (18 Marks)

(Total 40 Marks)

SECTION B: YOU ARE REQUIRED TO ANSWER ANY THREE OUT OF FIVE QUESTIONS IN THIS SECTION (60 MARKS)

QUESTION 2

a. Explain the definition of strategy provided by Chandler (1962) and extract its essential elements in a way that will help a would-be entrepreneur understand what a business strategy is all about. (10 Marks)

b. An adequate understanding of basic concepts and theories of ethics is a prerequisite for the evolution of the skills needed to address ethical issues that could arise while carrying out your duty as a professional accountant. Distinguish between ethical absolutism and ethical relativism. Also, identify **THREE** types of ethical relativism. (10 Marks)

(Total 20 Marks)

QUESTION 3

At a recently held board meeting of your company, there was a heated argument about the need to have a corporate social responsibility (CSR) policy. While some viewed CSR as a complete waste of resources, others viewed it as an absolute necessity.

Required:

a. With the aid of the Grey, Owen and Adams 7-point classification, analyse the possible ethical stances that could be taken by members of the board. (12 Marks)

b. Using the Johnson and Scholes cultural web, explain the elements that shape board members' understanding of corporate ethics. (8 Marks)

(Total 20 Marks)

QUESTION 4

a. Discuss the responsibilities of the Chairman as provided by the Nigerian Code of Corporate Governance. (10 Marks)

b. i. What is Board Diversity and explain **SIX** categories of Board Diversity? (5 Marks)

   ii. Evaluate the benefits of Board Diversity. (5 Marks)

(Total 20 Marks)

QUESTION 5

Oasis Bakeries is a producer of all kinds of bread, servicing only the Lagos market. In response to anticipated increase in the demand for bread, the company decided to increase its installed production capacity from 1,000 loaves to 5,000 loaves per day, having secured regulatory approval from the federal authority.

However, the market for bread in Lagos is largely dominated by bigger producers and there is some stability in the price of bread across all brands in the market. Thus, the risk of a price war is low. However, owing to the short shelf life of loaves of bread, most are sold to retailers on credit and due to a combination of reasons, credit default rate is increasing. The company by experience has also discovered that ovens, mixers and other equipment for the production of bread rarely break-down within the first 5 years of usage. However, procurement of raw materials such as flour and butter has become more challenging due to the activities of bigger bakeries and recent increase in import duty on all processed food.

Required:

a. Advise Oasis Bakeries on the level of exposure to any **FIVE** categories of risk inherent in its growth strategy. (10 Marks)

b. Analyse the impacts of risk on any **FIVE** of the stakeholder groups of Oasis Bakeries. (10 Marks)

(Total 20 Marks)

QUESTION 6

There are several models (out of which FOUR are more essential) for a professional accountant–client relationship which differ in the extent to which the client or the professional has authority and responsibility.

Required:

