THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

PATHFINDER

NOVEMBER 2019 DIET
SKILLS LEVEL EXAMINATIONS

Question Papers

Suggested Solutions

Examiner's Reports

Plus

Marking Guides

FOREWARD

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

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

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

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

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

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

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

NOTES

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

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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – NOVEMBER 2019

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: QUESTION (40 MARKS)

QUESTION 1

- You are the Financial Controller of Uchena Nigeria plc. The company was established about 15 years ago. At the last annual general meeting of the company, a new Managing Director was appointed.

  The new Managing Director is a non-finance executive with very little knowledge of accounting. He has requested for the past five years financial statements of the company for review.

  He has prepared a list of issues based on his review as follows:

  - When I look at the statement of financial position of one of the past financial statements, one of the categories of non-current asset is investment properties and another category is property, plant and equipment, in which all other properties are included. It is certain that the company invested in properties, so why do you have two categories for them in the statement of financial position? How did you decide what goes where?

  - A note to the financial statements states that, investment properties are measured at their fair values and not depreciated. Don't all non-current assets have to be depreciated over their estimated useful lives?

  - Another note to the financial statements states that, property included in the property, plant and equipment is measured at cost less accumulated depreciation rather than at fair value. Shouldn't all properties be measured in financial statements on a consistent basis?

  - Finally, I can't see from the financial statements where gains or losses relating to the measurement of investment properties are included;

The profit statement includes two main components: profit or loss and other comprehensive income; where would the gain or losses go? Presumably the treatment of gains or losses is same for any non-current assets, which one is measured at fair value?

Required:
Provide answers to the issues raised by the Managing Director. You should justify your answers with reference to the relevant IFRS. (12 Marks)

b. The Chief Accountant of Uchena Nigeria plc. has just forwarded the trial balance of the company to you for review before the preparation of draft financial statements for the year ended December 31 2018.

The trial balance are as follows:

	₦'m	₦'m
Ordinary share capital		43,200
Revenue		125,280
Staff cost	18,720	
Leasehold building	21,600	
Patent rights	4,320	
Work-in-progress January 1 2018	9,000	
Accum. Depreciation on building January 1 2018		4,320
Inventories of finished goods January 1 2018	11,160	
Consultancy fee	3,168	
Directors' salaries	25,920	
Computer at cost (Hardware)	3,600	
Accum. Depreciation on computer (Hardware) Jan. 1 2018		1,440
Retained earnings Jan. 1 2018		8,712
Dividend paid	9,000	
Cash and bank	31,680	
Trade receivables	30,240	
Trade payables		6,624
Sundry expenses	21,168	
	189,576	189,576

Additional information:

- On January 1 2018, buildings were revalued to ₦25,920million. This has not been reflected in the accounts. Computer (hardware) are depreciated over five years. Buildings are now to be depreciated over 30 years.
- The patent rights relate to a computer software with 3 year life span.
- An allowance for bad debts (irrecoverable debts) of 5% is to be created.
- Closing inventories of finished goods are valued at ₦12,960million. work-in-progress has increased to ₦10,080million.

- There is an estimated liability for current tax of ₦8,640million which has not been recognised.

Required:

- Prepare draft statement of profit or loss (analysing expenses by nature) for the year ended December 31, 2018. (6 Marks)

- Statement of changes in equity, for the year ended December 31, 2018; and (4 Marks)

- Statement of financial position as at December 31, 2018. (6 Marks)

c. State the main factors that IAS 8 requires management of a company to consider in selecting and applying accounting policies in the absence of any IFRS and identify the alternative accounting policies on the following items in the financial statements.

i. Inventories; and
ii. Depreciation (12 Marks)

(Total 40 Marks)

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

QUESTION 2

- In accordance with IAS 12 on Income Tax, the income tax expense in statement of profit or loss is composed of two tax components:

  (i) Current tax; and

  (ii) Deferred tax

  Required:

  Explain these **TWO** tax components. (5 Marks)

- Dan Ruwa Nigeria Limited is a company that is based in the North-western part of Nigeria and specialises in the production of bottled and sachets water.

  The company was incorporated on January 1, 2018.

  The summarised financial statements of the company for the year ended December 31, 2018 is as follows:

Extract of Statements of profit or loss for the year ended December 31, 2018

	₦'000
Revenue	270,000
Administrative and other allowable expenses	(138,000)
Accounting depreciation	(11,000)
Net profit before taxation	121,000

Extracts of statement of financial position as at December 31, 2018

Assets (Non-current assets)	**₦'000**
Property, plant & equipment	48,000
Motor vehicle	12,000
Less:	
Depreciation	(11,000)
Carrying amount December 31, 2018	49,000

	₦'000
Ordinary share capital	17,000
Retained earnings	12,000
Other liabilities	20,000
	49,000

The Federal Inland Revenue Service (FIRS) granted the company a capital allowance on its non-current assets, which amounted to ₦15,000,000 and company income tax rate is 30%.

Required:

i. Calculate the current income tax expense and the deferred tax liability balance that should be disclosed in the statement of financial position of the company as at December 31, 2018. (10 Marks)

ii. Prepare the statement of profit or loss of Dan Ruwa Nigeria Limited incorporating the tax expense for the year ended December 31, 2018.
(5 Marks)
(Total 20 Marks)

QUESTION 3

Family plc. is the parent company of Children Limited. The Statement of Financial Position of the two companies as at September 30, 2019 are presented below:

Statement of Financial Position as at September 30, 2019

ASSETS	**Family Plc**	**Children Limited**
NONCURRENT ASSETS	**₦'Million**	**₦'Million**
Office building complex	5,000	1,920
Plant and machinery	7,000	6,000
Investment in children shares	6,028	-
	18,028	**7,920**
CURRENT ASSETS		
Inventory	3,600	1,900
Trade receivables	4,100	1,700
Other receivables	300	20
Tax assets	0	100
Bank balances	1,440	840
	9,440	**4,560**
Total Assets	**27,468**	**12,480**
Equity and Liabilities		
Ordinary shares of N1.50k each	21,600	9,600
Retained earnings	1,260	480
	22,860	**10,080**
CURRENT LIABILITIES		
Trade payables	2,000	280
Other payables	928	200
Overdrafts	1,680	1,920
	4,608	**2,400**
Total Equity and Liabilities	**27,468**	**12,480**

The following information is relevant:

- Children Limited had been making continuous losses in the income statements over the past three years; recently, it is steadily returning into a profit making entity. Family Plc bought 4.8 billion equity shares in Children limited a year ago when Children Limited had retained earnings of ₦144 million and the fair value of the non-controlling interest was ₦3.396 billion. Profits were evenly distributed over the years.

- During the year ended September 30, 2019; Family plc. sold goods with an invoiced value of ₦576 million at cost plus 20% to Children limited. Half of the goods were still in the inventory of Children limited as at the end of the year.

- Children Limited owed Family Plc ₦72 million for the goods it purchased during the year ended September 30, 2019.

- Included in the other payables was the proposed dividend of 2½ kobo per ordinary shares of Children Limited for the year ended September 30, 2019. Both companies had agreed that the proposed dividend should be paid by the directors of Children Limited before consolidation.

  Required:

  Prepare the Consolidated Statement of Financial Position of Family plc. as at September 30, 2019. **(Total 20 Marks)**

QUESTION 4

- The IASB's framework for preparation and presentation of financial statements requires financial statements to be prepared on the basis that they comply with certain accounting concepts and underlying assumptions.

  Required:

  Explain the meaning of each of the following concepts and the underlying assumption.

  - Substance over form; and
  - Going concern (6 Marks)

- IAS 37 – Provisions, Contingent Liabilities and Contingent Assets, sets out the principles of accounting for these items and classifies when provision should not be made prior to its issue. The inappropriate use of provisions had been an area where companies had been accused of manipulating financial statements and of creative accounting.

  Required:

  Distinguish between provisions, contingent liabilities and contingent assets as contained in IAS 37. (14 Marks)
  (Total 20 Marks)

QUESTION 5

Sekiri Nigeria Limited is a major competitor to Ijor Ventures Limited. Both companies operate in the same industry in the last 20 years.

The summarised financial information of Sekiri Nigeria Limited for the last 2 years are as follows:

Sekiri Nigeria Limited
Summarised profit or loss for the year ended September 30,

	2019	**2018**
	₦'m	**₦'m**
Revenue	4,565	4,905
Cost of sales	(2,950)	(3,225)
Gross profit	1,615	1,680
Selling, distribution & admin expenses	(1,095)	(1,070)
Interest expense	(95)	(75)
Net profit before taxation	425	535
Taxation	(225)	(260)
Profit for the year	200	275

Statement of financial position as at September 30,

	2019	**2018**
	₦'m	**₦'m**
Assets		
Non-current assets:		
Intangible assets	240	200
Tangible assets (carrying amount)	1,080	1,030
	1,320	1,230
Current assets		
Inventories	1,470	1,515
Trade receivables	800	705
Bank	260	290
	3,850	3,740
Equity & liabilities	**2019**	**2018**
Equity	**₦'m**	**₦'m**
Ordinary share capital	500	500
Retained earnings	1,730	1,650
	2,230	2,150
Non-current liabilities		
Loan – notes	690	690

Current liabilities:		
Trade payables	375	375
Other payables	555	525
	3,850	3,740
Financial ratios of Sekiri Nigeria Limited:		
	2019	**2018**
Ratios:		
Gross profit margin	35.4%	34.3%
PBIT ROCE Equity plus loan notes	17.8%	21.5%
Net profit margin	11.4%	12.4%
Asset turnover	1.56times	1.73times
Gearing ratio	23.6%	24.3%
Debt/equity ratio	30.9%	32%
Interest cover	5.5	8.1
Current ratio	2.7	2.8
Quick ratio	1.1	1.1
Receivable payment period (days)	64	52
Inventory turnover period (days)	182	171
Payable turnover period (days)	46	42

Sekiri Nigeria Limited declared dividend of ₦120m each in years 2018 and 2019.

Required:

- As the Chief Accountant of Ijor Ventures Limited, write a report to your company's Finance Director analysing the performance of Sekiri Nigeria Limited which is your company's competitor. (10 Marks)

- Highlight **FIVE** areas, which will require further investigation, including reference to other pieces of information, which would complement your analysis of performance of Sekiri Nigeria Limited. (10 Marks)

(Total 20 Marks)

QUESTION 6

- IFRS 15 on revenue from contract with customers was issued for the purpose of ensuring that revenue are properly accounted for, better than what we have under IAS 18 and IAS 11.

Required:

i. Identify the **FIVE** step-model that needs to be followed by entities when recognising revenue from contract under IFRS 15.

ii. Explain how IFRS 15 is expected to improve the financial reporting of revenue. (6 Marks)

- Phonetell Nigeria Limited is a network service provider registered with the Nigeria Stock Exchange (NSE). The company has been operating in the country for the past 10 years.

  On September 1, 2019, the company entered into a service contract with its customers to provide a special model handset and one year service at a price of ₦250,000.

  If the customers acquired the handset only, it would be sold at a price of ₦75,000 and if the network service is separately provided for one year duration, the customer will be made to pay the sum of ₦200,000 for the one year duration.

  The financial year end of Phonetell Nigeria Limited is September 30.

  Required:

  Calculate the revenue from this contract for the accounting years ended 2019 and 2020 in accordance with the provisions of IFRS 15. (10 Marks)

- On September 20, 2019, Phonetell Nigeria Limited sold 100 units of Android PT-Tablet to a major customer for ₦200,000 each. The PT-Tablet costs Phonetell Nigeria Limited ₦160,000 each.

  The terms of sales are that the customers have the right to return the tablets for a full refund within 3 months. On expiration of the 3 months period, the customer can no longer return the PT-Tablet and payment becomes immediately due. Phonetell has entered into transactions of this type with these customers previously and can reliably estimate that 4% of the Android PT-Tablets are likely to be returned within the three-month period.

  Required

  Explain how the above transactions would be reported in the financial statements of Phonetell Nigeria Limited for the year ended September 30, 2019. (4 Marks)

  (Total 20 Marks)

SECTION A

SOLUTION 1

a) **Answers to issues raised by the Managing Director**

Further to your request on the above subject matter, kindly find below the detailed explanation on the classification of non-current asset into investment properties and property, plant and equipment, their recognition and measurement in the financial statement in line with the provision of IAS 16 – Property, Plant & Equipment and IAS 40 – Investment Property.

i. Basis for classification

- According to the provisions of IAS 16, property, plant and equipment is defined as tangible non-current assets that are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and are expected to be used during more than one year.

- On the other hand, IAS 40 defines investment properties as property (land or a building, part of a building or both) held to earn rentals or for capital appreciation or both.

- The following are not investment property:
- Property intended for sale in the ordinary course of business.
- Property being constructed or developed on behalf of third parties
- Owner – occupied property

ii. Measurement of investment property

- IAS 40 states that investment property should be measured initially at cost plus the transaction costs incurred to acquire the property.

  The standard further provides that subsequent to initial recognition, an entity may choose as its accounting policy, the fair value model, or the cost model.

- Under the fair value model, the entity should;
- revalue all its investment property to 'fair value' (open market value) at the end of each financial year, and
- recognise any resulting gain or loss in profit or loss for the period.

The investment property would not be depreciated.

- However, if it is not possible to arrive at a reliable fair value figure then, the cost model should be adopted. The cost model follows the provisions of IAS 16 where the investment property is valued at cost and the non-land element is depreciated over their estimated useful lives.

iii. Measurement of property, plant and equipment

- According to the provision of IAS 16, property, plant and equipent are initially recorded in the accounts of a business at their cost.

- Subsequent to initial recognition, IAS 16 allows a choice of accounting treatments after initial recognition. All items of property, plant and equipment in a class can be accounted for using one of two models:

- Cost model - Property, plant and equipment is carried at cost less any accumulated depreciation and any accumulated impairment losses.

- Revaluation model - Property, plant and equipment is carried at a revalued amount. This is the fair value at the date of the revaluation less any subsequent accumulated depreciation and any accumulated impairment losses.
- IAS 16 requires that the above choice must be applied consistently. A business cannot carry one item of property, plant & equipment at cost and revalue a similar item. However, the standard permits a business to use different models for different classes of property, plant & equipment. For example, a business can use the cost model for plant and equipment and use the revaluation model for property.

iv. Treatment of gains or loss on fair value of investment properties

- According to the provision of IAS 40 on Investment Properties, where an entity adopts the fair value model of measurement, such entity should:
- revalue all its investment property to 'fair value' (open market value) at the end of each financial year, and
- recognise any resulting gain or loss in profit or loss for the period.

- This is different from the revaluation model of IAS 16, where gains are reported as other comprehensive income and accumulated as a revaluation surplus.
- However, losses are generally recognized in the statement of profit or loss. The only exception to recognizing surplus in other comprehensive income is when it reverses a previous deficit which was recognized in the statement of profit or loss.

In such a case, the reversal is recognized in the statement of profit or loss.

b) **Uchena Nigeria Plc**

Statement of profit or loss for the year ended December 31, 2018

	Note	₦'m
Revenue		125,280
Changes in inventories of finished goods and work in progress	1	2,880
Staff costs		(18,720)
Depreciation and amortisation expenses	2	(3,024)
Other operating expenses	3	(51,768)
Profit before tax		54,648
Income tax expenses		(8,640)
Profit for the year		46,008

Uchena Nigeria Plc

Statement of financial position as at December 31, 2018

Non-current assets:	Note	₦ 'm
Property, plant & equipment (25,056 + 1,440)	6	26,496
Intangible assets:		
Patent rights	6	2,880
Total non-current assets		29,376
Current assets:		
Inventories	5	23,040
Trade receivables	4	28,728
Cash and bank		31,680
Total current assets		83,448
Total assets		112,824
Equity and liabilities:		
Ordinary share capital		43,200
Retained earnings		45,720
Revaluation reserves		8,640
Total equity		97,560
Current liabilities:		
Trade payables		6,624
Income tax payable		8,640
Total current liabilities		15,264
Total equity and liabilities		112,824

Uchena Nigeria Plc				
Statement of Changes in equity for the year ended December 31, 2018				
	Ordinary Shares	Retained Earnings	Revaluation Reserves	Total Equity
	₦ 'm	₦ 'm	₦ 'm	₦ 'm
Balance b/f	43,200	8,712	-	51,912
Profit for the year	-	46,008	-	46,008
Gain on revaluation of leasehold building	-	-	8,640	8,640
Dividend paid	-	(9,000)	-	(9,000)
	43,200	45,720	8,640	97,560

Working Notes

Wk. 1: Changes in inventories of finished goods and work-in-progress	₦ 'm
Increase in inventories of finished goods (12,960-11,160)	1,800
Increase in inventories of work-in-progress (10,080-9,000)	1,080
	2,880
Wk. 2: Depreciation and amortisation expenses	₦ 'm
Depreciation charge on buildings (25,920/30 years)	864
Depreciation charge on computer hardware (3,600/5 years)	720
Amortisation of patent rights (4,320/3 years)	1,440
	3,024
Wk. 3: Other operating expenses	₦ 'm
Consultancy fees	3,168
Directors' salaries	25,920
Sundry expenses	21,168
Allowance for bad debts (5% x 30,240)	1,512
	51,768
Wk. 4: Trade receivable	₦ 'm
Opening balance	30,240
Allowance for bad debts (5% x 30,240)	(1,512)
Closing balance (SOFP)	28,728
Wk. 5: Closing inventories	₦ 'm
Work-in-progress	10,080
Finished goods	12,960
	23,040

Wk. 6: Schedule of movement in non-current asset for the year ended Dec. 31, 2018			
	Leasehold Building	Computer Hardware	Patent Right
	₦ 'm	₦ 'm	₦ 'm
Cost b/f	21,600	3,600	4,320
Accumulated depreciation b/f	(4,320)	(1,440)	-
Carrying amount b/f	17,280	2,160	4,320
Gain on revaluation	8,640	-	-
Current year depreciation/amortization	(864)	(720)	(1,440)
Carrying Amount to SOFP	25,056	1,440	2,880

c) According to the provision of IAS 8, where there is no rule in IFRS that specifically applies to an item in the financial statements, management must use its judgement to develop and apply an accounting policy that results in information that is:

- relevant to the decision-making needs of users; and
- reliable in that financial statements;
- represent faithfully the results and financial position of the entity;
- reflect the economic substance of transactions and other events and not merely the legal form;
- are neutral i.e. free from bias;
- are prudent; and
- are complete in all material respects.

In making the judgement, management must consider the following sources in descending order:

- The requirements and guidance in IFRS dealing with similar and related issues:

- The definitions, recognition criteria and measurement concepts for assets, liabilities, Income and expenses set out in the Framework.

- Management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to the extent that these do not conflict with the above sources.

The alternative accounting policies on the following items in the financial statements are stated below:

(i) Inventories:

"IAS 2 – Inventories" states that there are two main cost formula that can be used in determining the historical cost of an item of inventory which is a choice between:

- First in, first out (FIFO); and
- Weighted average cost

(ii) Depreciation:

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. The depreciation method used should reflect the way in which the economic benefits of the asset are consumed by the business over time. The main choice is between:

- The straight line method (also known as the fixed instalment method) and
- The reducing balance method (also known as the diminishing balance method).
- Units of production method
- Sum-of-the-years'-digit method

EXAMINER'S REPORT

The question tests candidates' knowledge of preparation of final accounts. Part 'a' of the question tests treatments of property, plant and equipment and investment property in the financial statements, while part 'b' requires candidates to prepare statement of profit or loss, statements of changes in equity and statement of financial position and part 'c' requires candidates to state factors that Management of a company should consider when selecting accounting policies.

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

The commonest pitfall was the inability of the candidates to explain the treatment of property, plant and equipment and investment property in accordance with the relevant IFRS. Similarly, some candidates could not prepare draft statement of profit or loss analysing expense by nature rather most of them prepared the statement analysing expenses by function.

Candidates are advised to pay more attention to preparation of final accounts and application of relevant accounting standards for better performance in future examinations of the Institute.

Marking Guide

		Marks	Marks
a.	Answers to issues raised by Non Finance MD		
I	Basis for classification:		
	• Explanation of property, plant & equipment	1	
	• Explanation of investment property	1	
	• Examples of properties which are not investment property	1	3
ii	Measurement of investment property:		
	• Initial measurement at cost	1	
	• Subsequent measurement at fair value	1	
	• Where fair value is impossible to be determined	1	3
iii	Measurement of property, plant & equipment:		
	• Initial measurement at cost	1	
	• Subsequent measurement at cost or revaluation	1	
	• Stating consistency use of the chosen model	1	3
iv	Treatment of gain or loss on fair value of investment property:		
	• Gain or loss on fair value of investment property to be reported in statement of profit or loss for the period	1	
	• Gain in Revaluation of PPE to be reported under other comprehensive income for the period	1	
	• Exception to recognizing surplus under other comprehensive income	1	3
			12
b i.	Preparation of statement of profit or loss:		
	• Title of statement	¼	
	• Determination of profit before tax	3	
	• Determination of Profit for the year	1	
	• Workings for statement of profit or loss	1¾	6
ii	Preparation of statement of changes in equity:		
	• Title of statement	¼	
	• Presentation	3¾	4
iii	Preparation of statement of financial position:		
	• Title of statement	¼	
	• Determination of PPE	1¾	
	• Determination of total non-current assets	¾	
	• Determination of total current assets	1¼	
	• Determination of total equity	1	
	• Determination of total liabilities	1	6
	•		16
c	Factors to be considered when selecting and applying		

	accounting policies in the absence of IFRS		
	• Management must use its judgement to develop and apply an accounting policy	1	
	• The accounting policies to provide information which is reliable in the financial statements	1	
	• The accounting policy to represent faitfully the result and financial position	1	
	• Provide information which are neutral	1	
	• Provide information which are prudent	1	
	• Provide information which are complete	1	
	• The requirements and guidance in IFRS dealing with similar item	1	
	• Recent pronouncement of other standard setting bodies that use a similar framework	1	
			8
i	Inventories:		
	• First –In-First-Out (FIFO)	1	
	• Weighted Average Cost (AVCO)	1	
ii	Depreciation:		
	Any 2 correct methods of depreciation	2	4
			12
	Total		40

SOLUTION 2

(a) (i) CURRENT TAX

- Current tax is the amount of income tax payable or recoverable in respect of the taxable profit or loss for a period. At the end of a reporting period, an estimated amount usually by applying the corporate tax rate in force to accrue for the amount of tax payable based on the year profit. The tax charged is accounted for as follows:

  Dr - Profit or loss account
  Cr - Tax payable
- It is the amount payable to the tax authority in relation to the trading activities.

(ii) DEFERRED TAX

- Deferred tax is the tax consequence of future recovery/settlement of the carrying amount of assets/liabilities that are recognized in an entity statement of financial position.

- Deferred tax is not a current liability or an asset. Deferred tax arises because profit before taxation for accounting purposes is not the same amount as taxable profit for taxation purpose. That is a temporary difference.

- It is also an accounting measure used to match the tax effect of transactions with their accounting impact.

It is calculated as: temporary difference x tax rate

(b) (i) Current income tax for the year end December 31, 2018

	₦'000
Profit per a/c	121,000
Add: depreciation	11,000
	132,000
Less:	
Capital allowance	(15,000)
Taxable profit	117,000
Current tax payable @ 30%	35,100
Deferred tax as at December 31, 2018	
	₦'000
Carrying amount	49,000
Tax base (60,000 – 15,000)	(45,000)
Temporary difference	4,000
Deferred tax liability (30% x 4,000)	1,200

ii. DANRUWA NIG. LTD

Statement of profit or loss for the year ended December 31, 2018

	₦'000	**₦'000**
Revenue		270,000
Less:		
Admin expenses and other expenses	138,000	
Depreciation	11,000	
		149,000
Net profit before taxation		121,000
Income tax expenses - current	35,100	
- Deferred tax	1,200	(36,300)
Profit for the year		84,700

EXAMINER'S REPORT

The question tests candidates' knowledge and application of IAS 12 - Income Tax.