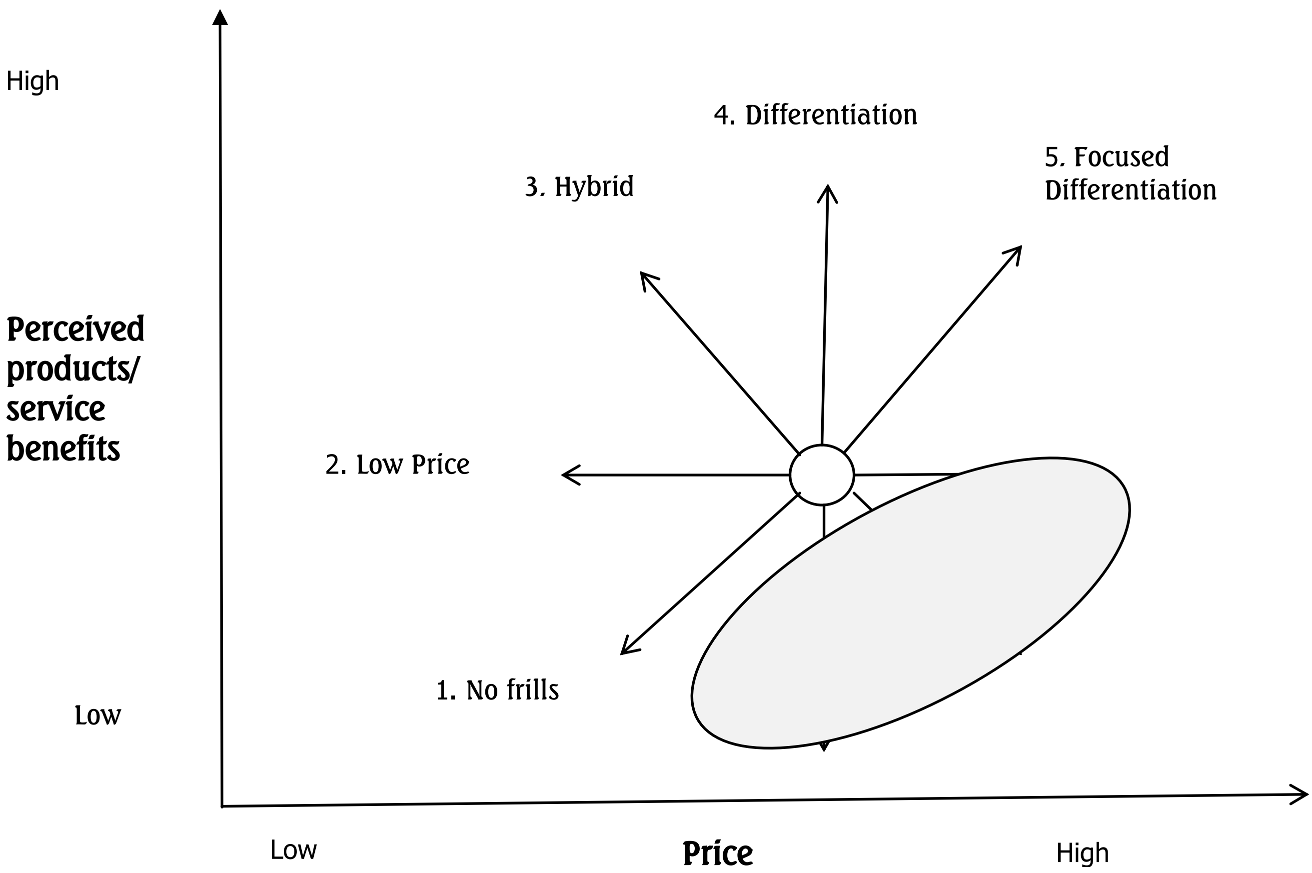
Explain the **FOUR** essential models for a professional accountant–client relationship with examples. **(Total 20 Marks)**

SOLUTIONS

SOLUTION 1

a.

Bowman's Strategic Clock



The strategic clock has 2 dimensions: Price and Perceived product/service benefits which are shown on a scale of low to high. The clock consists of business strategies, each of which is shown as a hand of a clock pointing in the direction of a combination of price and perceived benefits. However, all alternative business strategies can be grouped into five business strategies that can deliver competitive advantage to the firm, and others that will fail to deliver.

These five that can deliver competitive advantage as shown by positions on the diagram are:

i. Position 1: 'No Frills' Strategy
This offers products and services at low price without any perceived extra benefits.

- From the scenario, Air Spirit's low fare passenger and cargo products attract the lowest fares in the industry. But it comes with benefits that are superior to those delivered by its rivals

- Although the adoption of 'no frills' strategy will provide some competitive advantage, the level of perceived product benefit offered by the company is above average. Hence, a more suitable strategy that matches the level of perceived benefits offered by Air Spirit's passengers flight services should be adopted

ii. Position 2: Low Price
With this strategy, the product is perceived to deliver average benefits at low price with average product quality. This strategy can only be successfully pursued by the cost leader in the industry.

- From the scenario, it was said that the firm is pursuing low price strategy.

- This strategy is inappropriate as the product is delivering benefits that are above average though at the lowest price in the market.

iii. Position 3: Hybrid Strategy
- This is when the firm tries to achieve a mix of low price and differentiation strategy. The condition is that the product delivers high than average benefits and sells at below average price.

- Low cost of production and above average benefits are prerequisites for success of this strategy.

- From the given scenario, the company should consider pursuing the hybrid strategy because it is the low cost leader in the industry and its product is able to deliver superior benefits at the lowest cost.

iv. Position 4: Differentiation Strategy
- This is based on making the product appear to offer more benefits than rival products or services. This is achieved by adding different features and benefits and promoting the

product as being of higher quality that those of competitors. For this, the company will be able to charge a higher price, while at the same time attracting more customers.

- From the given scenario, the firm can also pursue this strategy by adding more benefits to its product and altering of customer perception to make them believe that its product is superior to those of its rivals through aggressive advertisement campaigns.

v. Position 5: Focused Differentiation strategy
This involves selling a product that offers superior benefits at above average price. Products in this category are strongly branded premium products such that higher prices can be justified.

- This could also be a viable strategy for the products of Air Spirit because if also offers the company the possibility of charging higher prices for products offering above average benefits.

vi. Strategies that will fail:
These are strategies that require charging higher than average prices for products that offer below average benefit.

- From the given scenario, the firm offers its product at below average price while offering above average benefits. Therefore it has not adopted this strategy.

- Adoption of this strategy will fail because it will not provide the firm any competitive advantage.

b. Michael Porter's five critical factors that explain the nature of competition in a market are:

i. **Threat of Potential Entrants**

- High profit in the industry is a signal for new entrants to venture into the market.

- New entrants drive up the level of competition within the market. As such, the higher the barriers to new entrants, the lower the level of competition.

- Several factors combine to determine the strength of barriers to entry. They include economies of scale, capital investment requirements, access to distribution channels, time to become established, know-how, switching cost and government regulations.

- From the given scenario, the cost of establishing chartered flight services provide a strong barrier to entry thus driving down the level of competition in the market.

ii. **Threat of Substitute Products**

- This threat exists when consumers can switch to substitutes.

- The strength of this threat is determined by the cost of switching between the products; the higher the switching cost, the lower the strength of this threat.

- From the given scenario, there is a substitute for chartered flights, that is, regular passenger flights with very little switching cost. This will drive up the level of competition in the market for chartered flights.

iii. **Bargaining power of suppliers**

- Suppliers may exert so much influence as to lower the level of profit made by the firm through increasing prices or lowering the quality of their supplies.

- Thus, the stronger the bargaining power of suppliers, the higher the degree of competition in the market.

- From the given scenario, there is no information about the bargaining power of suppliers of Air Spirit Limited, but it appears as if they are influential.

iv. **Bargaining power of customers**

- Customers bargaining power can significantly limit the profitability of an industry.

- Powerful buyers can successfully bargain for lower prices, improved product specification and quality, which may significantly lower profit.

- There is no direct indication in the scenario that the potential customers of chartered flights of Air Spirit have any bargaining power.

But,

- It can be inferred from the scenario that potential customers might have a strong bargaining power given their limited number and influence. This will increase the degree of competition in the market.

v. **Competitive rivalry**

- The degree of competition in an industry may also be affected by the level of competitive rivalry among competitors.
- Competitive rivalry might force rival firms to lower prices which may significantly affect their profitability.

Determinants of competitive rivalry in a market include:

i. Numbers of firms in the industry;
ii. Strength of the firms;
iii. Size of the firms; and
iv. Quality differences amongst products of the firms.

- From the given scenario there is no competitive rivalry in the market for chartered flight as it has only one firm. This means the level of competition in the market is low.

Conclusion

The level of competition in the market for chartered flights will be determined by the individual strength of each of the forces. From the given scenario, the threat of new entrants will be low and that of substitute products will be high but little information was given about the bargaining power of suppliers. Also, it could be inferred that the bargaining power of customers will be high while competitive rivalry will be low.

Examiner's report

This scenario-based compulsory question is in two parts. Part (a) of the question tests candidates' ability to use Bowman's Strategic Clock to analyse the effectiveness of a company's strategy. Part (b) tests candidates' ability to advise management on the choice of an appropriate strategy, using Porter's Five Forces model.

Virtually all the candidates attempted the question. Performance was slightly about average.

The common pitfall was the inability of some candidates to link the models to the scenario.

Candidates at the Skills level of the examination should endeavour to master the art of applying theory to practical situations. This is the main difference between Foundation and Skills levels of the examination.