Most of the candidates did not attempt the question, which could be a reflection of candidates not being familiar with this accounting standard.

Most of the candidates that attempted the question could not correctly explain the meaning of deferred tax, while others could not correctly calculate the deferred tax liability as at year end and this led to loss of marks.

Candidates are advised to ensure that they cover all sections of the syllabus, particularly all relevant accounting standards at the skills level of the Institute's examination for better performance in future.

Marking Guide

		Marks	Marks
a i.	Current tax		
	• Explanation of current tax	1	
	• Accounting for current tax	1	
ii	Deferred tax		
	• Explanation of deferred tax	1	
	• Causes of temporary difference	1	
	• Matching tax effect of transactions with their accounting impact	1	5
b i.	Calculation of current and deferred tax:		
	• Calculation of current tax	5	
	• Calculation of deferred tax	5	10
ii.	Preparation of statement of profit or loss		
	• Determination of profit before tax	3	
	• Determination of profit for the year	2	5
	Total		**20**

SOLUTION 3

Family Plc		
Consolidated statement of financial position as at September 30, 2019		
Non-current assets	**₦'m**	**₦'m**
Office building complex (5,000 + 1,920)		6,920
Plant and machinery (7,000 + 6,000)		13,000
		19,920

Current assets		
Inventory (3,600 + 1,900 – 48)	5,452	
Trade receivables (4,100 + 1,700 – 72)	5,728	
Other receivables (300 + 20 - 120)	200	
Tax assets	100	
Bank balance (1,440 + 840)	2,280	
Total current assets		13,760
Total assets		33,680
Equity and liabilities:		
Ordinary shares of ₦1.50 each		21,600
Retained earnings (wk. 7)		1,704
		23,304
Non-controlling interest (wk. 5)		3,560
Total equity		26,864
Current liabilities:		
Trade payables (2,000 + 280 – 72)	2,208	
Other payables (928 + 200 - 120)	1,008	
Overdraft (1,680 + 1,920)	3,600	
Total current liabilities		6,816
Total equity and liabilities		33,680

Working Notes

Wk. 1: Determination of total number of shares and percentage holdings	
Total nominal value of ordinary shares (₦'m)	9,600
Par value per share (₦)	1.50
Total number of ordinary shares in existence = 9,600/1.5 = 6,400million	
Number of ordinary shares acquired by Family Plc = 4,800million	
Percentage holding = 4,800/6,400 x 100 = 75%	
Wk. 2: Group structure	
Family Plc ---------------75%--------------- Children Ltd	
NCI = (100% - 75%) = 25%	

Wk. 3: Net asset of subsidiary	at rep. date	at acq. date	post-acq.
	₦ 'm	₦ 'm	₦ 'm
Ordinary share	9,600	9,600	-
Retained earnings	480	144	336
	10,080	9,744	336

Wk. 4: Determination of goodwill on acquisition

		₦'m	

Consideration transferred by parent		6,028	
NCI at fair value		3,396	
		9,424	
Less: Net assets of subsidiary at acquisition		(9,744)	
Gain on bargain purchase		(320)	
Wk. 5: Valuation of NCI		₦ 'm	
NCI at acquisition (Wk. 4)		3,396	
Add: Share of post-acquisition profit (25% x 336)		84	
Add: Share of gain on bargain purchase (25% x 320)		80	
		3,560	
Wk. 6: Unrealised profit		₦'m	
20/120 x 576 x ½		48	
Wk. 7: Consolidated retained earnings		₦ 'm	
Family Plc		1,260	
Add: Share of post-acquisition profit (75% x 336)		252	
Add: Share of gain on bargain purchase (75% x 320)		240	
Less: Unrealised profit (Wk. 6)		(48)	
Consolidated retained earnings		1,704	
Wk. 8: Intra-group dividend		₦'m	
4,800 x 2.5k		120	

EXAMINER'S REPORT

The question tests candidates' knowledge of preparation of consolidated financial statements.

About 90% of the candidates attempted the question and performance was above average.
The commonest pitfalls were the inability of some candidates to correctly determine the unrealised profits and compute the non-controlling interests.

Despite the above average performance of most of the candidates, it is still important for other candidates that performed below average to improve on their performance, by ensuring that they cover all sections of the syllabus, particularly the group accounts.

Marking Guide

	Marks	Marks
Preparation of consolidated statement of financial position:		
• Title of statement	½	
• Determination of total non current assets	1½	
• Determination of total current assets	3½	
• Determination of equity	1½	
• Determination of non controlling interest	2½	
• Determination of current liabilities	2½	
• Calculation of goodwill on acquisition	3½	
• Calculation of unrealised profit	½	
• Calculation of consolidated retained earnings	2½	
• Calculation of group structure	1½	20
Total		20

SOLUTION 4

4(a) (i) Substance over form

- This means recording the substance of transaction (and other events) requires them to be treated in accordance with economic reality or their commercial intent rather than in accordance with the way they may be legally constructed.

- This is an important element of faithfully representation.

- A good example of substance over form is a lease "transaction" where the lessee is allowed to recognize asset in its financial statement.

(ii) Going concern assumption

- It is a concept which assumed that a business entity has neither the intention nor necessity of liquidation or curtailing materially, the scale of its operation in the foreseeable future. That is, an entity is expected to continue till perpetuity.

  This is one important exception to the rule that the financial statements show evidence of the condition that exists at the end of the reporting period.

- A deterioration in operating results and financial position after the end of the year may indicate that the going concern presumption is no longer appropriate.

- There are some circumstances that could lead to going concern problems for example:

- Financial difficulty of a major customer leading to her inability to pay their debt.

- A change in market condition leading to loss in value of major investment.

- Shortage of important supplies.

- If it becomes clear that the client cannot be considered to be a going concern, then the financial statements will need to disclose this and the basis for preparing them will change to the break-up basis.

- This means that values will have to be adjusted to the amount expected to be realised through sales.

(b) Differences between provisions, contingent liabilities and contingent assets as contained in IAS 37 provisions

These are liabilities of uncertain amount or timing, which would have arisen from past events and settlements of which is expected to result to an outflow of economic benefits from the entity.

According to IAS 37, provisions should only be recognized:

- If it is probable that settlement resulting to outflow of economic benefits will take place.

- An entity has a present obligation either legal or constructive.
- Amount of such provisions can be reliably measured.
- Examples of item to provide for include:

Warranty, environmental damage, cost of decommissioning and restoring a site to its acceptable standard, cost of restructuring within an organization. However, provision should not be made for the following; future operating losses, proposed dividend, future expenditure or major repairs.

Contingent liabilities

- These are possible obligations arising from past events and whose existence will be confirmed only by the occurrence or non-occurrence of some uncertain future events which are not within the control of the entity.

- A liability is said to be contingent if it is not probable that settlement resulting to outflow of economic benefits from the entity will take place.

- If settlement of a liability is probable, then it is no longer a contingent liability but a provision.

- The word probable means an event is more than 50% likely to occur. The main difference between provision and contingent liability is the word "probable".

- According to IAS 37, contingent liabilities should not be recognized but should only be disclosed in the notes to the account.

Contingent assets

- These are possible assets arising from past events and whose existence will be confirmed by the occurrence or non-occurrence of some uncertain future events which are not within the control of the entity.

- If it is only probable that a possible asset will result to inflow of economic benefits to the entity then, it is a contingent asset. However, if it is virtually certain that an entity will receive inflow of economic benefits then, the entity should recognize an asset.

- This means the main difference between contingent asset and asset is the word "probable" and virtually certain" i.e. if receipt of an asset is only probable, then it is a contingent asset but if such receipt is virtually certain, then an asset is recognized.

- According to IAS 37, Contingent assets should not be recognized but should only be disclosed in the notes to the account.

EXAMINER'S REPORT

The question tests candidates' knowledge of accounting concepts and underlying assumptions.

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

Most of the candidates were able to satisfactorily explain the concept of going concern, however, only few of them were able to explain the concept of substance over form. Also, some of the candidates could not clearly distinguish between provisions, contingent liabilities and contingent assets and this led to loss of marks.

Candidates are advised to pay more attention to all relevant accounting standards for better performance in future examinations of the Institute.

Marking Guide

		Marks	Marks
a (i)	Correct definition of substance over form	1	
	Brief explanation of substance over form	1	
	Correct example of substance over form transaction	1	
(ii)	Correct definition of going concern	1	
	Brief explanation of going concern and its effect on financial reporting	1	
	Correct example of events that could create going concern problems	<u>1</u>	
			6
B	Definition of provisions in accordance with IAS 37	1	
	Explanation of provisions and conditions under which provisions should be made	2	
	Current examples of provisions	2	
	Definition of contigent liabilities in accordance with IAS 37	1	
	Explanation of contigent liabilities	2	
	Examples of contigent liabilities and its disclosure requirements in the financial statement	2	
	Definition of contigent assets in accordance with IAS 37	1	
	Explanation of contigent assets	1	
	Examples of contigent assets and its disclosure requirements in financial statement	<u>2</u>	
			<u>14</u>
	Total		<u>20</u>

SOLUTION 5

- To: Finance Director

From: Chief Accountant

Subject: Performance of Sekiri Nig. Ltd. (our company's competitor)

(i) Profitability

- The gross profit margin has remained relatively static over the two years period with just about 1% increase during the period.

- However, the ROCE has dropped from 21.5% to 17.8%. The net profit margin also fell in year 2019 inspite of the improvement in gross profit margin.

- This is an indication of increase in expenses (overhead) which suggests that they are not well controlled.

- The utilization of assets compared to the turnover generated has also declined reflecting a drop in their trading activities between years 2018 and 2019.

(ii) Trading levels

- It is apparent that there is a drop in trading activities between year 2018 and 2019.

- Revenue also dropped from ₦4,905 to ₦4,565 this may be as a result of the effect of change in the company's product mix.

- It appears that improved credit terms granted their customers (receivable payment period from 52 to 64 days) has not stopped the drop in revenue noted above.

(iii) Working capital

- Both the current and quick ratios demonstrated an adequate working capital situation.

- There has been an increased investment over the period in inventories and receivables which has been only partly financed by longer payment period to trade payables and a rise in other payables.

(iv) Capital structure or financial stability

- The level of gearing of the company remained relatively stable although no loan notes repayment was made by the company over the period under review:

- The poor performance of the company in term of profitability made it difficult for the company to adequately cover the interest payment on the loan hence the deterioration in the interest cover over the period.

- The long term loan of the company appeared to have funded the expansion in both non-current and current assets of the company.

Thank you.

Chief Accountant

- **Areas for Further Investigation**

(i) Long term loan (loan notes)
There is no indication of the maturity date for the repayment of loan notes. There may be a need to peruse the loan agreement in order to determine if the loan convenant has been violated by paying huge dividend.

(ii) Trading activities
The consistent decline in the revenue over the years calls for corrective actions such as looking at the pricing policy of competitors to determine right pricing, use content and social media marketing to improve sales and extending credit periods and discounts to customers.

(iii) Dividend policy
The company has maintained a stable dividend over the period. Presumably the company would have been able to make part repayment of the long term loan if it has retained part of all the dividends during the period.

It might be interesting to investigate the share price movement, calculate the dividend cover, etc.

(iv) Further breakdown
It would be useful to obtain further breakdown of some information in the financial statements. Examples include;

- Sales by segments, market or geographical areas.

- Cost of sales splits into raw materials, labour, overheads.
- Expenses analysed into distribution, administrative and selling expenses.

(v) **Accounting policies**

Accounting policies may have significant effect on certain items. In particular, it would be useful to know what is the accounting policies in relation to intangible assets, and whether there are changes to the company accounting policies.

EXAMINER'S REPORT

The question tests candidates' ability to interprete financial statement based on financial ratios provided.

About 95% of the candidates attempted the question and performance was below average.

The inability of the candidates to perform above average in this question was due to the fact that the examiner has already provided the accounting ratios rather than requesting the candidates to compute it. However, candidates demonstrated poor knowledge of the application and interpretation of ratios provided, while majority of the candidates could not highlight areas that required further investigation in the light of their interpretation.

Candidates are advised to pay more attention to interpretation of financial information, rather than focus on mere computations of accounting ratios if they are to improve on their performance in future examinations at the Skills Level.

Marking Guide

		Marks	Marks
(a)	Analysis of performance of Sekiri Nig. Ltd		
	• Presentation of report in memo format	1	
	• Conclusion of report	1	
	• Justification of profitability position of the competitor	2	
	• Assessing the trading level of the competitor	2	
	• Reviewing the working capital position of the competitor	2	
	• Capital structure and financial stability of the competitor	2	
			10

(b)	Areas for further investigation		
	• Identification of (5) areas that requires further investigation	5	
	• Explanation of issues to be investigated under each areas identified	5	
			10
	Total		20

SOLUTION 6

(a) Five steps to be followed for revenue recognition under IFRS 15

(i) Identify the contract(s) with customer.
(ii) Identify the performance obligation in the contract create.
(iii) Determine the transaction price.
(iv) Allocate the transaction price to each of the separate performance obligations.
(v) Recognize the revenue associated with each performance obligation as the performance obligation is satisfied.

How IFRS 15 is expected to improve revenue recognition

- The IASB issued IFRS 15 because the existing criteria for revenue recognition outlined in IAS 11 on contract and IAS – 18 on revenue where considered subjective.
- It was difficult to verify the accuracy of the reported figure for revenue and associated costs.
- One of the fundamental quantitative characteristics of useful financial information which is referred to in the IASB conceptual framework is faithful presentation.
- Information needs to be verifiable in order to ensure it meets this fundamental characteristics.
- IFRS 15 provides a more robust framework upon which to base revenue recognition decision thus increasing the verifiability of the revenue figures hence its usefulness.
- IFRS 15 also reduces window dressing of the financial statements and it maintains the credibility for the entity's finances.

(b)		**Performance obligation standalone contract**	**%**	**Combined contract (Revenue)**
		₦		**₦**
				(27.27% x 250,000)
	Handset	75,000	27.27	68,175
				(72.73% x 250,000)
	Network Services	200,000	72.73	181,825
		275,000	100	250,000

Revenue recognition for the year end September 30, 2019

	₦
Revenue on handset (one-off)	68,175
Revenue network services ($^1/_2$ x 181,825)	15,152
Total revenue for year 2019	83,327

Revenue recognition for the year ended September 30, 2020

	₦
Network services only ($^{11}/_{12}$ x 181,825)	166,673

(c)

- When the customer has a right to return products, the transaction price contains a variable element.
- Since this can be reliably measured, it is taken into account in measuring the revenue and the total revenue will be ₦19,200,000 i.e. (₦200,000 x 96).
- ₦20,000,000 i.e. (₦200,000 x 100) will be recognized as receivable.
- It implies that ₦800,000 i.e. (₦20,000,000 less ₦19,200,000) will be recognized as a refundable liability. This will be shown as current liability.
- The total cost of goods sold is (₦160,000 x 100) = ₦16,000,000 of this amount only ₦15,360,000 i.e. (₦160,000 x 96) will be shown as cost of sales.
- The other ₦640,000 i.e. (₦16,000,000 – ₦ 15,360,000) will be shown as a right of return assets under current assets (inventory).
- Reported Gross Profit = ₦3,840,000 (i.e ₦ 19,2000,000 – ₦ 15, 360,000)

EXAMINER'S REPORT

The question tests candidates' knowledge on application of IFRS 15 on Revenue from Contract Customers.

About 50% of the candidates attempted the question and performance was below average.
The commonest pitfall of the candidates was their inability to answer the computational aspect of the question (i.e. part 'b' and part 'c') which requires the application of the provisions of IFRS 15 and this led to loss of marks.

Candidates are advised to pay more attention to all relevant accounting standards at skills level of the Institute's examinations for better performance in future.

Marking Guide

		Marks	Marks
a (i)	Five step model identified	2½	
(ii)	Explanation of how IFRS 15 is expected to improve financial reporting of revenue	3½	
			6
B	Apportionment of revenue based on stand alone contract	5	
	Computation of revenue for year 2019	3	
	Computation of revenue for year 2020	2	
			10
C	Explanation of the computation of revenue to be recognised	1	
	Explanation of the computation of cost of sales to be recognised	1	
	Determination of refundable liability	1	
	Determination of Right of Return of assets	1	
			4
	Total		20

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – NOVEMBER 2019

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

Boniface Bank Limited placed an advert in the national dailies requesting for proposals for external audit services.

You are provided with the following information:

Boniface Bank Limited was licensed as a commercial bank in 2018. The shareholders' fund is ₦25billion and the bank is mainly in the retail business. The bank is a national bank with presence in the state capitals of the six geo-political zones in Nigeria. The bank is gaining recognition as an institution that finances small and medium scale enterprises in the country.

The policy of the bank is to have an auditor for a 10-year tenure and a partner rotation every five years.

Scope of work

In line with best practices, external auditors are expected to be independent and conduct the audit of the books of the bank in conformity with the International Financial Reporting Standards (IFRS) and the International Standards on Auditing (ISA). They are also expected to provide other services as the need arises that will not compromise their independence.

To be specific, the successful firm will be required to:

Conduct an audit and report on the state of affairs and operations of the bank for the year ended December 31, 2018;
- Advise management on the treatment and disclosures of certain items in the financial statements as the need arises, for example, new and revised standards;
- Make presentations to shareholders on the state of affairs and operations of the bank at the Annual General Meeting; and
- Present the management letter on weaknesses identified during the audit.

Qualifications of the firm

The audit firm to be selected should have at least six partners with good quality control processes and a robust audit software. In addition, the firm must have subject matter experts in the International Financial Reporting Standards.

The proposal should state the firm's experience in bank audits, fee quote, the proposed engagement team, the audit approach and relevant activities for smooth operation of the audit including steps necessary to conduct an hitch-free audit.

Independence

The proposal should indicate how the firm will ensure that it maintains her independence and avoids conflicts of interest throughout the period of appointment as auditors.

Submission

You are expected to submit your proposal not later than 5p.m. on December 13, 2018.

The shortlisted firms shall be invited for presentations as soon as possible and will be finally contacted for follow up interviews if successful.

(For any further clarification, please contact Olaolu Aki on 0071562534.)

The partners of your firm are interested in the proposal of Boniface Bank Limited. You have been requested to make input for the proposal as soon as possible.

Required:

Discuss the following:

a. Objectives of the external audit of Boniface Bank Limited. (4 Marks)

b. Eligibility for qualification as external auditor. (10 Marks)

c. Rights and duties of external auditors under the Companies and Allied Matters Act CAP C20 LFN 2004. (10 Marks)

d. Responsibility of management and those charged with governance. (10 Marks)

e. Requirements of auditors in relation to International Standards on Auditing (ISA 200). (6 Marks)

(Total 40 Marks)

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

QUESTION 2

The Financial Reporting Council of Kalagi, when performing a review of the financial statements of Yakoyo Plc., detected some errors and disclosure deficiencies which were brought to the attention of the management of the company. The management put the blame on the company's auditors and accused them of negligence.

The management of the company had earlier commissioned a consultant to review the company's internal control procedures. The report of the consultant revealed significant weaknesses in internal controls which did not feature in the external auditor's management letter.

In view of this, the company management believes that the external auditors are responsible for preparing the financial statements and should have detected and rectified all these issues.

You are a chartered accountant and an informed shareholder of the company.

You are required to explain:

a. "Expectation gap" in audit (5 Marks)

b. How the expectation gap can be bridged ($7^1/_2$ Marks)

c. Why an auditor may not detect fraud ($7^1/_2$ Marks)

(Total 20 Marks)

QUESTION 3

A financial analyst in his contribution at a seminar, stated that audited financial statements show the records of stewardship of a company's activities and the financial position of a company at the end of a period.

The financial report has input from key stakeholders who must perform their duties well and in an objective manner. In view of this, the report should give confidence to the users of the financial statements and support good corporate governance. The financial report is used for decision making and is prepared based on management estimates, judgement, assumptions and reliable evidence.

As a chartered accountant, you have been invited to make a contribution at the seminar in support of the statement of the analyst:

You are required to discuss:

- Parties to an audit assurance process, stating their duties and rights. ($4^1/_2$ Marks)
- When a professional should accept an assurance engagement. (8 Marks)
- How to recognise a reliable evidence in an audit and assurance engagement. ($7^1/_2$ Marks)

(Total 20 Marks)

QUESTION 4

During the review of the internal control activities of VIDA Plc., the Chairman of the Audit Committee stated in his concluding remarks that in any organisation, we may conclude that an entity has an effective control environment if management is committed to accurate financial reporting with the support of effective internal control system.

The **control** process assists the organisation to embark on proper data analysis and information management that will enable the business and its employees function effectively. Control focuses on activities before, during and after daily operations to ensure safeguards and management of assets to enable the organisation achieve its aims and objectives. An effective and efficient system of internal control will give great returns to shareholders and ensure transparent financial reporting.

Required:

Justify the above statement by identifying and explaining:

- Characteristics of an effective internal control system (8 Marks)
- Different types of internal control systems (6 Marks)
- Main components of internal controls (6 Marks)

(Total 20 Marks)

QUESTION 5

Your firm has just recruited some audit trainees. It is the practice of the firm to give orientation to the newly recruited so that they could be familiar with the firm's operations, especially before the commencement of an audit busy season.

As an audit senior in the firm, you have been directed to facilitate at the programme for the newly hired trainees. You were allocated a topic on the archiving and retrieval of audit documents for a current year audit.

Required:

Based on your experience over the years, discuss:

a. Audit working paper archiving (1 Mark)

b. The purposes of audit working papers archiving (6 Marks)

c. The types, contents and importance of audit working papers files (8 Marks)

d. The owner of audit working paper files and the conditions under which access to them could be granted to a third party. (5 Marks)

(Total 20 Marks)

QUESTION 6

A whistle blower reported to a regulator a misstatement in the financial statements of Koko Limited on overstated expenses and overvaluation of inventory.

An informed shareholder at the Annual General Meeting while commenting on the company's financial statements stated that the company directors should always act in the public interest.

You are required to explain:

a. 'Acting in the public interest' (6 Marks)

b. Professional scepticism (4 Marks)

c. The fundamental principles a professional accountant should comply with (10 Marks)

(Total 20 Marks)

SOLUTION ONE

In relation to the advert placed by Boniface Bank Limited, the following are to be discussed.

a. The objectives of the external audit of Boniface Bank Limited include:

- Statutory

- To enable the auditor express an opinion on whether the financial Statements he has examined give information as required by the Companies and Allied Matters Act CAP C20 LFN 2004 and give a true and fair view of the financial position of the company.

  The bank's approved auditor is also required to report to the shareholders whether the financial statements of Boniface Bank Limited comply with the requirements of the Central Bank of Nigeria.

- Regulatory

  To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatements, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

- To report on the financial statements, and communicate as required by International Statements on Auditing (ISAs), in accordance with the auditor's findings

b. For a person to be eligible as external auditor he must:

- Be a member of a body of accountants in Nigeria established from time to time by an Act;
- Not be an officer or servant of the company;
- Not be a partner of or in the employment of an officer or servant of the company;
- Not be a person or firm who offers to the company a professional advice in a consultancy capacity in respect of secretarial, taxation or financial management;
- Not be a body corporate;
- Not be a disqualified auditor of the company's subsidiary or holding company;
- Be approved by the Central Bank of Nigeria; and
- Must be resident in Nigeria.

c. As stated in Sections 360 and 363 of the **Companies and Allied Matters Act CAP C20 LFN 2004 –**

   a. **Rights of the external auditors include:**

   - Right of access to the company's books, accounts and vouchers;
   - Right to all information and explanations as he thinks necessary for the proper conduct of the audit;

- Right to attend any general meeting of the company and be heard;
- Right to receive notices and other communication relating to any general meeting; and
- Right to receive copies of all written resolutions of a company where applicable.

b. Duties of the external auditors

It shall be the duty of the company's auditors in preparing their report to carry out such investigations and state whether:

- He has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of the audit;
- The company has kept proper books of accounts, so far as appears from his examination of those books;
- The company's financial position and its statement of profit or loss, and other comprehensive income are in agreement with the books of accounts and returns;
- The information given in the directors' report for the year is consistent with the financial statements; and
- The company has complied with the requirements of any relevant laws or circulars issued by regulators.

c. Responsibility of management and those charged with governance is to:

- Ensure proper keeping of the accounting records of the company which disclose with reasonable accuracy the financial position of the company;

- Ensure setting of proper internal control for prevention and detection of fraud in the entity;

- Lay before the shareholders at the annual general meeting copies of the financial statements of the company;

- Prepare in respect of each year a report of their activities to be included in the financial statements;

- Appoint auditors and approve their remunerations;

- Provide the external auditor necessary information relevant to the audit; and

- Provide written representations to the auditor at the end of the audit.

d. Requirements of auditors in relation to International Standards on Auditing (ISA 200) include:

i. Identify and assess risks of material misstatements, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control;

ii. Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks;

iii. Form an opinion on the financial statements, or determine that an opinion cannot be formed, based on an evaluation of the audit evidence obtained;

iv. Comply with all **ISAs** relevant to the audit;

v. Comply with relevant ethical requirements;

vi. Plan and perform an audit with professional scepticism; and

vii. Exercise professional judgement in planning and performing an audit

EXAMINER'S REPORT

The question which is in parts (a) to (e) is compulsory. The question tests candidate's knowledge of:

Part (a) - Objectives of the external audit of a bank;
Part (b) - Eligibility for qualification as external auditor;
Part (c) - Rights and duties of external auditors under Companies and Allied Matters Act CAP C20 LFN 2004;
Part (d)- The responsibility of management and those charged with Governance; and
Part (e)- Requirements of auditors in relation to ISAs.

All the candidates attempted the question. Their understanding of the question generally was average. The performance of the candidates was average.

The commonest pitfalls were:

- The inability of the candidates to correctly state the responsibility of management and those charged with governance and requirements of auditors in relation to ISAs.
- Not proffering solutions to the composite parts of the question as in part (c) whose candidates restricted their solutions to either "rights" or "duties" respectively only.

Candidates are advised to interpret the requirements of a question well before proffering solutions.

Marking Guide

		Marks	Marks
1a	Objectives of external audit (2 marks each for every point stated (maximum of 2 points))		4
b	Eligibility for qualification as external auditor (2 marks each for every point explained (maximum of 5 points))		10
c	Rights of external auditors according to CAMA (2 marks each for every point highlighted (maximum of 2))	4	
	Duties of external auditors according to CAMA (2 marks each for every point explained (subject to maximum of 3 points.))	6	10
d	Responsibility of management and those charged with governance (2 marks each for every point stated (maximum of 5 points))		10
e	Requirements of auditors in relation to ISA (2 marks for every point stated (maximum of 3 points))		6
	TOTAL		**40**

SOLUTION TWO

2. Financial Reporting Council of Kalagi

a "Expectation gap" in audit

This can be explained as follows:

- Auditing expectation gap or simply expectation gap is the term used to signify the **difference in expectations of users of financial statements and auditor's expectation concerning audited financial statements**;

- Difference in "expectation" can arise on the performance, that is, the level of performance that users expect from auditors and how they actually perform;

- It is the public "expectation" that the auditor has a duty to prevent and defect fraud as this is an important reason for the audit; and

- The public believes that the audit opinion in the auditors' report amounts to a certificate that the financial statements are perfectly correct and should be relied upon for decision making processes like investments.

b The expectation gap can be bridged in the following ways:

- Users must understand that auditors can only provide reasonable assurance and not the absolute assurance. Users must understand that general purpose financial statements are meant for general needs of users and even if they have been audited in a best way possible but it does not mean audited financial statements can help in all decision making situations;

- Users must realize that auditor's work is relative to circumstances that require use of judgment which may be wrong. Although auditor works diligently, it does not always mean if judgment is wrong then auditor is guilty of ignorance; rather it will be assessed based on what auditor could possibly do and what he actually did;

- Although management is required to produce financial statements in a way that are easy to understand yet users are also expected to have certain degree of relevant knowledge on how to use and interpret financial statements. All financial statements are not for everyone to read and act upon;

- For auditor to understand users' expectations, they needs to arrange workshops or seminars so that users at least feel that they have been heard. Auditors must not rule out everything on the basis of lack of knowledge on part of users;

- Auditor must make audit reports easy to understand for the public and avoid, to great extent, any technical jargon that can impair ordinary person's understanding who lacks skilful insight of financial statements; and

- Auditor is already providing less than absolute assurance so he must not leave any effort undone to maintain reasonable level of assurance by complying with the requirements of relevant auditing standards. For example, proper planning, appropriate understanding of entity to design further audit procedures, maintaining sceptic attitude and reducing sampling risk to appropriate level.

c Reasons why an auditor may not detect fraud

The reasons why an auditor may fail to detect fraud and possibly material misstatements due to fraud include:

- It is not the auditor's primary duty and responsibility to detect fraud;

- The use of selective testing auditors approach is based on sampling technique;

- Fraud perpetrated by management members or through collusion among key staffs as a group may be difficult to detect;

- The extent of timing available for audit exercise and the need to meet reporting time requirement;

- The inherent limitations of internal control;

- Management override of internal controls;

- The fact that much of the evidence available to the practitioner is persuasive rather than conclusive;

- The use of professional judgment in gathering and evaluating evidence and forming conclusions based on that evidence; and

- Fraud prevalent factors on some members of management which may manifest through the inclusion of deliberate misstatements in financial statements.

EXAMINER'S REPORT

The question tests candidates' knowledge of "expectation gap" in audit and detection of fraud.

About 30% of the candidates attempted the question. The understanding displayed was low especially for parts (a) and (b) relating to expectation gap. The performance shown by candidates was then relatively low.

Candidates' shortcoming was their inability to explain expectation gap correctly. Candidates are advised to cover the syllabus well and make use of the Institutes' study text.

Marking Guide

		Marks	Marks
a.	Expectation Gap (2 ½marks for each point explained maximum of 2 points)		5
b.	How the expectation can be bridged (1½ marks each for a maximum of 5 points)		7½
c.	Why an auditor may not detect fraud (1½ marks each for a maximum of 5 points)		7½
	TOTAL		**20**

SOLUTION THREE

a. Parties to an audit assurance process, their duties and rights are as follows:

- Practitioner (auditor) – The individual providing professional service that will review the subject matter and provide the assurance using suitable criteria, for example, a chartered accountant, the audit firm, in a statutory audit;

- Responsible-party (Management) – The person(s) responsible for the subject matter, for example, the directors are responsible for preparing the financial statements to be audited;

- Intended users (stakeholders) – This is the person or class of persons to whom the report will be addressed for their specific usage. The intended user may be established by an agreement or law, while the responsible party may also be the intended users for example, the shareholders in a statutory audit.

b. Conditions for a professional to accept an assurance engagement

A practitioner accepts an assurance engagement only where the practitioner's preliminary knowledge of the engagement circumstances indicates that:

- Relevant ethical requirements, such as independence and professional competence will be satisfied; and

ii. The engagement exhibits all of the following characteristics:
  - The subject matter is appropriate;
  - The criteria to be used are suitable and are available to the intended users;
  - The practitioner has access to sufficient appropriate evidence to support the practitioner's conclusion;
  - The practitioner's conclusion, in the form appropriate to either a reasonable assurance engagement or a limited assurance engagement, is to be contained in a written report; and
  - The practitioner is satisfied that there is a rational purpose for the engagement.

c. How to recognise the reliability of audit and assurance evidence

There are a number of general principles set out in ISA 500 to assist the auditor in assessing the reliability of audit evidence. The reliability of audit evidence is largely influenced by its type and sources. It can be oral or documentary and can be self-generated, externally generated or internally generated.

These can be summarised as follows:

- Internally generated audit evidence is more reliable when the related controls are effective and management comprises people of integrity. ISA 500 requires that the auditor should be satisfied as to the accuracy and reliability of any internal evidence used in reaching a conclusion;

- Audit evidence is more reliable when it is obtained from independent sources outside the entity under audit. There is usually a synergy when external evidence is in agreement with internal evidence;

- Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference, for example, observation of the operation of a control by the auditor is more reliable than inquiry about the operation of that control;

- Audit evidence is more reliable when it exists in documentary form other than oral in nature. This could be paper, electronic or other medium, for example, a written record of a meeting made at a time is more reliable than a subsequent oral representation of the matters discussed; and

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

EXAMINER'S REPORT

The question tests candidates' knowledge of the audit assurance process and audit evidence.

More than 75% of the candidates attempted this question. Their performance was poor for part (b) wherein candidates did not understand the conditions for a professional to accept an audit assurance engagement.

The commonest pitfall was their inability to study or recognize this area very well.

Candidates should make good use of the Institute's study text and publications when studying for subsequent examinations.

Marking Guide

		Marks	Marks
a.	Parties to assurance process, rights and duties (1½ marks each for every point stated maximum of 3 points)		4½
b.	Conditions for a professional to accept assurance engagements (2 marks for every point stated and discussed maximum of 4 points)		8
c.	How to recognise the reliability of audit and assurance evidence (1½ marks each for every point and discussed subject to maximum of 5 points)		7½
	TOTAL		**20**

SOLUTION FOUR

VIDA PLC

a. The characteristics of an effective internal control include:

i. **Accuracy**

Effective controls generate accurate data and information. Accurate information is essential for effective managerial decisions. Ineffective controls would divert management efforts and energies on problems that do not exist or have a low priority and would fail to alert managers to serious problems that do require attention;

ii. **Timeliness**

There are many problems that require immediate attention. If information about such problems does not reach management in a timely manner, then such information may become useless and damage may occur. Accordingly, controls must ensure that information reaches the decision makers when they need it so that a meaningful response can follow;

iii. **Flexibility**

The business and economic environment is highly dynamic in nature. Technological changes occur very fast. A rigid control system would not be suitable for a changing environment. These changes highlight the need for flexibility in planning as well as in control.

Strategic planning must allow for adjustments for unanticipated threats and opportunities. Similarly, managers must make modifications in controlling methods, techniques and systems as they become necessary. An effective control system is one that can be updated quickly as the need arises;

iv. **Acceptability**

Controls should be such that all people who are affected by it are able to understand them fully and accept them. A control system that is difficult to understand can cause unnecessary mistakes and frustration and may be resented by employees;

Accordingly, employees must agree that such controls are necessary and appropriate and will not have any negative effects on their efforts to achieve their personal as well as organizational goals;

v. **Integration**

When the controls are consistent with corporate values and culture, they work in harmony with organizational policies, hence are easier to enforce. These controls become an integrated part of the organisational environment and thus become effective;

vi. **Economic feasibility**

The cost of a control system must be balanced against its benefits. The system must be economically feasible and reasonable to operate, for example, a high security system to safeguard nuclear secrets may be justified but the same system to safeguard office supplies in a store would not be economically justified. Accordingly the benefits received must outweigh the cost of implementing a control system;

vii. **Strategic placement**

Effective controls should be placed and emphasized at such critical and strategic control points where failures cannot be tolerated and where time and money costs of failures are greatest.

The objective is to apply controls to the essential aspect of a business where a deviation from the expected standards will do the greatest harm. These control areas include production, sales, finance and customer service;

viii. **Corrective action**

An effective control system not only checks for and identifies deviation but also is programmed to suggest solutions to correct such a deviation, for example, a computer keeping a record of inventories can be programmed to establish "if-then" guidelines. If inventory of a particular item then drops below five percent of maximum inventory at hand, the computer will signal for replenishment for such items.

ix. **Emphasis on exception**

A good system of control should work on the exception principle, so that only important deviations are brought to the attention of management. In other words, management does not have to bother with activities that are running smoothly. This will ensure that managerial attention is directed towards error and not towards conformity. This would eliminate unnecessary and uneconomic supervision, marginally beneficial reporting and a waste of managerial time.

b. **Different types of internal control systems include:**

i. **Budgetary/performance reviews** - These include reviews and analyses of actual performance against budgets, forecasts and prior period performance, including management accounting techniques such as variance analysis;

ii. **Management controls** - They include supervision by management of the work of subordinates, management, setting goals and targets and policy formulation;

iii. **Information processing** - A variety of controls are used to check the accuracy, completeness and authorisation of transactions. These controls are split into two broad grouping which are stated below:

Application controls; and
General IT controls.

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

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

vi. **Organisation** - There should be an organisational structure in place that defines and allocates responsibility as well as identifies lines of reporting.

c. **The main components of internal control are:**

- **Control environment**

It simply means controlled environment of the entity in which operations of the business are carried out. It is this control environment that keeps anyone in the entity from committing any wrong doing. If management is honest and encourages honesty and is strict towards falsehood, then employees would expect harsh consequences and only this will prevent the employees to commit any fraud individually or in collusion with others. It supplements the other functions (components) of internal control system.

An auditor is required to obtain understanding whether such environment has been developed by management through its management philosophy and behaviour in the entity;

- **Risk assessment process**

  One of the key roles of internal control system is to prevent or identify and correct misstatements. However, an entity would not wait for misstatements to happen only it should be prevented or detected and corrected. Most of the time an entity establishes its own risk assessment process to identify the risk of material misstatements happening before time. An Auditor obtains understanding of how the entity's risk assessment process whether, it is working as per expectations in the light of business risk or not by considering:

  - expected risks;
  - effects of such risks;
  - likelihood that risk will occur; and
  - decisions taken to control or mitigate such risks.

- **Information and communication**

  Information in every aspect of our lives including business environment has taken a pivotal role. During audit engagement, an auditor gains understanding regarding the information and communication system of the entity that acts as one of the components of internal control system. However, information system does not only mean the accounting system. It is the system through which an entity or to be precise, management, establishes and communicates within and outside the entity.

  An Entity's information system must not be confused with information technology. Although these days IT has helped us develop much better information systems, information system is simply a system through which an entity records, processes and communicates information regarding its financial position, performance, etc. and this system can be in manual form and even today around the world manual information system is maintained alongside IT based information system. Information system helps entity to capture business transactions and classify, measure, records and report on timely basis and in this process IT can help us in different ways

- **Control activities**

  Control activities are put in place by the management to make financial information authentic and reliable, for example, debtors cannot be written off without permission of the Finance Director or any other person given authority to write off debts. Similarly, credit sales cannot be made unless recommendation is sought from credit control department. Such control activities are in the nature of authorization.

Requirement to enter password to access certain modules of information system is an example of control activities. Similarly a validation check in the database system to make sure that contact number of supplier can only be in numbers or email address has been entered in a particular format containing symbols. All such checks will ensure that information is accurate; and

- **Monitoring**
  The last component of an internal control system is monitoring process. It can be considered as an in-built service to the internal control system that assesses the effectiveness of the entire internal control system. Monitoring process is carried out evaluating the current operations of internal control system and separate evaluations that include routine and non-routine system checks. Such evaluations may consider external information, for example, customer's feedback. In the light of such information, management or those charged with governance take necessary steps to keep the internal control system up to the mark so that risk of material misstatement is dealt with appropriately and updates of the system are done as and when necessary.

EXAMINER'S REPORT

The question tests candidates' knowledge on internal control system and internal controls.

About 40% of the candidates attempted the question. The understanding of the requirements of the question was low.

The commonest pitfall was the inability of candidates to differentiate between characteristics of an effective internal control system and different types of internal control systems.

Candidates should study internal control system and internal controls and be able to apply their knowledge to practical scenarios. The Institute study text should be of veritable advantage.

Marking Guide

		Marks	Marks
a.	The characteristics of an internal control system (2 marks each for every point, subject to a maximum of 4 points)		8
b.	Different types of internal control system (2 marks each for every point, explained subject to a maximum of 3 points)		6
c.	Main components of internal control (2 marks each for every 3 points identified subject to a maximum of 3 points)		6
	TOTAL		**20**

SOLUTION FIVE

a. Audit working paper archiving.

The retention under established period of assembled audit working papers (used in auditing of financial statements).

b. The purposes of audit working paper archiving include:

i. To ensure documents are in a safe place in case of potential litigation or for use under other circumstances;

ii. To make sure that all information and documents that were obtained from their clients are safe and not leaked to the person or party that should not access it; and

iii. To ensure compliance with the provision of statutes of limitation and other relevant legislations.

c. The types, contents and importance of audit working paper files are:

(i) Permanent audit file

Permanent audit files are the files that keep information that auditor use continuously. This information include, client's memorandum and articles of association, long term contract or agreement, minutes of Board of Directors, letter of appointment of auditors and other professionals. It is very important for auditors to keep the documents or event based on the nature and classification; and

(ii) Current audit file

Current audit files are the files that keep all information related to current year is auditing process. Those documents include the current year financial statements, general ledger, management accounts, minutes of board meetings in the year, and engagement letter. The file also includes the documents related to audit planning, audit program, current year audit adjustments or proposed audit adjustments, significant audit findings, as well as significant matters that require partner's attention, risks assessment, audit sampling, audit analytical review, as well as internal control documents.

(iii) Importance of audit working paper file include:

Assist the team to plan and execute/perform the audit;

- They serve, as useful audit tool as well as permanent record of audit work performed;
- A review of the audit working paper file gives an assurance that the audit work is both accurate and complete; and
- Working papers enable an experienced auditor with no previous connection with that audit to conduct quality control reviews or other inspection, that is, by understanding the work that has been performed and the conclusions that have been reached.

d. The owner of audit working paper files.

Audit working papers are the property of the auditor.

The conditions under which access to them can be granted to a third party

In order to adhere strictly to professional ethics, the auditor cannot disclose contents of a working paper file to a third party without consent of the client unless limited specified situations mentioned in ISA 230 Documentation and requirement of the law which include:

i. court order;

ii. For regulatory review for public interest; and

iii. For due diligence or when the client wants opinion on capital raising of capital.

EXAMINER'S REPORT

The question tests candidates' knowledge of:

Audit working papers archiving,
Purpose of working papers archiving, and
Types, contents, ownership, importance of and access to working papers .

About 60% of the candidates attempted the question and performance was fair.

The commonest pitfalls were the inability of candidates to explain audit working paper archiving and purposes of audit working papers archiving.

Candidates should be advised to cover the syllabus adequately before sitting for the examinations.

Marking Guide

		Marks	Marks
a.	Explanation of "Work paper archiving"		1
b.	Purposes of working paper archiving (2 marks each for every point identified)		6
c(i).	1 mark each for the types of working paper	2	
(ii).	2 marks each for explanation of types of working papers	4	
(iii)	1 mark each for 2 points of importance of working papers	2	8
d)i.	Stating of the owner of audit working papers	2	
(ii).	1 point each for any condition stated maximum of 3 points	3	5
	TOTAL		**20**

SOLUTION SIX

a. 'Acting in the public interest'

An aspect of professional bodies, which separates a profession from a trade is that members of the profession are expected to act in the public interest. It is therefore a responsibility of the accountancy profession **'to ensure that accountants should not act exclusively to satisfy the needs of a particular client or employer'**.

When the demands or needs of a client or employer appear to be contrary tothe public interest, accountants should consider the public interest.
Although professional code of ethics do not provide a clear definition, it is usual to associate the public interest with matters, such as:

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

b. Professional scepticism

According to ISA 200, professional scepticism means "An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence".

This does not mean that the auditors should disbelieve everything they are told, but they should view what they are told with a sceptical attitude, and consider whether it appears reasonable and whether it conflicts with any other evidence. In other words, they must not simply believe everything management tells them

c. Fundamental principles which a professional accountant should comply with are:

(i) Integrity

Accountants are expected to be persons of strong principles and high moral values for whom honesty and integrity always come first. Indeed, an accountant whose integrity is put in doubt can consider himself a write-off in the profession since it is a sine qua non characteristic.

In his daily routine, an accountant should lead by example and practise what he preaches so that his staff and colleagues may follow in his footsteps. This level of integrity needs to be applied consistently, fairly, and equitably irrespective of the race, sex, nationality, religion or any affiliation of the person concerned.

Judgements should not neither be affected by undue pressures from influential people nor by bribes or favours.

The most important feature of integrity is that the accountant can always walk with his head held high and that he does not feel afraid or intimidated in passing judgement or expressing opinions. Moreover he should not be scared to stand up and be counted whenever necessary even when nobody else finds the courage to speak up.

(ii) Objectivity

This principle can be put to test by subjective and strong opinions expressed by people occupying high positions. On their part, accountants need to reach their own conclusions free of any bias, even at the cost of going against the currents of public opinion.

Accountants should not rush in reaching their conclusions and they need to reflect carefully and evaluate both sides of the coin. People can be looking at things from a totally different perspective and still bring up seemingly valid arguments. This is in fact seen in many politicians who sing the praises of one side and demonise the other. Actually, counter-arguments to biased positions need to be built up with patience and be carefully articulated so that the accountant can put himself in a strong position to win the argument without giving rise to unnecessary aggravation. This would enhance his reputation of being fair, strong, but yet objective.

It is a well-known fact that whereas entrepreneurs tend to be generally over optimistic in justifying their ambitions and projects, accountants tend to be over cautious in the knowledge that an error in being overly optimistic can cost dearly. At the end of the day, accountants need to call a spade a spade and yet demonstrate that there is no hidden agenda against anyone or anything. The ultimate respect for the accountant is gained through the adoption of a balanced and fair approach.

(iii) Confidentiality

One of the most sensitive areas where an accountant has to show the highest degree of ethical behaviour and discretion with insider information. This matter acquires a higher significance in the case of public companies. The accountant has to be the main guardian of sensitive financial information and he therefore needs to prepare, circulate and explain the appropriate guidelines so that whoever is exposed to such information fully understands the relative importance and implications.

Another sensitive issue is that relating to remuneration packages where leakages of information can disrupt a harmonious organisation and give rise to jealousies, piques and resignations.

Price negotiations with suppliers and contractors submitting tenders for projects can induce these parties to offer various kinds of bribes and sweeteners and the accountant needs to be very vigilant for any sign of such illicit behaviour. Other areas where confidentiality is crucial are trade secrets, intellectual property, distribution lists and employee details, all of which are also vulnerable to these kinds of situations.

- **Professional behaviour**

Many a time the accountant is assumed to be the dull and nerdish type. While an accountant should always use good manners and etiquette he should also strive to be an interesting person with a pleasant and outgoing personality that belies this stigma. Such a disposition would help him integrate much easier with other members of the organisation and not be labelled the traditional 'wet blanket' or 'Mr No'.

Certain situations make it hard for the accountant to retain a professional behaviour. Living a life filled with deadlines compounded by an ever-changing regulatory environment, the accountant's resilience is tested to the limits. It is however important that in such situations he remains calm and composed since otherwise he could transmit the wrong signals down the line.

Professional behaviour is also expected from an accountant in meeting prescribed deadlines, providing advice, compiling reports, and extending his co-operation whenever necessary. An accountant can win the crowd by delivering whatever he promises on time while at the same time consistently exceeding expectations. This is a characteristic found in many accountants and it is important that it is nurtured on an ongoing basis.

The accountant should never try to be a prima donna. On the contrary, he needs to remain humble yet persuasive and assertive. These latter characteristics are not easy to develop especially since most accountants do not receive such appropriate training. Natural aptitudes and experience can help but accountants should be trained to express their views and conclusions in a confident, articulate and convincing manner, particularly when dealing with directors who are normally much more experienced in this area.

(iv) Competence and due care

This is an area in which most employers and clients expect the accountant to be always on top of the situation, knowing everything about his profession including the myriad new technical pronouncements, regulations and compliance obligations being dished out on a regular basis. Since the vast majority of people are averse to financial information, reports, and obligations including tax, many a time they leave it up to the accountant to handle such situations for them.