Marking guide

		Marks	Total
a	Diagram	2	
	Explanation of diagram	2	
	Listing of positions	6	
	Explanation of positions	12	
			22
b	Listing of forces	2½	
	Explanation of forces	12½	
	Conclusion	3	
			18
			40

SOLUTION 2

a. Chandler (1962) defined strategy as the determination of basic long-term goal and objectives of an enterprise and the adoption of courses of action and the allocation of resources necessary for executing these goals.

Essential elements of this definition are:

i. Determination of long-term goals and objectives;
ii. Identification and adoption of alternative courses of action; and
iii. Allocation of resources.

b. **Ethical Absolutism**:

i. Also known as moral absolutism, it holds that there is a set of ethical principles that is applicable to all situations, at all times and in all societies.

ii. It holds that there are absolute moral standards against which the morality of actions can be judged.

iii. It holds that what is right or wrong are recognised by objective standards that apply universally to everyone without exception

Ethical Relativism

The theory holds that

i. What is ethically acceptable or unacceptable is dependent on such factors as religion, time, situation, historical period or social class.

ii. There is no objective or absolute truth and no universal standard of morality.

Three types of ethical relativism:

i. **Descriptive Ethical Relativism**: This hold that different societies and cultures have different ethical systems and standards for determining what is right or wrong.

ii. **Normative/Cultural Relativism**: This affirms that moral values or beliefs are culture dependent. Hence, the moral value of each culture can only be judged within the context of the culture and not by reference to any standard external to the culture.

iii. **Religious Ethical Relativism**: This maintains that morality is determined by and dependent on religious standpoints or values. It however recognises that no religion is universally acceptable or practised.

iv. **Historical Relativism**: This variant of relativism holds that what is right or wrong is dependent on the historical period within which it is being considered.

Examiner's Report

This question has two parts. Part (a) tests the components of Chandler's definition of Strategy, while Part (b) tests candidates' understanding of ethical absolutism and ethical relativism.

About 60% of the candidates attempted this question, with overall performance being below average.

Candidates who did not perform well in this question did not know Chandler's definition of Strategy, hence could not state its elements. Others could not distinguish between ethical absolutism and ethical relativism.

Candidates are advised to distinguish between the definition of Strategy by various scholars, and between ethical absolutism and ethical relativism.

Marking guide

		Marks
A	Definition	4
	Explanation	6
B	Definition	4
	Types of relativism	6
		20

SOLUTION 3

a. Gray, Owen and Adam's framework classifies different groups of people and their views of the relationship between business, organisation and the society. These positions are:

i. **Pristine Capitalists**: The only objective that business entities should pursue is to make money for the shareholders and maximise shareholders' wealth.

ii. **Expedients**: Also believe that the main aim of a company is wealth maximisation for shareholders, but concessions should be made in favour of other stakeholders in order to put the company in a stronger strategic position, as doing so will likely maximise shareholders' wealth.

iii. **Proponents of social contract**: This group believes that societies franchise the existence of businesses and there exists a social contract between the parties, which compels businesses to act responsibly and fulfil certain obligations in response to societal needs. Companies must therefore act in accordance with the standards of behaviour that societies find acceptable.

iv. **Social ecologists**: Believe that businesses are responsible for creating social and environmental problems. Thus, it is their responsibility to find solutions to them.

v. **Socialists**: Believe that there should be a significant readjustment in the ownership of assets and the structure of the society.

vi. **Radical feminists**: Believe that societies and social systems are dominated by an aggressive masculine view of the world which is harmful and wrong. There is therefore the need for feminine values to guide attitude.

vii. **Deep ecologists/deep green**: These are individuals who oppose pristine capitalism and believe that human beings have no greater right to existence than other forms of life. Therefore, ethical decisions should be based on concern for all forms of life.

b. The cultural web is made up of 7 interrelated elements of culture within an entity:

i. **Routine and rituals**: 'The way things are done around here'. Individuals get used to the way things are done. These set the tone for behaviour in organisations.

ii. **Stories and myths**: These are used to describe the history of an organisation, and suggest the importance of certain individuals or events. They are passed by word of mouth, thus helping to create perception on how the entity got to where it is, and it can be difficult to challenge established myths and consider the need for a change of direction in the future.

iii. **Symbols**: These are representations of the nature of the organisation. Example include logo, company cars, company colours, etc.

iv. **Power structure**: Entities are influenced by people in the positions of power, like those in management positions. Power can also come through personal influence, experience and expertise.

v. **Organisation structure**: This affects culture. Hierarchies and bureaucratic structures might find it difficult to change and are often conservative in their outlook.

vi. **Control systems**: Performance management and reward systems within organisations establish the views about what is important. Individuals will focus on performance that earns rewards.