In view of this level of trust placed in them it is important for the accountant to always stay abreast of developments in the accounting profession so that he can alert his clients about the consequential challenges or opportunities that are bound to arise.

EXAMINER'S REPORT

The question tests candidates' knowledge of "acting in public interest", professional scepticism and fundamental principles an accountant should comply with.

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

The candidates' commonest pitfall was inability of candidates to explain "acting of public interest" and "professional scepticism" well.

Candidates should utilize the Institute's study text for the professional examinations.

Marking Guide

		Marks	Marks
a.	Acting in public interest (1 mark each for 1 point stated subject to a maximum of 6 points)		6
b.	Professional scepticism		
	(2 marks each for "altitude that includes a questioning mind)	2	
	(2 marks for "auditors should believe with a sceptical attitude")	<u>2</u>	4
c	Fundamental principle that an accountant should comply with		
	(1 mark each for 5 headers)	5	
	(1 mark each for 5 explanations)	<u>5</u>	<u>10</u>
	TOTAL		<u>**20**</u>

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – NOVEMBER 2019

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

Adeco Nigeria plc. is a large and diversified company with several factories. One of its factories that produces "Apet" has not been able to meet its sales target for over two years. The board has mandated the company's management to take an urgent decision on what to do with the factory.

The management has therefore, set up a committee of three, the factory manager, the marketing manager and the management accountant to analyse the situation and come up with a report on what they felt the management should do. The marketing manager has submitted two proposals to the committee. These are:

- a sales volume of 25,000 units can be achieved with a selling price of ₦13.50 per unit and an advertising campaign of ₦37,500; or

- a sales volume of 35,000 units can be achieved at a selling price of ₦11.25 with an advertising campaign costing ₦52,500.

The management accountant is to work on these proposals with the information provided by the factory manager and show with calculations that will help the committee determine which proposal to be recommended to management. The management accountant is also to provide a third option, the closure of the factory.

The factory manager has submitted the following information to the management accountant:

Budgeted sales and production of Apet	50,000 units
	₦'000
Sales	750.0
Less production costs:	
Material A – 1 kg per unit	75.0
Material B – 1 litre per unit	37.5
Labour – 1 hour per unit	187.5

Variable overhead	150.0
Fixed overhead	75.0
Non-production costs	75.0
Total cost	600.0
Budgeted profit	150.0

The following additional information has also been made available:

(i) There are 50,000 kg of material A in inventory. This originally cost ₦1.5 per kg. Material A has no other use and unless it is used by the division, it will have to be disposed of at a cost of ₦750 for every 5,000 kg.

(ii) There are 30,000 litres of material B in inventory. Any unused material can be used by another department to substitute for an equivalent amount of a material, which currently costs ₦1.875 per litre. The original cost of material B was ₦0.75 per litre and it can be replaced at a cost of ₦2.25 per litre.

(iii) All production labour hours are paid on an hourly basis. Rumours of the closure of the department have led to a large proportion of the department's employees leaving the organisation. Uncertainty over its closure has also resulted in management not replacing these employees. The department is therefore, short of labour hours and has sufficient to produce only 25,000 units. Output in excess of 25,000 units would require the department to hire contract labour at a cost of ₦5.625 per hour. If the department is shut down the present labour force will be redeployed within the organisation.

(iv) Included in the variable overhead is the depreciation of the only machine used in the department. The original cost of the machine was ₦300,000 and it is estimated to have a life of 10 years. Depreciation is calculated on a straight-line basis. The machine has a current resale value of ₦37,500. If the machinery is used for production, it is estimated that the resale value of the machinery will fall at the rate of ₦150 per 1,000 units produced. All other costs included in variable overhead vary with the number of units produced.

(v) Included in the fixed production overhead is the salary of the factory manager which amounts to ₦30,000. If the department were to shut down the manager would be made redundant with a redundancy pay of ₦37,500. All other costs included in the fixed production overhead are general factory overheads and will not be affected by any decision concerning the factory.

(vi) The non-production cost charged to the factory is an apportionment of the total non-production costs incurred by the factory.

The committee will be meeting in a week's time to prepare its report to management on the line of action management should follow, either one of the marketing manager's proposals or to close down the factory.

Required:

As the management accountant of Adeco plc., you are to:

a. Prepare detailed calculations to support the committee's recommendation to the management whether to:

   i. reduce production to 25,000 units

   ii. reduce production to 35,000 units

   iii. shut down the factory. (20 Marks)

b. Discuss the management accounting technique and principle that a management accountant will apply in preparing calculations to support management decision in such a circumstance as above. (10 Marks)

c. A customer has just placed a special order for 25,000 units of Apet and the customer is willing to pay ₦12.00 per unit. Advise the management whether to accept or reject the order. Assume that for any shortfall in material A required to produce the order, it can be bought at a price of ₦2.00 per kg. (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

Lunda Limited manufactures a range of products, many of which have short product lifecycles. Research and development staff recently designed three new products which would be manufactured in a single production cell of the company's factory. The combined monthly manufacturing overhead costs of the three products are summarised as follows:

Production set-ups (10 per month)	₦200,000
Material movements (400 per month)	₦1,800,000
Repairs (4,000 per month)	₦3,000,000
Total manufacturing overheads per month	₦5,000,000

The following information is available concerning the three new products:

	Product A	**Product B**	**Product C**
Production & sales, per month	2,000 units	5,000 units	1,000 units
Direct labour hours per unit	6	4	8

The company's target costing task group expressed the view that the new products would not be profitable, given the likely market prices and the cost of manufacturing the products using the proposed design. In response, the product designers indicated that no design changes were possible in relation to Product A or B, but that changes in the design of Product C would bring about the following reductions in the amount of monthly activity involved in manufacturing that product without compromising either the quality or quantity of output:

Production set-ups	Material movements	Repairs
2 per month	100 per month	1,000 per month

Required:

- Calculate the reduction in the cost per unit of each of the three products which would occur as a result of the design changes to Product C, in each of the following circumstances:
  - If manufacturing overheads are allocated to products using activity-based costing (ABC);
  - If manufacturing overheads are allocated to products on a direct labour hour basis. (10 Marks)

b. Discuss the view that an ABC system is essential for the implementation of target costing. Use the case of Lunda Limited to illustrate your answer. (5 Marks)

c. The following data relates to another product of Lunda:

	2016	2017	2018
Internal failures as percentage of units produced	3%	4%	5%
External failures as percentage of units sold	19%	14%	11%

Comment on the trends in this data set. (5 Marks)

(Total 20 Marks)

QUESTION 3

Rinc Nigeria Limited has two divisions, A and B. Division A specialises in the manufacture of a special part of a product while Division B is responsible for the completion of the production and sale of the final product. Division A not only produces but also sells some of its components to third parties though it remains a major supplier to Division B. Division B can also buy from other suppliers the same part to augment supply gap from Division A. The two divisions are both profit centres.

The following information are for the month of November:

	Division A	**Division B**
Production in units	20,000	-
Sales to Division B (units)	18,000	
Sales to third parties (units)	2,000	23,000
Purchases from outside suppliers (units)		5,000
Transfers from Division A (units)	-	18,000
Production cost per unit	₦200	
Transfer from Division A		₦220
Additional cost of production		₦30
Market value of sales to third parties	₦240	₦300
Cost of purchase from outside suppliers		₦225
Investment in the divisions	₦3,000,000	₦3,200,000

The company's cost of capital is 10%.

You are required to:

a. Determine the profit made by each division and the company for the month. (10 Marks)

b. Determine the returns on investment (ROI) and the residual income (RI) of the divisions and the company. (5 Marks)

c. State the advantages and disadvantages of both ROI and RI as parameters for appraising divisional performance. (5 Marks)

(Total 20 Marks)

QUESTION 4

Akoko plc. has recently developed a new product called "EKO" which has been in production for the past year. The plant producing 'EKO' is shut down for routine inspection and maintenance every three months, and during the first year's operation the costs of shut- down have been as follows:

Quarter	Shut-Down Cost
1	36,000
2	28,800
3	27,000
4	25,200

The management accountant attempts to forecast maintenance costs for the coming year and on examining the above data, it appears that these costs have been steadily decreasing. The plant engineers has suggested that this is probably due to the fact that the maintenance engineers are becoming more used to the procedures involved and also the fact that the plant itself is gradually settling down after initial operational problems. If this is the case, an appropriate learning curve could explain the situation which has been observed.

Required:

a. Explain the concept of learning curve. (4 Marks)

b. Estimate the rate of learning which is inherent in the data. Explain the meaning of the value you have calculated. (4 Marks)

c. Using the learning rate that you have determined, forecast the total cost of shut-down for routine maintenance during the coming year. (5 Marks)

d. Assume that learning ceases at the end of the second year, forecast the total cost of shut-down for routine maintenance during the third year. (4 Marks)

e. State **TWO** specific reasons why this forecast may be wrong. (3 Marks)

(Total 20 Marks)

QUESTION 5

Ezeabunafo Nigeria Limited, an aluminium company, has two divisions, A and B. Division A manufactures a single uniform product, which is partly sold in the external market and partly transferred to division B where it forms the major sub – assembly for that division's product.

The unit cost for each division's product is as shown here under:

	Division A	Division B
	₦	₦
Bought – in component (from Division A)	-	58
Direct Material	8	-
Direct Labour	4	46
Direct Expenses	4	6
Variable Production Overhead	4	24
Fixed Manufacturing Overhead	8	24
Selling and packing expenses (variable)	2	2
	30	160

Past data shows that average of 10,000 units of its products are sold on the external market each year by Division A at the standard price of ₦60.

In addition to the external sales, 5,000 units are transferred annually to Division B at a transfer price of ₦58 per unit (as above). The transfer price is derived by deducting variable selling and packaging expenses from the external price since these expenses are not incurred for internal transfers.

Division B's manager disagrees with the basis used to set the transfer price. He contends that the transfer price should be made at variable cost plus an agreed (minimal) mark up. It is his view that under the present set-up, his division is taking output that Division A would be unable to sell at the price of ₦60.

A study commissioned by the Marketing Director consequent on this disagreement shows the following:

Customers' demand at various selling prices

Division A			
Selling price/unit	₦40	₦60	₦80
Demand	15,000	10,000	5,000
Division B			
Selling price/unit	₦160	₦180	₦200
Demand	7,200	5,000	2,800

Division B's manager maintains that the study has buttressed his case and calls for a transfer price of ₦24 which he points out, would give Division B a reasonable contribution to its fixed overheads as well as enable B to earn a reasonable profit which also leads to an enhanced company-wide output and profit performance.

You are required to:

- Calculate the contribution at alternative selling prices shown in the study for Division A. Which price maximises the Division's profit? (6 Marks)

- Calculate the contribution as in (a) above for Division B. Show if B's current selling price of ₦180 is optimal for the firm as a whole. (5 Marks)

- Assuming a transfer price equal to Division A's variable costs, show the contribution at alternative selling price for Division B. (3 Marks)

- Calculate the contribution per unit and comment briefly on how the whole firm is affected under this situation. (3 Marks)

- Establish the likely effect on the company's profits if the suggestion by Division B's manager, of a transfer price of ₦24 is adopted. (3 Marks)

(Total 20 Marks)

QUESTION 6

a. Explain the **FOUR** classifications of cost of quality with examples of each. (6 Marks)

b. Benson Dinka is the management accountant of Dynamic Plc. Mr. Dinka realises that the present performance reporting system does not highlight quality costs. The reports contain the information below, but he wants this to be reported in an appropriate format.

The following information is available in respect of the year ended August 31, 2018.

1. **Production data:**

Units requiring rework	1,500
Units requiring warranty repair service	1,800
Design engineering hours	66,000
Inspection hours (manufacturing)	216,000

2. **Cost data:**

	₦
Design engineering cost per hour	1,500
Inspection cost per hour (manufacturing)	800
Rework cost per heating system unit reworked (manufacturing)	60,000
Customer support cost per repaired unit (marketing)	4,000
Transportation costs per repaired unit (distribution)	4,800
Warranty repair costs per repaired unit	64,000

3. Staff training costs amounted to ₦3,000,000 and product testing costs were ₦980,000.

4. The marketing director has estimated that sales of 1,400 units were lost as a result of bad publicity in trade journals. The average contribution per heating system unit is estimated at ₦120,000.

Required:

Prepare a cost of quality report for Dynamic plc. that shows its costs of quality (using appropriate headings) for the year ended August 31, 2018. (14 Marks)

(Total 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

$P = a - bQ$

$b =$

a = price when Q = 0

$MR = a - 2bQ$

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

Y

where b=

a

Coefficient of determination (r^2)

r^2

The Miller-Orr Model

Annuity Table

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

Where r = discount rate

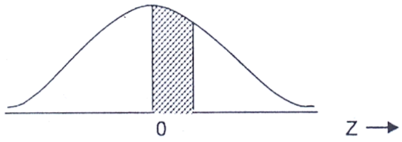
n = number of periods

Discount rate (r)

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

NORMAL DISTRIBUTION

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



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

SOLUTION 1

(a) Relevant savings and revenue

	25,000 units ₦	35,000 units ₦	Shut down ₦
Sales revenue	337,500	393,750	–
Material B	9,375	–	56,250
Sale of machinery	33,750	32,250	37,500
Total revenue/savings	380,625	426,000	93,750
Relevant costs			
Material A disposal	3,750	2,250	7,500
Purchase material B	–	11,250	–
Labour	93,750	150,000	–
Variable overhead			
(excl. depreciation)	60,000	84,000	–
Advertising campaign	37,500	52,500	–
Manager's salary	30,000	30,000	–
Redundancy pay	–	–	37,500
Total relevant costs	225,000	330,000	45,000
Net savings	155,625	96,000	48,750
Workings			
	25,000 units	35,000 units	Shut down
• Sales revenue			
No. of units	25,000	35,000	
Selling price	₦13.50	₦11.25	
Sales revenue	₦337,500	₦393,750	
• Savings made on material B			
Surplus available	5,000	–	30,000
Saving per litre	₦1.875	₦1.875	₦1.875
Total saving	₦9,375	–	₦56,250
• Sale of machinery			
Current market price	₦37,500	₦37,500	₦37,500
Reduction in value	₦3,750	₦5,250	–
Sale proceeds	₦33,750	₦32,250	₦37,500
• Disposal cost of material A			
Quantity to be disposed of	25,000	15,000	50,000
Cost of disposal	₦3,750	₦2,250	₦7,500
• Purchase cost of material B			
Production requirement	25,000	35,000	
No. of litres to be purchased	–		5,000
Purchase cost			₦11,250

• Labour costs			
Normal labour costs	₦93,750	₦93,750	
Contract labour	–	₦56,250	
	₦62,500	₦150,000	
• Variable overhead @ ₦2.40 per unit*	₦60,000	₦84,000	
*Variable overhead/unit Total variable overhead less depreciation Variable overhead/unit =	₦ 150,000 30,000 120,000	 ₦120,000 50,000 ₦2.40 per unit	
• Manager's salary – relevant			
• Redundancy pay – relevant			
• General fixed overheads and non-production overheads – not relevant			

(b) The cost accounting technique normally used by the management accountant to assist management in decision making is marginal costing technique, while the cost accounting principle is the relevant costs and relevant or incremental revenue principle.

Marginal costing might be used for decision-making. For example, marginal costing is used for limiting factor analysis and linear programming.

It is appropriate to use marginal costing for decision-making when it can be assumed that future fixed costs will remain constant, no matter what decision is taken, and that all variable costs represent future cash flows that will be incurred as a consequence of any decision that is taken.

These assumptions about fixed and variable costs are not always valid. When invalid, they are invalid, relevant costs should be used to evaluate the economic/financial consequences of a decision.

Relevant costs could be used for assessing the economic or financial consequences of any decision by management. Only relevant costs and benefits should be taken into consideration when evaluating the financial consequences of a decision.

A relevant cost is a future cash flow that will occur as a direct consequence of making a particular decision.

The key concepts in this definition of relevant costs are as follows:

- Relevant costs are costs that will occur in the future. They cannot include any costs that have already occurred in the past.
- Relevant costs of a decision are costs that will occur as a direct consequence of making the decision. Costs that will occur anyway, no matter what decision is taken, cannot be relevant to the decision.
- Relevant costs are cash flows. Notional costs, such as depreciation charges, notional interest costs and absorbed fixed costs, cannot be relevant to a decision.

(c) Special order

From the calculations in (a), the decision will be to produce 25,000 units at a price of ₦13.50. This means that the special order of 25,000 units could be produced, with the following relevant revenues and costs:

	₦
Revenue:	
Sales (25,000 × ₦12.00)	300,000
Savings made on material A disposal	3,750
	303,750
Costs:	
Material B (25,000 ₦2.25)	56,250
Labour (25,000 × ₦ 5.625	140,625
Variable overhead (25,000 × ₦2.40)	60,000
	256,815
Additional contribution	49,875

Decision: Adeco is advised to accept the special order as it will produce additional contribution of ₦49,875.

EXAMINER'S REPORT

The question tests relevant costing techniques, marginal costing principles and incremental costing approach.

Being a compulsory question, all the candidates attempted the question but performance was rather poor.

Major pitfall was candidates' lack of good grasp of the subject area.

Candidates' are advised to read the ICAN Study Text when preparing for future examination.

MARKING GUIDE

		Marks	Marks
1.	Relevant savings and costs:		
a(i)	Reduce production to 25,000 units		
	(2ticks = 1 mark) (14 ticks @½mark)	7	
(ii)	Reduce production to 35,000 units		
	(2ticks = 1 mark) (14 ticks @½mark)	7	
(iii)	Shut down the factory		
	(12ticks @½mark)	6	20
b	Management Accounting technique and principles used		
	• Relevant costing concept	5	
	• Marginal costing concept	5	10
c	Special order of 25,000 units		
	Computation (8 ticks @1 mark/tick	8	
	Correct decision	2	10
	Total		40

SOLUTION 2

a) Cost driver rates:

- Production set-ups ₦200,000/10 = ₦20,000 each
- Materials movements ₦1,800,000/400 = ₦4,500 each
- Repairs ₦3,000,000/4,000 = ₦750 each

Cost savings (reduction in cost) as a result of the design changes:

= (2 × ₦20,000) + (100 × ₦4,500) + (1,000 × ₦750) = ₦1,240,000

If ABC is used, all of the cost savings will be traced directly to Product C. Hence, the cost reductions will be:

- Product A: NIL
- Product B: NIL
- Product C: ₦1,240,000/1,000 = ₦1,240 per unit.

If overheads are allocated on a direct labour hour basis then the cost saving will be spread among all three products in proportion to their labour content:

- Total DLH = (2,000 × 6) + (5,000 × 4) + (1,000 × 8) = 40,000 DLH
- Cost saving = ₦1,240,000/40,000 DLH = ₦31 per DLH
- Product A: ₦31 × 6 = ₦186 per unit
- Product B: ₦31 × 4 = ₦124 per unit
- Product C: ₦31 × 8 = ₦248 per unit

b) When the anticipated cost of manufacturing a product according to a particular design is unacceptably high, a 'target' for cost reductions is set. These cost reductions must be brought about by design changes to the product. Otherwise the product cannot be manufactured.

- In the case of Luanda an ABC system is essential in order to ensure that cost savings made as a result of changing the design of Product C are fully reflected in the cost of the product.
- For example, if overheads are allocated on a labour hour basis then it appears that the cost of Product C has been reduced by only ₦248 per unit. Management may well decide that this is an inadequate reduction to justify production of the product. ABC analysis is needed in order to show that the cost saving is actually a much more substantial ₦124 per unit.
- Similarly, the ABC system rightly shows that there has been no change in the cost of Products A or B (because there have been no design changes). However, the non-ABC allocation gives the completely false impression that the unit costs of these products have been reduced. Management might decide that these apparent cost savings constitute sufficient grounds to begin producing these products, even though in reality nothing has changed.
- ABC is used to get a better grasp on costs, allowing companies to form a more appropriate pricing strategy.
- It is used for product profitability analysis.
- It ensures the cost estimates used are realistic.
- It uses overhead cost estimation
- It helps in assessing the activities that limit the production of products.

c) External failure rates have decreased considerably over time. Admittedly, this has to some extent been accompanied by an increase in the rate of internal failure. However, the overall trend is a positive one for two reasons:

1) The combined (internal plus external) failure rate is decreasing
2) An internal failure is less costly than an external failure. For example, an external failure creates costs (such as loss of customer goodwill and additional transport costs to and from the customer's premises) which are avoided if the defective item is detected internally by Luanda Ltd.

It seems likely that Luanda has made some efforts to increase the effectiveness of its internal quality control procedures. Thus, the proportion of defective items detected internally is increasing (hence the growing internal failure rate) but the proportion of defective items reaching the customer is decreasing.

It is disturbing that the vast majority of failures are still being detected by customers rather than by the company's internal quality procedures. As well as trying to improve the overall level of quality, the company should try to improve much further the effectiveness of its internal quality control procedures.

EXAMINER'S REPORT

This question tests candidates understanding of ABC approach in target costing and its application in cost saving. It also tests the efficacy of the ABC concept in target costing. Part C of the question tests candidates' knowledge in trend analysis using three series of external failure rates, internal failure rates and combined (total) failure rates.

About 80% of the candidates attempted the question but performance was just average.

Major pitfall was candidates' lack of good grasp of the subject matter.

Candidates' are advised to read the ICAN Study Text when preparing for future examination.

MARKING GUIDE

		Marks	Marks
2(a)	Reduction in cost per unit		
	• Using activity-based costing		
	• Computation of total reduction	3	
	• Computation of unit saving for each product		
		2	5
	• Using direct labour hour basis:		
	• Computation of total reduction	3	
	• Computation of unit savings for each product	2	5
b	Importance of ABC system		
	(Any 2 points out of 6@2½marks per point)		5
c	Correct comment on:		
	• External failure rates	1	
	• Internal failure rate	1	
	• Total failure rate	1	
	• The trend	2	5
	Total		**20**

SOLUTION 3

PERFORMANCE MEASUREMENT AND CONTROL – TRANSFER PRICING AND DIVISIONAL PERFORMANCE

RINC NIGERIA LIMITED

a.	Profit made by each division and the company			
		Div A ₦'000	Div B ₦'000	Company ₦'000
	Sales To 3rd parties	2,000 x 240 = 480	23,000 x 300=6,900	7,380
	Transfer to B	18,000 x 220 = 3,960	-	-
	Total	4,440	6,900	7,380
	Cost of sales: Cost of Production	20,000 x 200 = 4,000	-	4,000
	Transfer from A		18,000 x 220 = 3,960	-
	Purchases from 3rd parties		5,000 x 225 = 1,125	1,125
	Additional cost of Production		23,000 x 30 = 690	690
	Total Cost (Internal and External)	4,000	5,775	5,815
	Net Profit	440	1,125	1,565
b.	**RINC NIGERIA LIMITED** Returns on investment and residual income:			
	Returns	440,000	1,125,000	1,565,000
	Investment	3,000,000	3,200,000	6,200,000
	ROI	14.67%	35.2%	25.2%
	Cost of Capital	300,000	320,000	620,000
	Residual Income	140,000	805,000	945,000

- Advantages and disadvantages of ROI and Residual income in Divisional Performance evaluation.

Advantages of ROI

There are several advantages in using ROI as a measure of the performance of an investment centre. These include:

(i) It relates the profit of the division to the capital employed, and the divisional manager is responsible for both profit and capital employed;

(ii) ROI is a percentage measure and can be used to compare the performance of divisions of different sizes;

(iii) ROI as a measure of financial performance is easy to understand;

(iv) It focuses attention on capital as well as profit, and encourages managers to sell off unused assets and avoid excessive working capital (inventory and receivables);

(v) ROI ensures goal congruence between different divisions and the firm; and

(vi) It measures profitability better than other measures of investment.

Disadvantages of ROI

There are also disadvantages in using ROI as a measure of the performance of an investment centre. These includes:

(i) Investment decisions might be affected by the effect they would have on the division's ROI in the short term, and this is inappropriate for making investment decisions;

(ii) There are different ways of measuring capital employed. ROI might be based on the net book value (carrying value) of the division at the beginning of the year, or at the end of the year, or the average for the year. Comparison of performance between different organisations is therefore difficult;

(iii) When assets are depreciated, ROI will increase each year provided that annual profits are constant. The division's manager might not want to get rid of ageing assets, because ROI will fall if new (replacement) assets are purchased; and

(iv) ROI is an accounting measure of performance. An alternative system of performance measurement that includes non-financial performance indicators, such as a balanced scorecard approach, might be more appropriate.

Advantages of Residual Income

There are several advantages in using residual income as a measure of the performance of an investment centre. These include:

(i) It relates the profit of the division to the capital employed, by charging an amount of notional interest on capital employed, and the division manager is responsible for both profit and capital employed;

(ii) Residual income is a flexible measure of performance, because a different cost of capital can be applied to investments with different risk characteristics;

(iii) Residual income concept takes a long term view of divisional performance; and

(iv) Residual income performance measures are reconcilable to planning decisions using techniques such as NPV and IRR.

Disadvantages of residual income

There are also disadvantages in using residual income as a measure of the performance of an investment centre. These are:

(i) Residual income is an accounting-based measure, and suffers from the same problem as ROI in defining capital employed and profit;

(ii) Its main weakness is that it is difficult to compare the performance of different divisions using residual income. Larger divisions should earn a bigger residual income than smaller divisions; and

(iii) Residual income is not easily understood by management, especially managers with little accounting knowledge.

EXAMINER'S REPORT

This is a typical transfer pricing question that also tests candidates' knowledge of parameters used for measuring divisional performances.

Candidates were also required to show that they understand the advantages and disadvantages of return on investment and residual income parameters.

About 90% of the candidates' attempted the question but performance was average.

Major pitfall was candidates' lack of good grasp of the subject matter.

Candidates' are advised study the ICAN Study Text when preparing for future examination.

MARKING GUIDE

		Marks	Marks
a	Profit made by each division and company (any 20 ticks @½mark)		10
b	Determine ROI and RI of division and company		
	• ROI (any 6 ticks @½mark = 3)	3	
	• RI (any 4 ticks @½mark = 2)	2	5
c	Advantages/disadvantages of ROI and RI		
	• Advantages and disadvantages of ROI (6 ticks @½mark = 3)	3	
	• Advantages and disadvantages of RI (4 ticks @½mark = 2)	2	5
	Total		20

SOLUTION 4

a) The basic concept of a learning curve is that the more a particular task is performed the more proficient the individual becomes and, as a consequence, the time taken decreases.

In the initial stages, the learning effect is substantial leading to marked decreases in time. In latter stages, however, the individual becomes more familiar with the task and the rate of learning slows down.

This effect is captured in a relationship between the average time taken per unit and the cumulative number of units produced (or task repetitions). The form of this relationship is usually taken to be geometric (or logarithmic) as given by: $Y = ax^b$

where Y = average labour hours for the output level desired

X =

B =

b) Estimation of Rate of Learning:

From the data, the cumulative number of shut-downs (x) and the average cost of shut down (y) are as follows:

Cumulative Number	Cumulative Costs	Average Costs
	₦	₦
(X)		(Y)
1	₦36,000	₦36,000
2	64,800	32,400
3	91,800	30,600
4	117,000	29,250

When X, doubles from 1 to 2, then y decreases by a factor 32,400/36,000 = 0.90.

When X again doubles from 2 to 4, Y deceases by 29,250/32,400 = 0.903.

It is therefore clear that the learning rate is about 90%.

c) Forecast of total cost in the coming year:

At the end of the second year, the plant would have been shut-down 8 times (8 quarters).

Qtr 4 average cost is ₦29,250

			₦
:. Qtr 8 average cost	= 90% of ₦29,250	=	26,325
Total costs over 8 quarters	= ₦26,325 × 8	=	210,600
Less: Total cost during second year		=	117,000
Total costs during second year			93,600

d) Forecast of total cost of shut down after cessation of learning in the 3rd Year:

If learning ceases at the end of quarter 8, the cost applicable for quarter 8 (not the average cost after 8 shut-downs) will apply in **all** subsequent quarters.

* Determine the total costs after 8 shut-downs - determined in (c) above as ₦2l0,600

* Determine the total costs after 7 shut-downs:

** Average costs after 7 shut-downs by formula:

$$Y = 36,000\ (1)^{\text{Log}0.9/\text{Log }2}$$

$$Y = 36,000(7)^{-0152} = ₦26,782$$

** Total costs after 7 shut-downs = 7 x 26,782 = ₦187,474

* Cost for quarter 8 is ₦2l0,600-187,474=₦23,126

This is the cost that will apply per quarter subsequently in the absence of learning.

Thus the cost of shut-down during the third year will be: 4 quarters x ₦23,126 = ₦92,504.

e) **Two specific problems are:**

i) No allowance seems to have been made for inflation; and

ii) As the plant gets older, maintenance costs would be expected to rise. This factor has not been taken into account.

EXAMINER'S REPORT

This question tests candidates' ability to determine the learning curve rate and its application to compute average and total cost of shut down for Year 2 and Year 3 when the shut down costs are accumulated on a quarterly basis. In the end, candidates were expected to highlight two problems that affect learning curve concept.

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

Major pitfall was candidates' lack of good grasp of the principle involved.

Candidates' are advised to study the ICAN Study Text when preparing for future examination.

MARKING GUIDE

		Marks	Marks
A	Correct explanation of learning curve		4
B	• Computation/determination of learning rate	3	
	• Explanation of the value computed	<u>1</u>	4

C	Forecast cost of shut down in the coming year:		
	• Computation of average cost in second year	3	
	• Computation of total cost in second year	2	5
D	Forecast cost of shut down in the 3rd year:		
	• Computation of average cost in third year	2	
	• Computation of total cost in 3rd year	2	4
E	Two specific reasons why the forecast is wrong		
	(Any 2 points@1½marks each point)		3
	Total		**20**

SOLUTON 5

a. Calculation of contribution to each of the alternative selling prices for Division A

	₦	₦	₦
Selling price per unit	40	60	80
Less variable costs:			
Bought in materials	8	8	8
Direct labour	4	4	4
Direct expenses	4	4	4
Variable production overheads	4	4	4
Variable selling & packing	2	2	2
Contribution margin	18	38	58
Quantity demanded (units)	15,000	10,000	5,000
Total contribution (₦)	270,000	380,000	290,000

From the computation above, the selling price of N60 is the optimal price for the division because, it is at this price that the division maximises its contribution. Fixed cost is not considered because the cost does not make a difference among the alternatives.

b. Calculation of the contribution at each of the alternative selling prices for Division B

	₦	₦	₦
Selling price per unit	160	180	200
Less variable costs:			
Bought in materials	58	58	58
Direct labour	46	46	46
Direct expenses	6	6	6
Variable production overheads	24	24	24
Variable selling & packing	2	2	2
Contribution margin	24	44	64
Quantity demanded (units)	7,200	5,000	2,800
Total contribution (₦)	172,800	220,000	179,200

From the calculation above, ₦180 is the optimal price.

c. At a transfer price to A's variable costs, the contribution to Division B

	₦	₦	₦
Selling price per unit	160	180	200
Less variable costs:			
Bought in materials	20	20	20
Direct labour	46	46	46
Direct expenses	6	6	6
Variable production overheads	24	24	24
Variable selling and packing	2	2	2
Contribution margin	62	82	102
Quantity demanded (units)	7,200	5,000	2,800
Total contribution (₦)	446,400	410,000	285,600

The contribution to A = ₦24 – ₦20 = ₦4/UNIT. N20 represents the relevant or variable cost to division A.

The company as a whole will be indifferent at this point, since transfer pricing is an internal policy. Whichever transfer price is adopted between the sister divisions it should not jeopardise the overall objective or goal congruence of the company.

d. The company as a whole will be indifferent at this point, since transfer pricing is an internal policy. Whichever transfer price is adopted between the sister divisions it should not jeopardise the overall objective or goal congruence of the company.

EXAMINER'S REPORT

This question tests candidates' ability to use transfer price to compute divisional contribution under varying selling prices.

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

Candidates' are advised to study the ICAN Study Text when preparing for future examination.

Marking Guide

		Marks	Marks
a	Calculation of contribution to Division A:		
	Correct contribution at ₦40	1½	
	Correct contribution at ₦60	1½	
	Correct contribution at ₦80	1½	
	Decision on price that maximises contribution	1½	6
b	Calculation of contribution to Division B:		
	Correct contribution at ₦160	1	
	Correct contribution at ₦180	1	
	Correct contribution at ₦200	1	
	Decision on price that maximises contribution	2	5
c	Contribution of B where A transfer Price is variable cost:		
	Correct contribution at ₦160	1	
	Correct contribution at ₦180	1	
	Correct contribution at ₦200	1	3
d	Computation of unit contribution when transfer price is ₦24	2	
	Its impact on the firm	1	3
e	Effect on the company by adopting transfer price of ₦24		3
	Total		**20**

SOLUTION 6

a) The costs of quality fall into four categories

1. **Prevention costs** – costs incurred to preclude the production of products that do not conform to specifications. Examples include:
    - Quality training;
    - Testing of new materials;
    - Supplier evaluation;
    - Preventive equipment maintenance;
    - Extra purchase price of higher quality materials;
    - Design engineering; and
    - Process engineering

2. **Appraisal costs** – costs incurred to detect which of the individual units of products do not conform to specifications. Examples include:
    - Inspection of goods received;
    - Product testing;
    - Inspection of part-finished production, i.e. work-in-progress; and
    - Inspection of finished output.

3. **Internal failure costs** – costs incurred on defective products before they are shipped to customers. Examples include:
    - Spoilage;
    - Rework;
    - Scrap; and
    - Staff waiting time and machine downtime due to disruption of workflows caused by defective materials and part-finished products.

4. **External failure costs** – costs incurred on defective products after they are shipped to customers. Examples include:
    - Warranty repair costs;
    - Liability claims;
    - The replacement of failed products;
    - The cost of handling complaints; and
    - Additional transport costs

Appraisal and prevention costs are sometimes known as the cost of conformance (for goods) or the costs of compliance (for services). Internal and external failure costs are the costs of non-conformance or non-compliance.

b) **Cost of quality report for the year ended 31 August 2015**

	Quantity	Rate (₦)	Total costs (₦'000)	% of Total Costs
Preventive costs (P)				
Design engineering	66,000	1,500	99,000	14.89
Training			3,000	00.45
Total prevention costs			102,000	15.34
Appraisal costs (A)				
Inspection (manufacturing)	216,000	800	172,800	26.00
Product testing			980	00.15
			173,780	26.15
Total appraisal costs				
Internal failure costs (IF)				
Rework (manufacturing)	1,500	60,000	90,000	13.53
Total internal failure costs			90,000	13.53
External failure costs (EF)				
Customer support (marketing)	1,800	4,000	7,200	01.08
Transportation costs (distribution)	1,800	4,800	8,640	01.30
Warranty repair	1,800	64,000	115,200	17.33
Publicity costs	1,400	120,000	168,000	25.27
Total extended Failure cost			299,000	44.98
Grand Total costs (P + A + IF + EF)			**664,820**	**100.00**

EXAMINER'S REPORT

The question tests candidates' ability to classify cost of quality and how to prepare a cost of quality report under the 4 categories of cost of quality.

About 75% of the candidates attempted the question and performance was good.

Candidates are advised to study the ICAN Study Text when preparing for future examination.

MARKING GUIDE

		Marks	Marks
A	Explanation of 4 classifications of cost of quality @1½ marks per point		6
B	Cost of quality report:		
	• Individual cost of quality (9 ticks @½ mark)	4½	
	• Total cost of quality (5 ticks @1 mark)	5	
	• Cost of quality in percentage (9 ticks @½mark)	<u>4½</u>	14
	Total		**<u>20</u>**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – NOVEMBER 2019

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

Ogogo Local Government is one of the 26 Local Governments in Alimosho state of Federal Republic of Wazobia. The Local Government has adopted Treasury Single Accounting (Direct method) and prepares its accounts using IPSAS accrual basis.

There has been wide spread fraud since the retirement of the Treasurer of the council about two years ago. However, there was no adequate information to suggest that there was fraud or misappropriation of funds. The Chairman invited you to his office as the new Treasurer and handed over some of the financial data from treasury department to you as detailed below:

The trial balance for the year ended December 31, 2017 is as follows:

Description	Debit	Credit
	₦' million	₦' million
Property, plant & equipment;		
- Motor vehicles	5,000	
- Land and building (land is N5billion)	20,000	
- Furniture	500	
- Equipment	2,500	
- Plant & machinery	5,000	
Receivables;		
- Local rates	100	
- Local licenses and fees	60	
- Rent of Local Government property	50	
- Prepayment: Insurance	8	
Inventories:		
- Office stationery	4	
- Cash & cash equivalents	16	

Accumulated depreciation for PPE		
- Motor vehicle		1,000
- Building		2,000
- Furniture		36
- Equipment		25
- Plant & equipment		500
Accrued expenses:		
- Consultancy		15
- Utility bill		9
Capital grant from the State Government		150
Reserves		30,000
Accumulated net surplus/ (deficit)	497	
Total	**33,735**	**33,735**

The following transactions took place in the Office of the Treasurer of the Local Government for the year ended December 31, 2018.

i. Listed below are the revenue and expenditure items for the year ended December 31, 2018

Head	**Description**	**Amount**
		₦'million
2004	Personnel department	18,410
2005	Finance department	13,100
1003	Local licences and fees	130
1005	Local rates	150
1006	Rent on local government property	160
1004	Sale of land	78
2001	Office of the chairman	67
2006	Education department	44
2003	The council	39
1001	Statutory allocation from Federal Government	49,500
1002	Share of State internally generated revenue	8,230
1008	Other grants	560
1008	Commercial undertakings	24
2002	Office of the secretary	33
2007	Primary health care department	87
1009	Miscellaneous receipts	61

2009	Works and housing department	2,146
2010	Commerce and industry	38
2013	Other charges	11
2012	Miscellaneous	218
4000	Capital expenditure	262
2011	Traditional office	14

(ii) Code 1 is used as prefix for revenue, 2 for recurrent expenditure and 4 for capital expenditure

(iii) Preliminary investigations carried out revealed the following irregularities, which occurred and were discovered within the year:

- Included in the payments for the expenses under primary health care department were various duplicated vouchers amounting to ₦7million;

- There were some falsifications in the bills for items bought for the provision of water under other charges. The total discrepancies amounted to ₦3million.

(iv) The following agreed revenue demand notices were sent to the indigenes of the Local Government during the year.

Details	**₦'million**
Local licences and fees	150
Local rates	185
Rent on Local Government property	172

(v) Included in the payments under works and housing is the cost of motor vehicles of ₦25 million while medical equipment costing ₦35 million was included in primary health care department expenses.

(vi) Included in the payments under works and housing is the cost of land including construction of access roads, certificate of occupancy etc, amounting to ₦100 million. The land was acquired by the Local Government and sold to local prospective land owners at a cost of ₦520,000 per plot. The land consists of 200 standard plots for the construction of houses of their choice. Only 150 plots were fully subscribed and paid for during the year.

(vii) Included in the payments under finance department is the cost of office stationery of ₦25 million while the value of office stationery based on stock sheet as at December 31, 2018 was ₦6.5 million.

(viii) Capital grant from the State Government was received on December 31, 2017 and utilised in 2018.

(ix) The capital expenditure paid during the year was for the acquisition of land for the new Local Government Health Centers.

(x) Some of the accounting policies for depreciation adopted by the Government include the following depreciation rates;

	%
Motor vehicle	20
Building	2
Furniture	10
Equipment	15
Plant & machinery	15

Note: All non-current assets were purchased at the beginning of the year.

(xi) The following expenses were incurred but not settled as at end of the year.

	₦'million
Consultancy (Finance department)	15
Utility (Other charges)	6
Repairs & maintenance (Works and housing)	9
Salaries and wages (Personnel department)	23
Insurance (Finance department)	5.5

You are required to prepare:

a. The journal entries to record the loss of fund (3 Marks)

b. The statements of financial performance for year ended December 31, 2018 (15 Marks)

c. The statement of financial position as at December, 31 2018 (17 Marks)

d. Identify **FIVE** external controls and **FIVE** problems of Local Government in Nigeria (5 Marks)

(Total 40 Marks)

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

QUESTION 2

- With continuing pressure to control costs and maintain efficiency, the time has come for all public sector organisations to embrace zero-based budgeting. There is no longer a place for incremental budgeting in any organisation, particularly those in public sector, where zero-based budgeting is far more suitable.

Required:

Explain the terms 'incremental budgeting' and 'zero-based budgeting' and identify the five main stages involved in preparing zero-based budgets.

(10 Marks)

b. Through functional classification of public expenditure, the economic effects of various government activities can be determined or measured, which would also be helpful for proper policy formulation.

Required:

Identify and explain **TWO** functional areas of public expenditure and discuss **TWO** effects on the economy. (10 Marks)

(Total 20 Marks)

QUESTION 3

a. In accordance with Section 2(1-2) of the Pension Act 2014, both the public and private sectors pension schemes are now contributory. The employers and employees are expected to contribute a minimum of 18% in aggregate towards the retirement of the employees. The rate is subject to review as may be agreed between the employer and employees.

Required:

Identify **TWO** categories of persons exempted from the scheme and **THREE** deficiencies of the scheme. (10 Marks)

b. The Debt Management Office (DMO) in Nigeria manages the Nation's public debt:

Required:

Explain the term **"Public Debt"** and discuss **THREE** benefits and **TWO** demerits of public debt. (10 Marks)

(Total 20 Marks)

QUESTION 4

a. Mr Dokun, a revenue collector in High Court of Okoko State submitted the following information for the month of August 2019:

Date	Payer	Reasons for payment	Amount
			₦
5/8/19	Mr.Okon	Registration of contractor	50,000
14/8/19	Mr.Ahmed	Court fine	135,000
16/8/19	Mr.Charles	Declaration of age	1,000
20/8/19	Mr.Bako	Court fine	500,000
26/8/19	Mrs.Ogun	Registration of contractor	50,000

The money collected under this Revenue head 300, has the following sub-heads:

(i) Declaration of age 002
(ii) Court fine 005
(iii) Registration of contractor 115

All payments made to revenue collector were through a designated bank with copies of bank tellers produced by the payers. The revenue collector made a bank transfer of all takings to the main cashier on August 29, 2019 and was issued with Treasury receipt number AA12356. The receipt used by the revenue collector was KB 30001 to KB 30050. The one issued to Mr Okon was KB 30022.

Required:

Write up the revenue collector's cashbook as at August 31, 2019. (10 Marks)

b. Public projects can be financed through debt, taxation and other related revenue. The choice of any one method depends on the objective and the overall long-term implications for the economy.

Required:

Discuss **TWO** circumstances under which debt financing is appropriate and identify **FOUR** documents required for issuance of bond to a state or local government. (10 Marks)

(Total 20 Marks)

QUESTION 5

a. IPSAS 24 on Presentation of Budget Information in Financial Statements requires a comparison of budgeted amounts and the actual amount arising from execution of the budget to be included in the financial statements of entities. The standard also requires disclosure of an explanation of the reasons for material differences between the budget and actual amounts to ensure that public sector entities discharge their accountability obligations and enhance the transparency of their financial statements.

Ogoja State Government provided the following budget information for the year ended December 31, 2018.

Description	**Actual 2018**	**Supplementary budget 2018**	**Initial budget 2018**
	₦' million	**₦' million**	**₦' million**
Revenue			
Government share of FAAC (Statutory revenue)	864,112	-	865,000
Government share of VAT	188,997	-	189,000
Tax revenue	46,764	-	43,929
Investment income	475	-	574
Aids & grants	139	-	-
Other revenues	1,404	-	-
Transfer from other government entities	3,714	-	-
Total revenue	**1,105,605**	**-**	**1,098,503**
Expenditure			
Salaries, wages & social benefits	913,324	39,959	923,219
Overhead cost	559,976	93,239	550,000
Grants & contributions	281,340	-	-
Depreciation, impairment and	50,362	-	-

amotisation charges			
Bad debts charges	10,809	-	-
Public debt charges	1,296	-	-
Transfer to other government entities	5,719	-	-
Total recurrent expenditure	**1,822,826**	**133,198**	**1,473,219**
Capital expenditure based on sectors			
Administrative sector	88,704	-	87,339
Economic sector	25,330	-	29,183
Law and justice sector	15,407	-	22,301
Social sector	35,139	-	52,379
Total capital expenditure	**164,580**	-	**191,202**
Total expenditure:	**1,987,406**	**133,198**	
Budget surplus/(deficit)	**-881,801**	**-133,198**	**-565,918**

You are required to prepare consolidated budget report for the year ended December 31, 2018. (10 Marks)

b. A Public Private Partnership (PPP) is a cooperative arrangement between two or more public and private sectors, typically of a long-term nature.

Required:

Identify and explain **THREE** benefits and **TWO** adverse consequences of Public Private Partnership (PPP) (10 Marks)

(Total 20 Marks)

QUESTION 6

a. The objective of enactments relating to public financial management, among others, is to safeguard the public funds from plunder. One way to achieve this objective is by making specific provisions on the modalities for making payment from the Consolidated Revenue Fund. The law requires that all payments from the Consolidated Revenue Fund should be authorised and the payments should comply with certain general rules.

Required:

Identify and explain **THREE** ways of authorising payments out of the Consolidated Revenue Fund and **TWO** statutory payments permissible by law to be a direct charge to Consolidated Revenue Fund (CRF) (10 Marks)

b. The Bureau of Public Enterprises (BPE) is charged with the implementation of privatisation programme.