Examiner's report

This question comprises two parts. Part (a) requires candidates' ability to use Grey, Owen and Adams 7-point classification to analyse the ethical stance of members of a board, while, Part (b) requires candidates to use Johnson and Scholes' Cultural Web to explain the determinants of corporate ethics.

About 60% of the candidates attempted this question. Many of the candidates scored above average marks.

Candidates who performed poorly did not understand the underlying principles tested by the question.

Candidates are advised to pay attention to the details of principles, concepts and theories to be applied at this level of the examination.

Marking Guide

		Marks
a	Listing	6
	Explanation	6
b	Listing	4
	Explanation	4
		20

SOLUTION 4

a) The responsibilities of the Chairman as contained in the Nigerian Code of Corporate Governance are to:
   i) Play a leading role in ensuring that the board and its committees have relevant skills, competences and experience;
   ii) Act as the main link between the board and the Chief Execcutive Officer (CEO);
   iii) Advise the CEO on the effective discharge of his/her duties;
   iv) Be responsible for the efficient functioning of the board and its effectiveness;
   v) Call board meetings, set the agenda and lead board meetings;
   vi) Decide how much time should be given to each item on the agenda of board meetings;
   vii) Make sure that the board spends its time dealing with strategic matters and not matters that should be delegated to the executive management;
   viii) Represent the company in its dealings with shareholders and (usually the media); and
   ix) Be the 'public face' of the company.

b. (i) Board Diversity means

- having a range of people that are different from one another on the board.

(ii) Categories of board diversity are:
- Age;
- Race/Ethnicity;
- Gender;
- Educational background;
- Professional qualification(s);
- Experience;
- Personal attitudes;
- Marital status; and
- Religion.

Age:

- There should be a mixture of the youths, middle-aged and elderly people on the board.

Race/Ethnicity

- There should be representation of various ethnic nationalities on the board.

Gender

- Mixture of males and females on the board.

Educational Background

- There should be a mix of different types of relevant skills, trainings and academic orientations.

Professional Qualification(s)

- Professional discipline of board members should be mixed.

Experience

- Experience of Board members should cover as many relevant areas of disciplines as possible.

Personal Attitude

- The board should have a mix of different personal attribute, including conservatives, moderates and extravagance particularly in the areas of risk taking and risk aversion.

Marital Status

- Board representation should cover relevant segments of the society such as singles, married, divorced, widows etc. relevant to the operation.

Religion

- The board should consist of people with different religious backgrounds as much as possible.

b(ii) **Evaluation of benefits of board diversity**

Benefits

- More effective decision making
- A diverse board should help reduce 'groupthink' and hence result in more objective decisions being made. Groupthink describes the tendency of a group to make collective decisions that minimize conflict rather than critically evaluate alternatives.
- It helps in retaining focus to make better quality decisions
- Diversity should help the board approach problems from a greater variety of perspectives and raise challenging questions, resulting in a more vigorous debate, thus help in retaining focus on managing and

controlling risks, and the companies' customers through better quality decisions.

- With ever-increasing competition in a global environment, a more diverse board will be better placed to understand diverse stakeholders' claims.
- It encourages better utilisation of talent pool for non-executive directors.
- It enhances corporate reputation and investor relations by establishing the company as responsible corporate citizen.
- It serves as a positive signal to both internal and external stakeholders that the company does not discriminate against minorities.
- By reflecting the diversity of society and the community with a diverse board, the social contract between a business and its stakeholders, plus the strategic fit with the environment become significantly enhanced.
- It is an investment appraisal metric.