Required:

Identify **FIVE** commercialisation and **FIVE** privatisation functions of the (BPE).
(10 Marks)
(Total 20 Marks)

SOLUTION 1

a. Ogogo Local Government

Journal entries to record the loss of fund

Details	DR	CR
	₦' million	₦' million
Non-personal advances	10	
Primary health care department		7
Other charges		3
Being fraudulent payment or overpayment made and discovered within the current financial year		

b. Ogogo Local Government

Statement of financial performance for the year ended December 31, 2018

Code	Details	₦' million	₦' million
	Revenue		
1001	Statutory allocation from federal government		49,500.00
1002	Share of state internally generated revenue		8,230.00
1003	Local licences and fees **(Wk 1)**		150.00
1004	Profit on sale of land		3.00
1005	Local rates **(Wk 1)**		185.00
1006	Rent on local government property **(Wk 1)**		172.00
1007	Commercial undertakings		24.00
1008	Other grants		560.00
1009	Miscellaneous receipts		61.00
	Capital grant from state government		150.00
	Total revenue		**59,035.00**
	Expenditure		
2004	Personnel department **(Wk 2)**	18,433.00	
2005	Finance department **(Wk 2)**	13,088.50	
2001	Office of the chairman	67.00	
2006	Education department	44.00	
2003	The council	39.00	
2008	Agriculture and water resources	42.00	
2002	Office of the secretary	33.00	
2007	Primary health care department **(Wk 2)**	45.00	
2009	Works and housing department **(Wk 2)**	2,030.00	
2010	Commerce and industry	38.00	
2013	Other charges **(Wk 2)**	5.00	
2012	Miscellaneous	218.00	
2011	Traditional office	14.00	
	Depreciation (Wk 3)		
	- Motor vehicles	1,005.00	

	- Building	300.00	
	- Furniture	50.00	
	- Equipment	380.25	
	- Plant and machinery	750.00	
	Office stationery (Wk 4)	22.50	
	Total expenditure		**36,604.25**
	Surplus for the year		22,430.75
	Accumulated net surplus/ (deficit) b/f		(497.00)
	Accumulated net surplus/ (deficit) c/f		**21,933.75**

c. **Ogogo Local Government**

Statement of financial position as at December 31, 2018

Non- current assets	**Cost/ valuation**	**Accum. Dep/Amort**	**Carrying amount**
	₦' million	**₦' million**	**₦' million**
Property, plant & equipment; (Wk 5)			
Motor Vehicles	5,025.00	2,005.00	3,020.00
Land and building (land is N5billion)	20,000.00	2,300.00	17,700.00
Land for primary health centers	262.00	-	262.00
Furniture	500.00	86.00	414.00
Equipment	2,535.00	405.25	2,129.75
Plant & machinery	5,000.00	1,250.00	3,750.00
Total	**33,322.00**	**6,046.25**	**27,275.75**
Current assets			
Receivables;			
Local rates		135.00	
Local licenses and fees		80.00	
Rent of local government property		62.00	
Non-personal advance		10.00	
Inventories			
Office stationeries		6.50	
Cash &its equivalents **(Wk 6)**		24,398.00	
Investment: Cost of land		25.00	
Total current assets			**24,716.50**
Total assets			**51,992.25**
Current liabilities			
Accrued expenses:			
Consultancy	15.00		
Utility bill	6.00		
Salaries and wages	23.00		

Repairs & maintenance	9.00		
Insurance	5.50		
Total current liabilities		**58.50**	
Total liabilities			**58.50**
Net assets			**51,933.75**
Net assets/ equity			
Reserves			30,000.00
Net surplus			21,933.75
Total net assets/equity			**51,933.75**

Working notes

(Wk 1) Analysis of receipts

Details	**Local licences & fees**	**Local rates**	**Rent of government property**
	₦' million	**₦' million**	**₦' million**
Cashbook	130	150	160
Receivables b/f	(60)	(100)	(50)
	70	**50**	**110**
Receivables c/f	80	135	62
Transfer to account	**150**	**185**	**172**

(Wk 2) Analysis of expenses

Details	**Works & housing Dept.**	**Primary healthcare Dept**	**Finance Dept**	**Personnel Dept.**	**Other charges Dept.**
	₦' million	**₦' million**	**₦' million**	**₦' million**	**₦' million**
Cashbook	2,146	87	13,100	18,410	11
Motor vehicles	(25)	-	-	-	-
Cost of land	(100)	-	-	-	-
Cost of medical equipment	-	(35)	-	-	-
Office stationeries	-	-	(25)	-	-
Net payment	**2,021**	**52**	**13,075**	**18,410**	**11**
Accruals b/f					
Consultancy	-	-	(15)	-	-
Utility	-	-	-	-	(9)
	2,021	**52**	**13,060**	**18,410**	**2**
Prepayment b/f-			8		

Insurance	-	-		-	-
Accruals c/f					
Consultancy	-	-	15	-	-
Utility	-	-	-	-	6
Repairs & maintenance	9	-	-	-	-
Salaries and wages	-	-	-	23	-
Insurance	-	-	5.5	-	-
	2,030	**52**	**13,088.5**	**18,433**	**8**
Duplication/falsification	-	(7)	-	-	(3)
Balance charged	2,030	45	13,088.5	18,433	5

Wk 3 Calculation of depreciation

Details	**Motor vehicles**	**Building**	**Furniture**	**Equipment**	**Plant & machinery**
	₦' million	**₦' million**	**₦' million**	**₦' million**	**₦' million**
Cost as at 1/1/18	5,025	15,000	500	2,535	5,000
Additions	25	-	-	35	-
Cost as at 31/12/18	5,025	15,000	500	2,535	5,000
Depreciation rates	20%	2%	10%	15%	15%
Depreciation charged	1,005	300	50	380.25	750

Wk 4 Office Stationery

Details	**₦' million**
Bal as at 1/1/18	4
Additions	25
	29
Bal as at 31/12/18	(6.5)
Amount charge	22.5

Wk 5 Property, plant & equipment schedule

Details	**Motor vehicles**	**Building**	**Furniture**	**Equipment**	**Plant & machinery**
	₦' million	**₦' million**	**₦' million**	**₦' million**	**₦' million**
Cost as at 1/1/18	5,000	15,000	500	2,500	5,000
Additions	25	-	-	35	-
Cost as at 31/12/18	5,025	15,000	500	2,535	5,000
Depreciation rate per annum	20%	2%	10%	15%	15%
Acc. Dep. as at	1,000	2,000	36	25	500

1/1/18					
Depreciation charged	1,005	300	50	380.25	750
Acc. Dep. as at 31/12/18	2,005	2,300	86	405.25	1250
Carrying amount	3,020	12,700	414	2,129.75	3,750

Wk 6 Cash book for the year ended December 31, 2018

Code	Details	₦' million	₦' million
	Balance b/f	16	
	Receipts		
1001	Statutory allocation from federal government	49,500	
1002	Share of state internally generated revenue	8,230	
1003	Local licences and fees	130	
1004	Sale of land	78	
1005	Local rates	150	
1006	Rent on local government property	160	
1007	Commercial undertakings	24	
1008	Other grants	560	
1009	Miscellaneous receipts	61	
	Total receipts	**58,909**	
	Payments		
2004	Personnel department		18,410
2005	Finance department		13,100
2001	Office of the Chairman		67
2006	Education department		44
2003	The Council		39
2008	Agriculture and water resources		42
2002	Office of the Secretary		33
2007	Primary health care department		87
2009	Works and housing department		2,146
2010	Commerce and industry		38
2013	Other charges		11
2012	Miscellaneous		218
4000	Capital expenditure		262
2011	Traditional office		14
	Total payments		**34,511**
	Balance c/f	-	24,398
	Total	**58,909**	**58,909**

d. External controls:

The following are the external control measures:

- Legislative control (National Assembly and State Assembly);
- Federal Government and State Executive control;
- Control by the general public comments by individuals on Local Government Councils;
- External control from Auditor-General for the Local Government;
- External control from Auditor-General for the State; and
- External control from Auditor-General for the Federation of Nigeria.

Problems/limitations of Local Government Councils

These are:

- Local government councils are not allowed to raise tax or introduce a new form of tax without express permission from the state government;
- They have limited revenue sources;
- They cannot raise loans or maintain loan funds without permission;
- Because they cannot raise loans, councils find it difficult to execute essential capital development projects;
- Poor revenue collections may cause delay in the payment of staff salaries and difficulty in executing essential capital development projects;
- The non-payment or delay in payment of federal/state government grants or shares of oil revenues to the local authorities;
- The non-viability of certain local authorities, especially those whose areas have small population figures;
- Rising cost and increasing demand for improved services; and
- Ineffective financial and management controls, internally and externally.

EXAMINER'S REPORT

The question tests candidates' knowledge on the preparation of local government financial statements based on International Public Sector Accounting Standard (IPSAS) accrual and journal entries to record loss of fund in the public sector. Candidates are also expected to identify external controls and problems of local government in Nigeria.

All the candidates attempted the question but performance was below average.

The commonest pitfalls were the inability of the candidates to prepare final accounts of local government and identify the problems facing the local government in Nigeria.

Candidates are advised to have adequate knowledge of preparation of financial statements of public sector entities based on IPSAS accrual. Candidates are also advised to pay more attention to relevant provisions of International Public Sector Accounting Standards (IPSAS) for better performance in the Institute's future examinations.

MARKING GUIDE

		Marks	Marks
a.	**Journal entries**		
	Title	½	
	Entries	1½	
	Narration	1	3
	Sub-total		**3**
b.	**Statement of financial performance**		
	Title	¼	
	Correct calculation of total revenue	2¾	
	Correct calculation of total expenditure	5	
	Correct calculation of Net Surplus for the year	1	
	Correct calculation of Surplus carried forward	1	10
	Workings		
	Correct calculation of income to be recognised during the year. **(Wk 1)**	¾	
	Correct calculation of expenses to be charged during the year. **(Wk 2)**	2½	
	Correct calculation of depreciation charges for the year. **(Wk 3)**	1¼	
	Calculation of office stationeries to be charged during the year**(Wk 4)**	½	5
	Sub-total		**15**
c.	**Statement of financial position**		
	Title	¼	
	Correct calculation of total non-current assets	5¼	
	Correct calculation of total current assets	2	
	Correct calculation of total assets	½	
	Correct calculation of total current liabilities/ total liabilities.	1½	
	Calculation of total net assets	½	
	Correct calculation of reserves and net surplus	½	
	Correct calculation of total net assets/equity	½	11
	Workings		
	Property, plant & equipment schedule (Wk 5)		
	Correct calculation of cost at the end of the year.	2½	
	Correct calculation of accumulated depreciation at the year end.	2½	
	Adjusted cashbook (W.vi)		
	Recognition of balance b/f	¼	
	Correct calculation of total receipts	¼	
		¼	
	Correct calculation of total payments		
	Correct calculation of closing balance	¼	6
	Sub- total		**17**
d.	**External controls and problems of local government in Nigeria**		
	Five correct five external control of local government in Nigeria	2½	
	Five correct five problems of local government in Nigeria	2½	5
	Sub-total		**5**
	Total		**40**

SOLUTION 2

- ## Incremental and zero-based budgeting

  Incremental budgeting is the term used to describe the process whereby a budget is prepared using a previous period's budget or actual performance as a base, with incremental amounts then being added for the new budget period.

  Zero-based budgeting, on the other hand, refers to a budgeting process which starts from a base of zero, with no reference being made to the prior period's budget or performance. Every department function is reviewed comprehensively, with all expenditure requiring approval, rather than just the incremental expenditure requiring approval.

  Stages involved in preparing zero-based budget

  Zero-Based budgeting involves the use of decision-package approach, based on the identification of activities, which may be classified into the following five basic events:

  - Identification of decision units and formulating operational plans. The entire ministry or parastatal is divided into smaller components called decision units;
  - Analysing the whole budget into decision packages, based on the decision-units, to which costs are assigned and to the alternative ways of executing the same operation. It also involves assessing the effect of not performing the activity at all. Different levels of performance between the minimum and maximum points are evaluated so as to obtain optimality;

  iii. Ranking the decision packages covering the activities, both new and existing, in a competitive manner;

  iv. Determination of the cut-off point, to choose the packages which can be included and those to be rejected; and
    - Priortisation of the packages, to highlight the ones, which fit in with the available resources.

b. The public expenditure can be classified into four major functional areas:

i. **General government services**

This category covers both civil and defence expenditure meant to provide basic administrative structure and includes general administration, tax collection, police, currency and mint, external affairs, defence, non-plan provision against natural calamities, etc. these are indispensable activities performed by the state, the benefits of which cannot be allocated to specific groups, businesses or individuals;

ii. **Social and Community Services**
They cover basic social amenities supplied directly to the community, households or individuals, and include education, health care, social security and welfare, housing, community development, recreational and cultural activities. This class of expenditure is required to improve and maintain the living conditions of the people;

iii. **Economic services**
This category covers all expenditures, which directly or indirectly promote economic activity within the country, and incorporates expenditures on agriculture, industry, transport and communications and other economic services. They are necessary to create stock of capital that will generate future flow of income for growth and development of the economy; and

iv. **Transfer services**
It covers those items which cannot be classified under the above three heads like interest payments, pensions, food subsidies, statutory grants-in-aid to states, special loans, aid to foreign countries and the like. It's known as transfer because the benefit accrues to a third party.

Effects of public expenditure

The effects of public expenditure on the economy can be examined by reference to its impacts on a number of macroeconomic and socio-political activities as discussed below:

i. **Public expenditure and economic stabilisation**:
The philosophy of laissez-faire does not always guarantee automatic achievement of economic objectives of full employment, general price stability, equitable distribution of income, socially desired growth rate as well as soundness of foreign accounts. In fact, the more advanced and free the market economy, the greater the tendency of fluctuations in macroeconomic variables such as income, employment and general price level. Public expenditure as an anti-cyclical tool can be designed in such a manner as to create effective demand thereby stimulating investment activities. Stimulation of investment will lead to increase in employment, output and reduction in price, other things being equal. It must be emphasised however, that the total demand should be regulated so that the demand flows would match the supply flows otherwise the stimulating effect would result into inflationary pressure.

ii. **Public expenditure and production**:
Public expenditure can help the economy to attain a higher level of production. Through stimulation of investment activities, it can help to create conditions favourable for market forces to push up production. It can be used to create human skills through education and training and maintenance of social overheads. Expenditure on

education and health promotes human capital development and also promotes physical stock of capital for growth. Expenditure on education, health, communication, increases people's productivity at work and hence their incomes. With rise in income savings also increase and this in turn has a beneficial effect on capital formation and investment. Through research and development, new and effective methods of production can be invented whereby local resources are used.

iii. **Public expenditure and economic growth**:
The goals of planning are growth and social welfare, which can be realised only through government expenditure. Consequently, the government allocates funds to various sectors like agriculture, industry, transport, communications, education, energy, health, exports, and the likes with a view to achieve impressive growth. Government expenditure has been very helpful in maintaining balanced economic growth in the country. In furtherance of this, government takes keen interest in allocating more resources for development of backward regions. Such efforts reduce regional inequality and promote balanced economic growth. The government propels the growth in an industry by either increasing it's spending in it or supporting it in the forms of subsidies, lower interest rate for investments etc. For example, the government through Central Bank of Nigeria (CBN) had created various funds with differential interest rates to be disbursed to the perceived users with the aim of correcting market failure thereby growing the economy.

iv. **Public expenditure and distribution**:
An important aspect of the market mechanism is the inequalities of income and wealth, which arise on account of nature endowment and get widened through the institutions of private property and inheritance. Welfare consideration favours an equitable distribution of income and wealth since the purpose of economic policy is to attain the maximum level of social benefits possible. A shift towards equality may be achieved through various forms of public expenditure especially those that are meant to help the poorer sector of the society. For instance, items of common consumption may be subsidised and production of those, which are in short supply, can be taken up by public sector. Public expenditure on social security and subsidies to poor are aimed at increasing their real income and purchasing power. Expenditure on education, communication, health has a positive impact on productivity of the weaker section of society, thereby increasing their income earning capacity.

EXAMINER'S REPORT

Part (a) of the question tests candidates' knowledge of incremental and zero based budgetary systems, while part (b) was on functional areas of the public expenditure.

Majority of the candidates attempted the question. The performance in part (a) of the question was above average while performance in part (b) was below average.

The commonest pitfalls were the inability of the candidates to identify the stages involved in preparing zero-based budget and identify functional areas and effects of public expenditure on the economy.

Candidates are advised to have a good grasp of the basic features of incremental, zero-based budgeting and any other budgeting system. The Pathfinder and Study Text of the Institute are relevant learning materials on this aspect of the syllabus.

MARKING GUIDE

	Details	Marks	Marks
a.	Explanation of incremental budgeting	2½	
	Explanation of zero- based budgeting	2½	
	Identification the **five** main stages in the preparation of zero-based budget	<u>5</u>	10
b.	Two correct identification and explanation of functional classification of public expenditure	5	
	Discussion of two effects of public expenditure	<u>5</u>	<u>10</u>
	Total		<u>**20**</u>

SOLUTION 3

a. Categories of persons exempted from the scheme

The categories of persons exempted from the contributory pension scheme in accordance with Section 5 (1) of Pension Reform Act 2014, are:

- The categories of persons mentioned in Section 291 of the Constitution of the Federal Republic of Nigeria 1999 (as amended) including the members of Armed Forces, the intelligence and Secret Services of the Federation;
- An employee who is entitled to retirement benefits under any pension scheme existing before 25th day of June 2004 and has three (3)or fewer years to retire; and
- Fully funded pension scheme

Deficiencies of Pension Reform Act, 2014

- **Scope and coverage:** The scheme applies to employees in both the public and private sectors. Mandatory contribution is applicable to organisations in which there are fifteen (15) or more employees (previously five (5) employees). This effectively reduces the number of employers and employees that are likely to benefit from the scheme. Given the low level of contributors under the scheme, this change is counter productive.

- **Basis of contribution:** Contributions are now to be based on 'monthly emoluments' being the total emolument as defined in the employee's contract of employment provided it is not less than the total of the employee's basic salary, housing and transport allowance. This definition is vague and could be interpreted to mean that all items that are paid on a monthly basis (in addition to basic, housing and transport) would form part of the base on which the pension rates are applied. This potentially larger base could well mean that many employers will see an increase of over 100% in their pension contribution obligations while employees' net pay will reduce unless their employers chose to increase their salaries to accommodate the additional contribution.

- **Rates of contribution:** The rates of contributions to be made under the new Scheme by both the employer and employee are a minimum of 10% and 8% respectively (7.5% of the employee's monthly basic, housing and transport allowances by both parties under the repealed Act). Again, this will increase the cost of employment and may force many employers to take drastic measures such as rationalisation of staff strength.

- **Commencement date**: The Pension Reform Act 2014 (Act) was signed into law by the President on July 1, 2014 with the same date as commencement date, does not give room for transition arrangement and proper planning by affected employers.

- **Gaps in coverage:** Only employers with a minimum of fifteen (15) employees are required to contribute to the new Scheme. The Act provides that in the case of private organisations with less than three (3) employees participation in the Scheme would be governed by guidelines issued by the National Pension Commission (PenCom). However, the Act is silent on the applicability of the Scheme to private organisations with more than three (3) but less than fifteen (15) employees. Also what happens to employers with five (5) to fourteen (14) employees regarding their past contributions under the old Act?

- **Sole contribution by employers:** The Act provides that an employer can take full responsibility of the contribution but in that case, the contribution shall not be less than 20% of the employee's monthly emolument. This provision contradicts the combined contribution by both parties of 18%. Employers will therefore be discouraged from taking full responsibility.

b. Public debt

Public debt refers to the total amount of money borrowed by government either within or outside the economy for the purpose financing development programmes or to support the balance of payments position. In other words, it is the total outstanding financial obligations of government during a given period that is commonly referred to as public debt. It is a good source of capital formation, most especially in developing economies where there is low level of income that is not sufficient for consumption thereby creating poor savings culture.

Benefits of public debt

The benefits of public debt include the following:

- Rapid economic growth and welfare improvement would be achieved if borrowed funds were utilised to finance economically and socially viable projects.
- The confidence of local and foreign investors in the economy would be boosted, if public debt were used to control inflation. New and additional investment would lead to creation of new jobs and greater output of welfare- enhancing goods and services.
- If borrowed funds are spent on public works, standards of living will improve, especially via creation of new jobs and the transformation of the environment.
- Public debt reduces income inequalities if it is spent on social, security and projects that are of more benefits to the lower income groups.
- Those who lend money to government by purchasing government securities, instead of keeping idle savings, will become richer as they acquire additional assets to boost their wealth portfolio.

Negative effects of public debt

The adverse consequences or disadvantages of public debt include the following:

- Excessive government borrowing within the economy tends to crowd out private investments. That is, government competes with private companies in the financial market and deprive them loanable funds they need to grow their activities;
- Tax burden on future generation. Public debt imposes unfair tax obligation on future generation especially when borrowed funds are

deployed to fund consumption rather than investment programmes or when such funds are diverted to non-self-liquidating projects or projects that are poorly designed, thereby making execution impossible;

- Funding excessive interest rate on public debt in hard currency deprives the nation of foreign exchange needed to procure critical inputs, especially in a country like Nigeria that is highly dependent on import with respect to raw materials required in the industrial sector. This leads to declining industrial capacity utilisation and loss of industrial jobs;
- Borrowing comes with conditionalities that may become too stringent for the debtor nation(s), like trade liberalisation, withdrawal of subsidies on essential products, expenditure reduction, non-increase of salary of public servants and other stiff conditions that might have great consequence on living standards of the people;
- It is an ineffective way of controlling inflation. As a matter of fact, debt servicing may create inflationary effects at a time of full-employment. Specifically, the financing of domestic debt usually causes aggregate demand to increase when creditors bring the income generated through their investment in government securities into circulation;
- Debt servicing problem is aggravated when short and medium-term loans are committed to long-term projects with amortisation becoming due before projects are completed; and
- Borrowing tends to widen the level of income inequalities since it is the rich only that can invest in government securities or lend to government and hence benefit from high interest payment.

EXAMINER'S REPORT

Part (a) of the question tests candidates' knowledge of the provisions of Pension Reform Act 2014 as it relates to categories of persons exempted from the scheme and deficiencies of the scheme. Part (b) tests candidates' knowledge of public debt including its benefits and demerits.

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

Candidates' major pitfalls were their inability to identify deficiencies of Pension Reform Act, 2014 and benefits of public debts.

Candidates are advised to pay more attention to the provisions of Pension Reform Act. 2014 and public debt instruments for better performance in future examinations of the Institute. The Pathfinder and Study Text of the Institute are relevant learning materials on this aspect of the syllabus.

MARKING GUIDE

	Details	Marks	Marks
a.	Identification of any **two** categories of persons exempted from the scheme	4	
	Identification of any three deficiencies of the scheme	6	10
b.	Explanation of public debt	2½	
	Three benefits of public debt	4½	
	Two negative effects of public debt	3	10
	Total		**20**

SOLUTION 4

a.

High Court of Okoko State

Date	Rev. Receipt No	Classification	From whom Receivable	Amount	Date	Treasury Receipt No	Amount
		Hd/Sub- Hd		₦			₦
5/8/19	KB 30022	300 / 115	Mr Okon (Registration of Contractors)	50,000	29/8/19	A12356	736,000
14/8/19	KB 30023	300/005	Mr Ahmed (Court Fine)	135,000			
16/8/19	KB 30024	300/002	Mr Charles (Declaration of Age)	1,000			
20/8/19	KB 30025	300/005	Mr Bako (Court Fine)	500,000			
26/8/19	KB 30026	300/115	Mrs. Ogun (Registration of Contractors)	50,000			
	Total			**736,000**			**736,000**

Revenue collector's cash book for the month of August 2019

b. Circumstances for debt financing

i. **War and other emergencies:** The financial cost of war is enormous. It is not captured in national budget. Most often, war is an emergency. It is practically difficult to raise revenue through tax. A nation facing war will not have any other option than debt financing, no matter the conditionality attached to the procurement of such debt;

ii. **Inadequate tax revenue:** Unlike debt, financing of public expenditure through tax revenue is preferable since it involves no interest payment and repayment of the principal. Tax revenue usually accumulates over a fiscal year but fund from debt can be made available over a shorter period. Also, debt financing will be embraced where actual tax receipts are falling much below the anticipated volume; and

iii. **Debt conditionality:** Debt may be tied to a particular project for certain areas or people. The cost of the project can be met through borrowing and then recovered from the beneficiaries through a levy or some other means. For instance a particular irrigation project might benefit the farmers of a particular area.

Documentations for issuance of government bond

- Profile of the state showing its population size, major industries, their locations and other major projects embarked upon. The information has to be submitted with an application to the Securities and Exchange Commission (SEC) as well as the Nigerian Stock Exchange (NSE);
- A profile of the assets and liabilities of the state in the last five years and a for five years;
- Sources of revenue for the past five years, indicating the percentage contribution of each source to the total revenue;
- The law of the state authorising it or its agency to borrow from the capital market;
- A feasibility report of the project to be financed;
- A draft of the Trust Deed in respect of the proposed issue;
- The consent of the Federal Ministry of Finance to the state's request to borrow from the capital market;
- Letter of authority from the state government to the Central Bank of Nigeria or the Accountant-General of the Federation, to seek direct recovery of loans and interest from the affected Government's statutory allocations in case of default; and

- Letter of consent from the Central Bank of Nigeria or the Accountant General of Federation to deduct (quarterly) adequate funds from the state's allocations for the redemption of the loan in case of default.

EXAMINER'S REPORT

Part (a) of the question tests candidates' knowledge on how to prepare revenue collector's cash book, while part (b) tests knowledge of debt financing and identification of documents required for issuance of bonds to a state or local government.