Disadvantages

- Diverse boards may have difficulty in reaching decisions because of divergent views.
- There may be increased conflicts and frictions
- Tokenism: Ineffective participation of minority groups.

Marking Guide

		Marks	Total
A	Points		10
b(i)	Definition of Board Diversity	2	
	Listing	1½	
	Explanation	1½	
			5
b(ii)	Evaluation of Board Diversity		5
			20

Examiner's Report

This question has two parts. Part (a) tests candidates' understanding of the responsibilities of a board chairman as specified by the Nigerian Code of Corporate Governance, while Part (b) requires an understanding of board diversity.

Only about 50% of the candidates attempted this question. Performance was below average because several of the candidates confused the responsibilities of the board with those of the chairman of the board.

Candidates sitting this paper are advised to study the relevant codes of corporate governance specified in the syllabus.

SOLUTION 5

a. Types of risk that Oasis Bakeries will likely face are as follows:

i. **Market risk**: This is change in market price of input or output (where prices are not determined by the firm).

The price of inputs of Oasis bakeries may increase leading to losses. Given that the price of bread is fairly stable, the firm may not be able to successfully pass the hike in input prices to customers without loss of sales. Therefore, the level of exposure to market risk may be high;

ii. **Credit Risk**: Risk of losses due to bad debts and delays by customers in settling their debts.

Most of the sales of bread to retailers are done on credit basis and of late, there is an increase in rate of default by customers. This makes exposure of the firm very high;

iii. **Liquidity Risk**: Risk that the firm will be unable to make payments to settle liabilities when payments are due.

There is nothing in the scenario that suggests that Oasis Bakeries has any exposure to liquidity risk;

iv. **Technology risk**: Risk associated with change in technology which may affect the operations and/or profitability of the firm. A change in technology might necessitate acquisition of new modern equipment which may drive up costs, lower sales and profit.

There is nothing in the scenario that indicates Oasis Bakeries' level of exposure to technology risk;

v. **Legal risk**: This is loss suffered for failure to comply with regulations.

From the given scenario, all regulatory requirements had been met. As such, the legal risk may be minimal;

vi. **Health safety and environment risk**: Risks to the health and safety of employees, customers and the general public.
By inference, the level of the firm's exposure to health, safety and environment risk is high due to the high probability of occurrence of events that are associated with the industry in which it operates. Such occurrences include contamination of food items used as inputs and fire outbreaks from the use of ovens, etc;

vii. **Reputation risk:** Risk that a company or its product brand's reputation with the general public will be damaged.

There is no information from the given scenario that describes the level of exposure to reputation risk; and

viii. **Business probity risk:** Risk of losses for failure to act in an honest way.
The scenario provides no information on business probity risk of the company.

b. The likely impact of risks on stakeholders of Oasis Bakeries are as follows:

i. **Employees:** Are exposed to risks associated with their jobs. Risks such as health, safety and environment could have a direct bearing on them, leading to injuries, stress and even loss of lives and permanent disabilities. Growth in production capacity could positively affect the probability that such loss could occur;

ii. **Investors:** Investors put money in businesses with expectation of some returns based on their respective perception of risk taken by the entity. Some invest in businesses they perceive to be high risk with the expectation of commensurate return on their investments, while other investors might invest due to perceived low risk and stable income derivable. Investors are expected to be informed about the level of risk the firm is assuming so as to make informed decision about their investment;

iii. **Creditors and Suppliers:** They face risks of default in payment from the firm. The fact that Oasis Bakeries sells most of its bread on credit exposes it to high liquidity and solvency risk which increases the exposure of its suppliers and creditors to credit risk;

iv. **Community and general public:** They are exposed to the risks of the action of companies and failure of the business to control their risk. Actions of Oasis Bakeries could negatively impact the host community and the general public through the degree of exposure to health, safety and environment risk. For example, a fire outbreak caused by a faulty gas-fired oven may lead to loss of properties located around the company. Also, smoke emissions from wood-fired ovens may impact negatively on the environment and may pose a health hazard to the host community;

v. **Government:** Exposure to liquidity and solvency risk by Oasis Bakeries implies high risk of default in tax payment. Also, the general wellbeing of the company impacts on the level of wealth creation and employment enjoyed by the society. Thus, the government also faces some risk from the level of success recorded by Oasis Bakeries; and

vi. **Customers**: Customers face risks from a number of sources. Operational risks from human error or machine breakdown could lead to delay in supplies to customers. This could negatively impact customers as bread is a staple for most households. Also, product safety risk exposes customers to health hazard, depending on the effectiveness of safety controls put in place by the bakery.

Marking Guide

		Marks	Total
a	Listing	2½	
	Explanation	7½	
			10
b	Listing	5	
	Explanation	5	
			10
			20

Examiner's Report

This scenario-based question requires candidates' knowledge of risk. Part (a) tests knowledge of risks inherent in growth strategy and Part (b) tests the impact of corporate risk on stakeholder groups.

This is one of the popular questions amongst the candidates. General performance was good. The few candidates who performed poorly could not classify risk well.

Candidates are advised to pay attention to the details of concepts covered by this subject.

SOLUTION 6

The FOUR (4) essential models that are most appropriate in different circumstances based on authority and responsibility of the parties are:

i) Agency Relationship;
ii) Contractual Relationship;
iii) Paternalistic Relationship; and
iv) Fiduciary Relationship.

i) **Agency Relationship**

- In this relationship, the client has most of the authority and responsibility for decision–making.
- The professional is an expert acting on behalf of a client, but under instructions from the client.
- The client knows what to do and instructs the professional to do it.

Examples

Examples of this is the relationship between a client and an accountant

- When rendering advisory services, the accountant carries out the clients' instructions, and provides information and possibly advice, but the client makes the decisions.
- The company's board of directors makes the decisions about what the financial statements should contain.
- Accountants operating as a consultant.
- It can also exist when the accountant is not independent but is acting on the client's instructions and on behalf of the client, e.g. an accountant who is asked to prepare a tax return for a client.

ii) **Contractual Relationship**

In this relationship

- The client and the professional are 'equal' in terms of authority and responsibility for decision-making.
- There is a contract between them, in which the client arranges for the accountant to carry out some work, and the accountant undertakes to do the work.
- This kind of relationship exists when the accountant has some expertise or technical knowledge that the client does not have, so, the client hires the accountant to provide services.

Examples

- A firm of accountants may be engaged to provide advice to a company on the implementation of a new law or set of regulations.
- The accountant provides technical advice and the client acts on the advice given.

iii) **Paternalistic Relationship**

This is a type of relationship that exists

- Between parents (who have more knowledge and experience than their children) and their children.

In a paternalistic relationship,

- The accountant has most of the decision–making authority and responsibility; and can make decisions without the client's knowledge or consent.
- The accountant exercises his or her judgment in what is considered to be the client's best interests.
- Paternalistic relationships between a professional and a client can be the relationship model that causes greatest concern because the professional will be virtually taking over the client's affairs.

Examples

This type of situation may exist between

- a professional accountant and a client.
- the professional accountant must have experience and knowledge and the client should be inexperienced and without much knowledge of the matters that the accountant deals with.

iv) **Fiduciary Relationship**

This is a relationship between

- A professional and a client, in which the professional (as a fiduciary) has an obligation to act in the best interests of the client.
- The professional has superior technical knowledge and greater expertise than the client, unlike a paternalistic relationship, in a fiduciary relationship the client retains significant authority and responsibility for making decisions.
- Both parties in the relationship have responsibilities and the judgments of both carry weight.
- The client depends on the accountants for much information and advice, but the client's consent is needed for any decision, and in many instances the client is involved in reaching decisions and also makes the final decision.

For some issues, the client may recognise the technical knowledge of the accountant, and allow the accountant to make the decisions.

Marking Guide

		Marks	Marks
i)	Listing	4 x 1	4
ii)	Agency relationship	4 x 1	4
	Contractual relationship	4 x 1	4
i)	Paternalistic Relationship	4 x 1	4
ii)	Fiduciary relationship	4 x 1	4
	Total		**20**

Examiner's Report

This question tests candidates' ability to explain the models of professional accountant-client relationship.

About 60% of the candidates attempted this question. Overall performance was average.

The common pitfall was the inability of some candidates to relate the levels of authority and responsibilities to each model.

Candidates are advised to study well in preparation for future examination.