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

Candidates' major pitfalls were little knowledge of circumstances under which debt financing is appropriate and documents required for issuance to a state or local government.

Candidates are advised to pay more attention to all arrears of the syllabus for better performance in future Institute's examinations.

MARKING GUIDE

	Details	Marks	Marks
a.	Title	½	
	Eight columns of the format in revenue collector's cash book	2	
	Correct entries	7½	10
b	Two correct identification and explanation of circumstances for public debt finance.	4	
	Four correct documents for issuance of government bond	6	10
	Total		**20**

SOLUTION 5

a.

Ogoja State Government

Consolidated budget report for the year ended December 31, 2018

Description	Actual	Final	Supp.	Initial	Variation
		Budget	Budget	Budget	on final
	2018	2018	2018	2018	Budget 2018
	₦' million		₦' million	₦' million	₦' million
Revenue	A	B=C+D)	C	D	E=B-A
Government share of FAAC (Statutory revenue)	864,112	865,000	-	865,000	888
Government share of VAT	188,997	189,000	-	189,000	3
Tax revenue	46,764	43,929	-	43,929	(2,835)
Investment income	475	574	-	574	99
Aid & grants	139	-	-	-	(139)
Other revenues	1,404	-	-	-	(1,404)
Transfer from other government entities	3,714	-	-	-	(3,714)
Total revenue	**1,105,605**	**1,098,503**	-	**1,098,503**	**(7,102)**
Expenditure					
Salaries, wages & social benefits	913,324	963,178	39,959	923,219	49,854
Overhead cost	559,976	643,239	93,239	550,000	83,263
Grants & contributions	281,340	-	-	-	(281,340)
Depreciation, impairment & amortisation charges	50,362	-	-	-	(50,362)
Bad debts charges	10,809	-	-	-	(10,809)
Public debt charges	1,296	-	-	-	(1,296)

Transfer to other government entities	5,719	-	-	-	(5,719)
Total recurrent expenditure	**1,822,826**	**1,606,417**	**133,198**	**1,473,219**	**(216,409)**
Capital expenditure based on sectors					
Administrative sector	88,704	87,339	-	87,339	(1,365)
Economic sector	25,330	29,183	-	29,183	3,853
Law and justice sector	15,407	22,301	-	22,301	6,894
Social sector	35,139	52,379	-	52,379	17,240
Total capital expenditure	**164,580**	**191,202**	-		**26,622**
Total expenditure:	**1,987,406**	**1,797,619**	**133,198**	**1,664,421**	**(189,787)**
Budget Surplus/(Deficit)	**(881,801)**	**(699,116)**	**(133,198)**	**(565,918)**	

b. **Benefits of public private partnership:**

- **Efficiency**: There is the belief that the private sector is better at managing investment projects and achieving overall cost efficiencies than the public sector which is bedeviled with unnecessary bureaucracies;

- **Extra investment**: Extra funding can kick-start more projects thereby bringing about economic and social benefits. The Private Finance Initiatives (PFI) provide private sector funds for projects that might prove difficult for government to finance through higher borrowing and taxes. Projects supporting health or education will improve productive capacity, increase economic growth and can therefore be funded out of future incomes that the projects help to generate;

- **Delivery**: The private sector is not paid until the asset has been delivered, which encourages timely delivery. PFI construction contracts are fixed price contracts with financial consequences for contractors, if delivered late; and

- **Dynamic efficiency**: Private sector is better placed to bring innovation and good design to projects, higher quality of delivery and lowering of maintenance costs. The bidding process for PFI projects creates competition at the point of tendering.

Adverse consequences of private partnership:

- **Risk**: The ultimate risk with a project lies with the public sector (government). Private finance agreements are complicated to organise and there is no guarantee that the private sector will make a better cost benefit analysis of a project than the public sector;
- **Debt costs**: Private finance has always been more expensive than government borrowing, but since the financial crisis the difference between the costs has widened significantly. The difference in finance costs means that Public Private Partnership (PPP) projects are significantly more expensive to fund over the life of a project. This represents a significant cost to taxpayers;
- **Inflexibility and poor value for money:** Long service contracts may be difficult/costly to change – especially when the management of a project seems to have gone wrong. There have been many stories of flawed projects for example private firms contracted out to provide car parking, cleaning and other services in hospitals built and run as part of a PPP. Infrastructure may not be designed to last more than the length of the contract and will need replacing or maintenance at high costs;
- **Administration**: High spending on advisors, lawyers and the costs of the bidding process. The cost of bidding for a PFI project may be unnecessarily too high for the public sector, thereby increasing the estimated budgetary provision; and
- **Addiction**: Governments can become addicted to PFI, rather than using government borrowing for key projects. The PFI have added to public sector debt but created many private sector fortunes.

EXAMINER'S REPORT

Part (a) of the question tests candidates' knowledge on how to prepare of consolidated budget report, while part (b) tests the benefits and adverse consequences of Public Private (PPP) in executing public projects.

Few candidates attempted the question and performance was above average

Candidates' major pitfalls were their poor knowledge of preparation of consolidated budget as required by IPSAS 24 and inability to identify benefits and adverse consequences of Public Private Partnership (PPP).

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

MARKING GUIDE

	Details	Marks	Marks
a.	Title	½	
	Calculation of final revenue budget and variation	2¾	
	Calculation of final recurrent expenditure budget and variation	3¼	
	Calculation of variation on final capital budget	1¼	
	Calculation of total expenditure budget including variation	1¼	
	Calculation of budget surplus/(deficit)	1	10
b.	Three correct identification and explanation of benefits of PPP	6	
	Two correct identification and explanation of adverse consequences of PPP	4	10
	Total		**20**

SOLUTION 6

a. Payment of public moneys from the Consolidated Revenue Fund (CRF) should be authorised by one of the following:

- **An Appropriation Act passed by National or State Assembly.** When a budget is laid before National or State Assembly is approved by passing an Appropriation Act and any expenditure covered by the Appropriation Act is properly authorised for payment out of the Consolidated Fund. (Section 81 or 121 of the Constitution of Federal Republic of Nigeria);
- **Supplementary estimate approved by a resolution of National or State Assembly.** Whenever a new estimate is brought to Parliament for approval, it constitutes a supplementary estimate and when approved by Parliament through a resolution, it serves as authority for spending from the Consolidated Fund. (Section 81(4) or 121(4) of the Constitution of Federal Republic of Nigeria);
- **Request of expenditure in advance of appropriation approved by the President.** If the Appropriation Bill in respect of any financial year has not been passed into law by the beginning of the financial year, the President may authorise the withdrawal of moneys in the Consolidated Revenue Fund of the Federation for the purpose of meeting expenditure necessary to carry on the services of the government of the federation for a period not exceeding months or until the coming into operation of the Appropriate Act, whichever is the earlier. (Section 82 or 122 of the Constitution of Federal Republic of Nigeria); and
- **Issuance of financial warrants:** Government expenditure must be properly authorised and approved. The authority, which confers power on the officer controlling expenditure or a vote, to incur expenditure, is called "Warrants." All warrants should be issued and signed by the Minister of Finance. Warrants

can be divided into two groups, i.e. recurrent and capital expenditure warrants.

Charges to the Consolidated Revenue Fund (CRF)

The charges to the CRF are grouped as follows:

- **All recurrent expenditure heads in the approved estimates,** e.g. personnel cost, overhead cost and servicing of national debts;
- **Salaries and consolidated allowances of statutory Officers:** These are expenditure chargeable directly to the Consolidated Revenue Fund, irrespective of budget approval. Statutory officers include commissioners of the following bodies:
    - Police Service Commission;
    - Public Complaints Commission;
    - Public Service Commission;
    - Nigerian Law Reform Commission;
    - Independent National Electoral Commission;
    - Auditor - General for the Federation;
    - President and Justices of the Federal Court of Appeal;
    - Chief Judge and Judges of the Federal High Court; and
    - Chief Justice and Justices of the Supreme Court.

iii. **Pension and gratuity:** These are the entitlements of both statutory and non-statutory officers, including members of the armed forces.

b. Functions of the Bureau of Public Enterprises (BPE) as regard commercialisation:

The functions of the BPE in respect of commercialisation are to:

- Implement the council's policy on commercialisation;
- Prepare public enterprises approved by the council for commercialisation;
- Advise the council on further public enterprises that may be commercialised; Ensure the updating of the accounts of all commercialised enterprises to ensure financial discipline;
- Ensure the success of the commercialisation exercise and monitor, on a continuous basis for such period as may be considered necessary, the operations of the public enterprises after commercialisation;
- Review the objectives for which public enterprises were established in order to ensure that they adapt to the changing needs of the economy;
- Ensure that public enterprises are managed in accordance with sound commercial principles and prudent financial practices;
- Interface with the public enterprises, together with the supervising ministries, in order to ensure effective monitoring and safeguard of the public enterprises' managerial practices;
- Ensure that the board and management of each commercialised enterprise and the government of the federation keep to the terms and conditions of the

performance agreements, if any, between the public enterprise concerned and the government of the federation;

- Maintain and review on a continuous basis, any performance agreement between a public enterprise and the government of the federation;
- Evaluate and recommend to the council whether or not a public enterprise is eligible for funding through grants, loans, subventions or equity; and
- Perform such functions with respect to commercialisation as the council may, from time to time, assign to it.

Function of Bureau of Public Enterprises (BPE) as regard privatisation

The functions of the BPE in respect to privatisation are to:

- Implement the council's policy on privatisation;
- Prepare public enterprises approved by the council for privatisation;
- Advise the council on further public enterprises that may be privatised;
- Advise the council on the capital restructuring needs of the public enterprises to be privatised;
- Carry out all activities required for the successful issue of shares and sale of assets of the public enterprises to be privatised;
- Make recommendations to the council on the appointment of consultants, advisers, investment bankers, issuing houses, stockbrokers, solicitors, trustees, accountants and other professionals required for the purposes of privatisation;
- Advise the council on the allotment pattern for the sale of the shares of the public enterprises set out for privatisation;
- Oversee the actual sale of shares of the public enterprises to be privatised by the issuing houses, in accordance with the guidelines approved, from time to time, by the council;
- Ensure the success of the privatisation exercise taking into account, the need for balance and meaningful participation by Nigerians and foreigners in accordance with the relevant laws of Nigeria; and
- Perform such functions with respect to privatisation as the council may, from time to time, assign to it.

EXAMINER'S REPORT

Part (a) of the question tests candidates' knowledge on the ways of authorizing payments out of Consolidated Revenue Fund (CRF) and the statutory payments, while part (b) tests the concepts of commercialisation and privatisation functions of Bureau of Public Enterprises (BPE).

Few candidates attempted the question and their performance was below average.

Candidates' major pitfalls were their poor understanding of functions of BPE as regards commercialisation and privatisation. They were also to identify ways of authorising payment out of the Consolidated Revenue Fund (CRF)

Candidates are advised to cover all sections of the syllabus and make use of Pathfinder and Study Text of the Institute for better preparation and good performance in future examinations of the Institute.

MARKING GUIDE

	Details	**Marks**	**Marks**
a.	Three correct identification and explanation of payment from the Consolidated Fund	6	
	Two correct identification and explanation of charges to the Consolidated Revenue Fund	4	10
b	Five correct functions of the Bureau	5	
	Five correct functions of the Bureau	<u>5</u>	10
	Total		**<u>20</u>**

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA

SKILLS LEVEL EXAMINATION – NOVEMBER 2019

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

Premier Insurance Plc. (PIP) was incorporated in 2000. It commenced insurance business in 2001. 49% of the company's equity was held by its foreign technical partners, with the remaining 51% held by Nigerians. The company's technical agreement requires that the technical partners were to produce the Managing Director while the Nigerian shareholders will produce the Chairman and Deputy Managing Director. As a result of this arrangement, Mr. R. Stalwart emerged as Managing Director, Chief E. Acquah as Chairman and Mr. D. Dede as Deputy Managing Director.

Mr. Stalwart is a veteran in the insurance industry. He has over 20 years experience in leading insurance companies across three continents. He has worked with the technical partners serving as Chief Executive Officer in three insurance companies within the group. He also has strong connections within the expatriate community in Nigeria.

Chief Acquah is a rich and prominent politician with strong connections in government circles. He held about 25% of the Nigerian shareholding at the commencement of operations.

Mr. Dede is a brilliant young underwriter and finance expert, who is well connected in the Nigerian insurance market. He oversees the Business Development Unit.

Business outlook

The company's premium and investment incomes were rising steadily until 2010. The company's profits were further buoyed by the rental income realised from its heavy investment in real estate. The company also enjoyed a lot of government patronage due to the strong connection of its chairman, who was a leader of the ruling party.

During this period, the company attracted and retained some of the best hands in the industry. It offered highly competitive packages to its staff. Sales commissions and other productivity bonuses were however not included as most of the large accounts were obtained through the connections of the Chairman and the Managing Director.

No serious attention was paid to prompt settlement of claims, other than those of marine and government businesses. Besides, though well remunerated, staff were fixed in their ways, so response time to enquiries and claims were long and in most cases, inconclusive. Also, there were no targets set for staff and so, no productivity bonuses paid.

In 2010, the global economic crisis started having its full impact on the Nigerian economy. The technical partners of the company reduced their investment from 49% to 10%, as a result of which Mr Stalwart had to resign as Managing Director of the company. The exit of Mr. Stalwart coupled with the loss of Chief Acquah's party at the general elections, led to a dramatic drop in premium income from the usual government and multinational companies' businesses. The slump in the real estate sector adversely affected the rental income. Interest rates also fell, leading to a reduced investment income. Profits plummeted, ultimately leading to accumulation of losses.

Re-organisation

Chief Acquah resigned as Chairman of the board of PIP. After the resignation of Mr. Stalwart, the new investors demanded for a re-organisation of the company. Hence, Mr. Dede was appointed the new Managing Director with the mandate to evaluate the strategic performance of PIP and develop a strategy to improve the performance of the company in the market.

Required:

a. Discuss Fitzgerald and Moon building block model for analysing performance management systems in service industries. (12 Marks)

b. Apply the Fitzgerald and Moon building block model to evaluate the strategic performance of Premier Insurance Plc. (20 Marks)

c. Summarise the outcome of the evaluation of the performance management system of Premier Insurance Plc. and recommend elements of a new strategy for the company based on the Fitzgerald and Moon building block model. (8 Marks)

(Total 40 Marks)

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

QUESTION 2

As a risk management consultant, you are required to provide a comparative overview of the International Corporate Governance Network (ICGN) guidelines and the Financial Reporting Council of Nigeria (FRCN) Code of Corporate Governance on responsibilities for the oversight and management of corporate risk. **(20 Marks)**

QUESTION 3

a. There are basic concepts that must be observed for good corporate governance in an entity.

Required:
Discuss these concepts and show how they relate to good corporate governance. (14 Marks)

b. The public sector is the driver of the economies of many developing nations, hence, Public Finance Management has become the focus of attention in many of these economies in recent years. Development partners have therefore drawn the attention of the governments of these countries to the report of the Nolan Committee on Standards in Public Life which set out standards of behaviour amongst politicians and in the civil service in the UK.

Required:

Discuss **SIX** of these principles for public office holders and show how they can enhance performance in the public sector. (6 Marks)

(Total 20 Marks)

QUESTION 4

In their quest to create economic wealth, business organisations leave environmental and social footprints.

Required:

a. Discuss environmental and social footprints of organisations. (10 Marks)

b. Discuss the concept of carbon neutrality in relation to the operations of companies. (5 Marks)

c. Discuss the concept of social ecology. (5 Marks)

(Total 20 Marks)

QUESTION 5

a. You are preparing for a job interview as a risk manager. This requires you to make a ten-minute presentation on the functions and determinants of the efficiency of a risk manager. Present an outline of your 10-minute presentation. (10 Marks)

b. Analyse the alternative types of board structure that a company might adopt and provide an argument in support of the one you consider to be more viable. (10 Marks)

(Total 20 Marks)

QUESTION 6

Well defined business strategies will provide viable solutions to basic business problems which are essential to business growth and sustainability.

Required:

a. Define 'business strategy' and highlight **EIGHT** questions that a five-year business strategy must seek to answer. (5 Marks)

b. Distinguish ethical subjectivism from situation ethics. (6 Marks)

c. Discuss ethical non-consequentialism, its emphasis on duty and highlight **TWO** of its problems. (9 Marks)

(Total 20 Marks)

SOLUTION 1

A. DISCUSSION OF FITZGERALD AND MOON BUILDING BLOCK MODEL

Fitzgerald and Moon (1996) suggested that a performance management system in a service organisation can be analysed as a combination of three building blocks:

- Dimensions
- Standards
- Rewards

OR PRESENTED AS SHOWN IN THE DIAGRAM BELOW

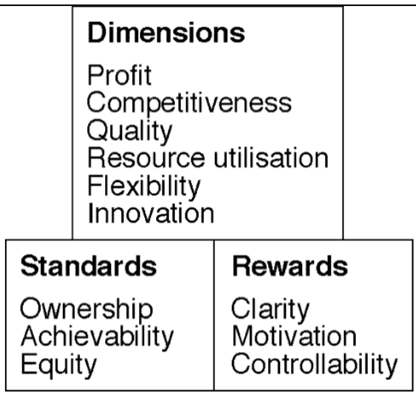


Illustration: Building blocks for performance measurement systems

These are shown in the following diagram.

Some performance measures that might be used for each dimension are set out in the following table:

Dimension of performance	Possible measure of performance
Financial performance	Profitability Growth in profits Profit/sales margins Note: Return on capital employed is possibly not so relevant in a service industry, where the company employs fairly small amounts of capital.
Competitiveness	Growth in sales Retention rate for customers (or percentage of customers who buy regularly: 'repeat sales') Success rate in converting enquiries into sales Possibly market share, although this may be difficult to measure
Service quality	Number of complaints Whether the rate of complaints is increasing or decreasing Customer satisfaction, as revealed by customer opinion surveys Number of errors discovered
Flexibility	Possibly the mix of different types of work done by employees Possibly the speed in responding to customers' requests
Resource utilisation	Efficiency/productivity measures Utilisation rates: percentage of available time utilised in 'productive' activities
Innovation	Number of new services offered Percentage of sales income that comes from services introduced in the last one or two years

The dimensions of performance should also distinguish between:

- 'results' of actions taken in the past, and
- 'determinants' of future performance.

Performance: results of past actions

Fitzgerald and Moon suggested that results of past actions are measured by:

- financial performance; and
- competitiveness

Determinants of future performance

Other dimensions of performance measure progress towards achieving strategic objectives in the future. The 'drivers' or 'determinants' of future performance are:

- quality;
- resource utilisation;
- flexibility; and
- innovation.

Standards

The second part of the Fitzgerald and Moon framework relates to setting expected standards of performance, once the dimensions of performance have been selected.

There are three questions relevant to setting standards of performance: These are:

- To what extent do individuals feel that they own the standards that will be used to assess their performance? Do they accept the standards as their own, or do they feel that the standards have been imposed on them by senior management?

- Do individuals responsible for achieving the standards of performance consider that these standards are achievable, or not?

- Are the standards fair ('equitable') for all managers in all business units of the entity?

Rewards

- The third aspect of the Fitzgerald and Moon performance measurement framework is rewards. This refers to the structure of the rewards system, and how individuals will be rewarded for the successful achievement of performance targets.

- One of the main roles of a performance measurement system should be to ensure that strategic objectives are achieved successfully, by linking operational performance with strategic objectives.

- The system of setting performance targets and rewarding individuals for achieving those targets must be clear to everyone involved. Provided that managers accept their performance targets, **motivation** to achieve the targets will be greater when the targets are **clear**.

- Employees may be motivated to work harder to achieve performance targets when they are rewarded for successful achievements, for example with the payment of a bonus.

- Individuals should only be held responsible for aspects of financial performance that they can control. This is a basic principle of responsibility accounting.

B. **APPLYING THE FITZGERALD AND MOON FRAMEWORK TO PIP.**

The actual measures of performance used by companies in service industries will vary according to the nature of the service. In this case, details in the scenario are used to evaluate the performance management system in PIP.

Dimensions of performance

The company used only two of the six dimensions of performance to assess the performance of the company during the period under review.

Dimension of performance	Measures used	Comments
Financial performance	- Premium Income - Investment Income - Rental Income - Profitability - Growth in profit	Profit is seen as a very important measure of performance.
Competitiveness	Market share (at company level).	Not monitored but could be obtained through published market share statistics.
Quality of service on specific transactions	Response time to enquiries and customers' observations	Not monitored.
Quality of service overall	Claim settlement period	Not monitored.
Flexibility	No formal performance measurement	Managers and staff were not encouraged to be flexible or proactive as management depended on the 'guaranteed' income from government and marine businesses, irrespective of responsiveness.
Resource utilisation	Premium per square metre. Wastage rates	The competences of the existing staff not fully utilised, hence human resource not well utilised.
Innovation	Number of new products launched	There is evidence of new product development, but the products were not introduced to market because management did not place priority on innovation.

Resource utilisation	Premium per square metre. Wastage rates	The competences of the existing staff not fully utilised, hence human resource not well utilised.
Innovation	Number of new products launched	There is evidence of new product development, but the products were not introduced to market because management did not place priority on innovation.

Standards of performance

Standard	**Comments**
Profit	
Ownership	No standards were set as there were no annual targets and business planning.
Achievability	Not applicable as no profit targets were set.
Equity	Not applicable as the conditions were the same for all units and departments.
Quality of service	
Ownership	No standards were set by management.
Achievability	Achievability could not be measured. There are also no external standards to which performance could be compared.
Equity	Not applicable as the conditions were the same for all staff.

Rewards

Staff were well remunerated compared to industry average, but rewards were not linked with productivity. Commissions and productivity bonuses were not granted.

c. **SUMMARY**

- Based on the strategic analysis above, the strategy adopted by PIP had emphasised short-term outlook to the detriment of the long-term outlook by placing all attention on the immediate sources of income, viz government and marine businesses.

- The company focussed fully on the dimensions of performance which indicate results of past action, i.e. financial performance.

- Determinants of future performance such as innovation, quality of service, resource utilisation and flexibility were ignored.

RECOMMENDATIONS

Dimensions of performance

Going forward, PIP should focus on the following dimensions of performance (which are determinants of future performance) in addition to financial performance:

- **Innovation** - new products developed should be launched and additional products developed;

- **Quality of service** - more emphasis should be placed on the quality of service such as the response time claims settlement and enquiries;

- **Resource utilisation** - the company should make better use of its resources, including human resources; and

- **Flexibility** - the company should adopt a flat structure which will enable lower level managers take decisions faster, thus, making the organisation more responsive and the staff more flexible.

Standards

Standards should also be set for all the dimensions of performance so that achievements can be compared with these standards.

Rewards:

A reward system, which will link reward to performance, should be developed. Commissions and productivity bonuses should be paid to deserving staff.

EXAMINER'S REPORT

This 40-mark compulsory question tests candidates' understanding of the Fitzgerald and Moon Building Block model for analysing performance management systems in service industries and application of the model to evaluate the strategy in a given scenario. Candidates were also required to recommend changes to improve the strategy.

As expected, most candidates attempted the question.

Candidates' performance was poor.

The poor performance was due to over-concentration of candidates on the models for evaluation of performance systems in manufacturing outfits to the detriment of models relating to service industries.

Another common pitfall was the inability of candidates to apply the model to evaluate the strategy adopted by the company in the given scenario and hence, could not recommend improvements.

Candidates are enjoined to cover the syllabus fully and develop skills to apply concepts and models to given scenarios.

MARKING GUIDE

		MARKS	MARKS
a.	Identification of three building blocks	3 x 1	3
	Explanation of each of the 6 dimensions	6 x ½	3
	Results of past actions	1 x 1	1
	Determinants of future performance	1 x 1	1
	Explanation of the standards building block	4 x ½	2
	Explanation of rewards building block	4 x ½	2
			12
b.	Introductory remark	1 x 1	1
	Application of dimensions of performance		
	Financial performance	3 x 1	3
	Competitiveness	2 x 1	2
	Quality of service	2 x 1	2
	Flexibility	2 x 1	2
	Resource utilization	2 x 1	2
	Innovation	2 x 1	2
	Application of standards of performance	2 x 1	2
	Profit		
	Ownership	2 x 1	2
	Application of rewards	2 x 1	2
c.	Summary	2 x 1	20
	Recommendations		2
	Dimensions	4 x 1	4
	Standards	1 x 1	1
	Rewards	1 x 1	1
			8
			40

SOLUTION 2

International Corporate Governance Network (ICGN) corporate risk oversight guidelines

The International Corporate Governance Network's (ICGN) guidelines on responsibilities for the oversight and management of corporate risk (2010) specify as follows:

- The risk oversight process begins with the board, which is responsible for deciding the company's risk strategy and business model. It should understand and agree on the level of risk that goes with chosen business model. It should also exercise oversight on the implementation of a strategic and operational risk management system by management;

- Management has the responsibility for developing and implementing the company's strategic and routine operational risk management system, within the strategy set by the board and subject to board oversight;

- Shareholders have a responsibility to assess the effectiveness of the board in overseeing risk. Investors are not themselves responsible for the oversight of risk in the company; and
- The ICGN Guidelines provide guidance on processes for the oversight of corporate risk by the board and within the company, for investor responsibility and for disclosures by a company on its risk management oversight processes.

The Financial Reporting Council of Nigeria (FRCN) code of corporate governance

The FRCN code states the role of the board as follows:

- Should "undertake at least annually, a thorough risk assessment covering all aspects of the company's business;
- Should ensure that the company's risk management policies and practices are disclosed in the annual report;
- This assessment should be carried out by the Risk Management Committee in collaboration with the Audit Committee, which should then report its findings to the full board;
- The responsibilities of the board of directors and management for risk management are the same as their responsibilities for the system of risk internal control;

- Should decide a company's policies with regards to risk internal control, the board should consider the nature and extent of the risks facing the company;
- Determine extent and categories of risk which it considers as acceptable for the company to bear;
- Determine likelihood that the risks will materialise (and events will turn out worse than expected);
- Ensure company's ability to reduce the probability of an adverse event occurring, or reducing the impact of an adverse event when it does occur; and
- Balance the cost of operating the controls against the benefits that the company expects to obtain from the control.

The considerations above should apply to strategic risks as well as to operational risk and internal control systems;

- The board of directors is to maintain a sound system of risk management, and to carry out a review of the effectiveness of the risk management system at least once each year.

Comparison of ICGN guidelines with the FRCN code

- Both ICGN guidelines and the FRCN Code of Corporate Governance are complementary.
- The ICGN guidelines provide an overview of the responsibilities of the board, management and shareholders in respect of risk management.
- The FRCN guidelines provide some additional details on the responsibilities of the board of directors and management.
- These are construed to be largely the same in respect of the system of risk internal control.

EXAMINER'S REPORT

The question tests candidates' understanding of the inter-relationship between International Corporate Governance Network (ICGN) guidelines and the Financial Reporting Council of Nigeria (FRCN)'s Code of Corporate Governance on responsibilities for oversight and management of corporate risk.

About 60% of candidates attempted the question.

Performance was slightly above average.

While most candidates were well grounded in the contents of the FRCN codes, a number of candidates were not conversant with the contents of the ICGN guidelines with respect to responsibilities for oversight and management of corporate risk. Many of the candidates also did not appreciate the inter-relationship between the ICGN Guidelines and the FRCN Code.

Candidates are advised to pay attention to the inter-relationship between ICGN Guidelines and FRCN Code.

MARKING GUIDE

	MARKS	MARKS
ICGN guidelines	4 x 2½	10
FRCN code	10 x 1	10
		20

SOLUTION 3

3a. The Concepts of Corporate Governance
These concepts facilitate the good governance of a corporate entity. They include:

i. **Fairness**

- Fairness refers to the principle that all shareholders should receive fair treatment from the directors.
- At a basic level, it means that all the equity shareholders in a company should be entitled to equal treatment, such as one vote per share at general meetings of the company and the right to the same dividend per share.
- In Nigeria, the concept of fair treatment for shareholders is supported by the law (which provides some protection for minority shareholders against unjust treatment by the directors or the majority shareholders).

ii. **Openness/transparency**

- This implies 'not hiding anything'. Intentions should be clear, and information should not be withheld from individuals who have a right to receive it.
- Transparency means clarity. It should refer not only to the ability of the shareholders to see what the directors are trying to achieve.
- It also refers to the ease with which an 'outsider', such as a potential investor or an employee, can make a meaningful analysis of the company and its intentions.
- Transparency therefore, means providing information about what the company has done, what it intends to do in the future and what risks it faces.

In listed companies (stock market listed companies), openness includes matters such as:

- requiring major shareholders to declare the size of their shareholding in the company, and
- requiring the board of directors to announce to the stock market, information about any major new development in the company's affairs, so that all shareholders and other investors are kept informed.

iii. Independence

- Independence means freedom from the influence of someone else.
- A principle of good corporate governance is that a substantial number of the directors of a company should be independent, which means that they are able to make judgements and give opinions that are in the best interests of the company, without bias or pre-conceived ideas.
- Similarly, professional advisers to a company such as external auditors and solicitors should be independent of the company and should give honest and professional opinions and advice.
- The independence of a director is threatened by having a connection to a special interest group.
- Executive directors can never be independent, because their views will represent the opinions of the management team.
- Similarly, a retired former executive might still be influenced by the views of management, because he or she shares the 'management culture'. Directors who represent the interests of major shareholders are also incapable of being independent.
- The independence of external auditors can be threatened by over-reliance on fee income from a client company. When a firm of auditors, or a regional office of a national firm, earns most of its income from one corporate client, there is a risk that the auditors might choose to accept what they are told by the company's management, rather than question them rigorously and risk an argument.
- Familiarity can also remove an individual's independence, because when one person knows another well, he is more likely to accept what that person tells him and support his point of view. Auditors are at risk of losing their independence if they work on the audit of the same corporate client for too many years.

iv. Honesty and Integrity (probity)

- Honesty is an essential quality for directors and their advisers.
- An individual who is honest, and who is known to be honest, is believed by others and is therefore more likely to be trusted.

- Integrity is similar to honesty, but it also means behaving in accordance with high standards of behaviour and a strict moral or ethical code of conduct.
- Professional accountants, for example, are expected to act with integrity, by being honest and acting in accordance with their professional code of ethics.
- If shareholders in a company suspect that the directors are not acting honestly or with integrity, there can be no trust, and good corporate governance is impossible.

v. **Responsibility and Accountability**

- The directors of a company are given most of the powers for running the company. Many of these powers are delegated to executive managers, but the directors remain responsible for the way in which those powers are used.
- An important role of the board of directors is to monitor the decisions of executive management, and to satisfy themselves that the decisions taken by management are in the best interests of the company and its shareholders.
- The board of directors should also retain the responsibility for certain key decisions, such as setting strategic objectives for their company and approving major capital investments. A board of directors should not ignore their responsibilities by delegating too many powers to executive management and letting the management team 'get on with the job'. The board should accept its responsibilities. With responsibility, there should also be accountability. In a company, the board of directors should be accountable to the shareholders. Shareholders should be able to consider reports from the directors about what they have done, and how the company has performed under their stewardship, and give their approval or show their disapproval.

  Some of the ways in which the board are accountable are as follows:
  - Presenting the annual report and accounts to the shareholders, for the shareholders to consider and discuss with the board. In Nigeria for example, this happens at the annual general meeting of the company; and
  - If shareholders do not approve of a director, they are able to remove him from office. Individual directors may be required to submit themselves for re-election by the shareholders at regular intervals. In Nigeria for example, it is common practice for directors to be required to retire every three years and stand for re-election at the company's annual general meeting.

vi. **Reputation:**

- A large company is known widely by its reputation or character. A reputation may be good or bad. The reputation of a company is based on a combination of several qualities, including commercial success and management competence. However, a company might earn a good reputation with investors, employees, customers and suppliers in other ways.
- As concerns for the environment have grown, companies have recognised the importance of being 'environment friendly' or 'eco-friendly'.
- Reputation is also based on honesty and fair dealing, and on being a good employer.

Importance of reputation

- Investors might be more inclined to buy shares and bonds in a company they respect and trust. Some investment institutions are 'ethical funds' that are required to invest only in 'ethical' companies.
- Employees are more likely to want to work for an employer that treats its employees well and fairly. As a result, companies with a high reputation can often choose better-quality employees, because they have more applicants to choose from.
- Consumers are more likely to buy goods or services from a company they respect, and that has a reputation for good quality and fair prices, and for being customer-friendly or environment-friendly. Companies that are badly governed can be at risk of losing goodwill – from investors, employees and customers.

vii. **Judgment**

- Directors make judgments in reaching their opinions.
- All directors are expected to have sound judgment and to be objective in making their judgements (avoiding bias and conflicts of interest).
- The board should be able to exercise objective judgment on corporate affairs, independent of management.
- Independent non-executive directors are expected to show judgment that is both sound and independent.

3b. Nolan's Seven Principles of Public Life apply to public sector entities and not-for-profit entities, as well as to companies. This is evident in Nolan's Seven Principles of Public Life. These were issued in the UK by the Nolan Committee on Standards in Public Life, which was set up in 1995 to report on standards of behaviour amongst politicians and in the civil service and other public sector bodies.

The seven principles are as follows:

i. **Selflessness**

Holders of public office should not make decisions that are in their personal self-interest. Their decisions should be based entirely on concern for the public interest.

ii. **Integrity**

Holders of public office should not put themselves under any financial obligation or other obligation to another individual or organisation that might influence how they act in the course of carrying out their duties.

iii. **Objectivity**

Holders of public office, in awarding contracts or making recommendations, should base their decisions on merit. This will enhance fair play and efficiency in the public sector.

iv. **Accountability**
Holders of public office are accountable to the public and should submit themselves to public scrutiny.

v. **Openness**
Holders of public office should be as open as possible about the decisions they take and the reasons for those decisions. They should only withhold information when this is in the public interest to do so.

vi. **Honesty**
Holders of public office have a duty to declare any conflict of interest they might have and should take steps to resolve them whenever they arise.

vii. **Leadership**
Holders of public office should promote and support these principles by setting an example with their own behaviour and giving a lead to others.

EXAMINER'S REPORT

Part (a) of the question tests candidates' understanding of the concepts of corporate governance and how they relate to good corporate governance.

Part (b) of the question tests candidates' understanding of the principles enunciated in the report of the Nolan Committee on Standards in public life and how they enhance performance in public sector.

About 50% of the candidates attempted this question.

Performance was just above average.

The common pitfall was candidates' inadequate knowledge of the principles enunciated in the Nolan report of the Nolan Committee on Standards in Public life.

Candidates at the skills level must be able to relate the local environment to global best standards.

MARKING GUIDE

		MARKS	MARKS
a.	Concepts of corporate governance (½ mark for identification and 1 ½ for explanation of each concept)	7 x 2	14
b.	Nolan's Seven Principles	6 x 1	<u>6</u>
			<u>20</u>

SOLUTION 4

(A)I. ENVIRONMENTAL FOOTPRINT (ECOLOGICAL FOOTPRINT)

- An environmental footprint, also called an ecological footprint, is a term that means the impact that an entity's operations has on the environment.
- The amount of raw materials that it uses to make its products or services, where the raw materials are subject to depletion, non-renewable resources that it uses to make its products or services and the quantity of wastes and emissions that it creates in the process.
- In the past, it was accepted that in order to grow, companies (and economic activity as a whole) had to increase their environmental footprint.
- With the recognition today that the world cannot go on increasing its environmental footprint, many leading companies are looking for ways to reduce the size of their own particular footprint and 'tread more softly'.
- Reducing an environmental footprint involves the development and implementation of policies for better (more efficient) resource management, and using different resources 'green' procurement policies waste minimisation and waste management (for example, policies on reducing pollution and recycling waste).

(A)II. SOCIAL FOOTPRINT

- A social footprint is the effect of an entity's economic activity on society and people. In general, economic activity is seen as providing benefits for society, although some companies are much more 'people-friendly' than others. Some companies, for example, use child labour and/or pay subsistence-level wages to their workers.

Companies might seek to measure the contribution of their activities towards society in terms of:

- Total number of workers employed or increase in the total number of employees;
- The proportion of the total work force employed in different parts of the world;
- The proportion of the total work force that is female or from different ethnic groups;
- Health and safety at work (for example, numbers of employees injured each year per 1,000 of the work force); and
- Noise pollution emanating from the operations of an entity.

B. CARBON NEUTRALITY

- The effect on the environment of economic activities by individual companies may be measured in terms of emissions of carbon-based pollutants, such as the release of carbon dioxide into the atmosphere.
- Some environmentally-conscious companies already measure their impact on carbon pollution, and might have a stated environmental policy of being 'carbon neutral'.
- Carbon neutrality exists when a company is able to counterbalance its use of carbon products, and particularly its carbon dioxide emissions, with activities that reduce the amount of carbon dioxide in the atmosphere such as growing trees or plants (which absorb carbon dioxide from the atmosphere).
- Some companies have also tried to reduce their impact on carbon dioxide pollution by switching to the use of fuel and energy that does not involve carbon consumption.

C. SOCIAL ECOLOGY

- Social ecologists argue that the environmental crisis has been caused by companies seeking growth, profits and economic self-interest.
- Nothing fundamental has changed. Companies are still trying to get bigger and more profitable, even though they use environmental ideology to express their plans and ambitions.
- They argue that the environmental crisis cannot be averted without a radical change in human society.

The following comments are illustrative of the thinking of social ecologists:

- Environmental problems are caused by companies that seek continued growth in size and profits;
- Social ecologists also argue that the structure of society and the future of the environment are closely linked;
- They argue that most environmentalists focus wrongly, on improving technology to improve the environment, or even on restricting population size. These environmentalists are focusing on symptoms of the environmental problems, not its root causes; so they will not find any lasting solution; and
- A truly 'green' entrepreneur cannot possibly survive in today's capitalist culture, because by using ecologically/environmentally sound methods they would be at a disadvantage to more ruthless business rivals who will produce at a lower cost.

EXAMINER'S REPORT

This question tests candidates' understanding of environmental and social footprints of organisations, the concepts of carbon neutrality and social ecology.

About 70% of the candidates attempted this question.

Performance was slightly above average.

Those candidates who performed poorly in this question showed inadequate knowledge of carbon neutrality and social footprint.

Candidates are admonished to endeavour to fully cover the syllabus with particular attention on the newly introduced areas.

MARKING GUIDE

		MARKS	MARKS
a.i.	Environmental/ecological footprint	5 x 1	5
a.ii.	Social footprint	5 x 1	5
b.	Carbon neutrality	4 x 1 ¼	5
c.	Social ecology	5 x 1	<u>5</u>
			<u>20</u>

SOLUTION 5

A. Functions and Efficiency of the risk manager

i. A risk manager might be given responsibilities in respect of all aspects of risk. Alternatively, risk managers might be appointed to help with the management of specific risks.

ii. A risk manager is not a 'line' manager and is not directly responsible for risk management. His role is to provide information, assistance and advice, and to improve risk awareness within the entity and encourage the adoption of sound risk management practice.

iii. The role of a risk manager might therefore include:

- Helping with the identification of risks
- Establishing 'tools' to help with the identification of risks
- Establishing modelling methods for the assessment and measurement of risks
- Collecting risk incident reports (for example, health and safety incident reports)
- Assisting heads of department and other line managers in the review of reports by the internal auditors
- Preparing regular risk management reports for senior managers or risk committees
- Monitoring 'best practice' in risk management and encouraging the adoption of best practice within the entity.

Efficiency of a risk manager

The efficiency of risk managers depends partly on the role of the risk manager and partly on the support that the risk manager receives from the board and senior management.

- The specific role of the risk manager might give him authority to instruct line managers on what to do. For example, a health and safety manager can insist on compliance with health and safety regulations. Some risk managers have the authority to make decisions for the entity: the manager responsible for insurance, for example, might have the authority to buy insurance cover against certain risks.

- The status of the risk manager depends on the amount of support he receives from the board and senior management. A culture of risk awareness should be promoted by the board of directors.

- The risk manager's interpersonal skills to get support of line managers to implement his/her proposals.

B. THE OPTIONS ARE UNITARY AND TWO-TIER BOARD STRUCTURES

- A unitary board has a single board of directors, which is responsible for performing all the functions of the board.
- A two-tier board – structure consists of
  - a management board, and
  - a supervisory board.

- The **management board** is responsible for the oversight of management and business operations. It consists entirely of executive directors, and its chairman is the company's chief executive officer.
- The **supervisory board** is responsible for the general oversight of the company and the management board. It consists entirely of non-executive directors, who have no executive management responsibilities in the company. Its chairman is the chairman of the company, who is the most significant figure in the corporate governance structure.
- It is important that the responsibilities of the management board and supervisory board be clearly defined. For instance, a function of the chairman of the company (and supervisory board) is to work closely with the CEO. As chairman of the management board, the CEO reports to the chairman of the company. If there is a good relationship between the CEO and chairman, the chairman will speak for the company's management at meetings of the supervisory board.
- In large companies, the supervisory board can be quite large, in order that it can represent a sufficient number of different stakeholder interests. Directors who represent an interest, such as the interests of a major shareholder or the company's employees, are not 'independent' – unlike most non-executive directors on the unitary boards of listed companies (stock market companies).

iii. Advantages of a two-tier board structure are as follows:

- It separates two different roles for the board. The management board is responsible for operational issues, whereas the supervisory board monitors the performance of management generally, including the executive directors on the management board.

- It is an appropriate structure for a company that recognises the interests of different stakeholder groups. These stakeholder interests can be represented on the supervisory board, without having a direct impact on the management of the company.
- The legal duties of non-executive directors on the supervisory board can be different from the legal duties of executive directors on the management board. This is sensible, because independent directors are part-time appointments and are not involved in the management of the company. In a unitary board, the legal duties of non-executive directors and executive directors are the same.
- It promotes independence of directors.

Advantages of a unitary board are as follows:

- The size of unitary boards can be small, because there is no requirement to appoint directors who represent stakeholder interest groups. Small boards are more likely to act quickly in an emergency or when a fast decision is required;
- In a unitary board structure, it is easier for the non-executive directors and the executive directors to work co-operatively. With a two-tier structure, there is a risk that the two boards will not co-operate fully, especially when the chairman of the company and the CEO do not work well together;
- It is more cost effective than the two-tier board; and
- Unitary boards work towards a common purpose, which is what the board considers to be the best interests of the shareholders and others. With two-tier boards, there is more opportunity for disagreements on the supervisory board between directors who represent different stakeholder interests.

Which is more viable?

This is a function of the size of the company. It might be advisable for big companies to adopt the two-tier board structure.

EXAMINER'S REPORT

Part (a) of the question on risk management is testing the functions and determinants of the efficiency of a risk manager. Part (b) is on Corporate Governance and it tests comparative analysis of types of board structure.

About 80% of the candidates attempted this question. Performance was just average.

Candidates who did not perform well in this question were unable to effectively outline the determinants of the efficiency of a risk manager or/and could not articulate reasons for preference of either of the single or two-tier board.

It is recommended that candidates should master the art of applying knowledge to simple scenarios.

MARKING GUIDE

		MARKS	MARKS
a.i.	Definition of risk manager	1 x 1	1
ii.	Definition of risk manager	1 x 1	1
iii.	The role of risk manager	5 x 1	5
iv.	Efficacy of risk manager	3 x 1	3
			10
b.	Identification of options of board structure	2 x ½	1
	Explanation of management and supervisory boards	4 x 1	4
	Advantages of 2- tier boards	2 x 1	2
	Advantages of unitary boards	2 x 1	1
	Comparison of the two board structures	2 x ½	1
			10
			20

SOLUTION 6

a. A business strategy may be defined as a pattern of activities designed to achieve the objectives of an organization.

A strategic five-year plan for a company will therefore consider questions such as:

- Where are we now?
- Where do we want to be in five years' time?
- How do we get from where we are now to where we want to be?
- How large will the company be?
- What will it be doing?
- Where will it be operating?
- How many employees will it need and what skills will they need?
- What technology should be used?

b.

i. Ethical subjectivism

- This is a meta-ethical approach to morality.
- This is the view that what is right or wrong in any given situation is simply dependent on what individual think about it.
- If an individual thinks that something is 'right', then it is 'right', and if society thinks that something is 'wrong', then it is 'wrong' for him or her.

ii. Situation ethics

- This is based on the view that what is right or wrong in any given situation depends on the circumstances of the situation. There are no 'universal' rules of morality: each situation is unique. Ethical decisions should therefore be taken on a case-by-case basis
- There may be accepted general moral principles, such as the principles that it is wrong to kill or steal, but these should not be applied rigorously in all situations.

c. Non-consequential or deontological theories of ethics

i. Non-consequential theories of ethics are based on the view that what is right or wrong does not depend at all on the consequences of the action or decision.

ii. This approach to ethics is also called a duty-based approach. It is based on the view that certain moral obligations are self-evident and need no further justification. Actions are inherently 'good' or 'bad', regardless of their consequences, and a clear distinction can be made between 'right' and 'wrong' without considering consequences or utility.

iii. A prominent advocate of this theory is the German philosopher, Immanuel Kant. He holds that it is wrong to lie even if the lie would save a friend from a murderer. The deontological approach affirms that people should always do the right thing because it is right, regardless of the consequences.

iv. **Ethics of duties**

- An aspect of the deontological approach to ethics is that a person has certain fundamental duties that he or she must always uphold, and there are no circumstances when breaching those duties is morally correct.
- This view is important for professional accountants, because they are required to uphold the principles in their professional code of ethics.

Main criticisms of non-consequential theories

The main criticisms of the non-consequential theory of ethics include:

- It can be difficult to accept that a decision or action is morally 'right' if it has undesirable consequences, when an alternative course of action might offer beneficial consequences; and
- There may be situations when an individual's duties are in conflict. This happens, when for example, the principles of his or her professional code of ethics conflict with the company's code of corporate ethics.

EXAMINER'S REPORT

This composite question consists of three parts.

Part (a) requires a basic knowledge of business strategy and the questions it seeks to address.

Part (b) tests a comparative analysis of ethical subjectivism and situation ethics.

Part (c) is a discussion of ethical non-consequentialism.

Most candidates attempted this question.

Performance was average.

Those candidates who did not perform well confused the various philosophies of ethics.

Candidates are advised to pay particular attention to the details and applications of the various theories and philosophy.

Comments on the overall performance in the paper

The overall performance in this subject was below average as many candidates failed to apply the Fitzgerald and Moon Building Block model to the scenario in question1. This adversely impacted their chance of success.

To enhance the chance of success of candidates at future examinations, candidates and trainers are therefore enjoined to note the following:

(i) At the skills level, more emphasis is placed on application of principles, concepts and theories to scenarios, rather than re-statement of facts;

(ii) The differences in the contents of Corporate Strategic Management and Ethics (CSME) syllabus from the Management Governance and Ethics (MGE) syllabus; and

(iii) Full coverage of the syllabus with emphasis on the newly introduced areas.

MARKING GUIDE

		MARKS	MARKS
a.	Definition of business strategy	1 x 1	1
	Questions inherent in business strategy	8 x ½	4
			5
b.	Ethical subjectivism	3 x 1	3
	Situation ethics	2 x 1 ½	3
			6
c.	Non-consequential/deontological theories of ethics	3 x 1	3
	Ethics of duty	2 x 1 ½	3
	Criticisms of non-consequential theories	2 x 1 ½	3
			9
			20