ATSWA

ACCOUNTING TECHNICIANS SCHEME WEST AFRICA

STUDY TEXT

PRINCIPLES AND PRACTICE OF FINANCIAL ACCOUNTING

PUBLICATION OF ASSOCIATION OF ACCOUNTANCY BODIES IN WEST AFRICA (ABWA)

ASSOCIATION OF ACCOUNTANCY BODIES IN WEST AFIRCA (ABWA)

ACCOUNTING TECHNICIANS SCHEME

WEST AFRICA (ATSWA)

STUDY TEXT FOR

PRINCIPLES AND PRACTICE OF FINANCIAL ACCOUNTING

THIRD EDITION

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DISCLAIMER

This book is published by ABWA; however, the views are entirely those of the writers.

PREFACE

INTRODUCTION

The Council of the Association of Accountancy Bodies in West Africa (ABWA) recognised the difficulty of students when preparing for the Accounting Technicians Scheme West Africa examinations. One of the major difficulties has been the non-availability of study materials purposely written for the scheme. Consequently, students relied on text books written in economic and socio-cultural environments quite different from the West African environment.

AIM OF THE STUDY TEXT

In view of the above, the quest for good study materials for the subjects of the examinations and the commitment of the ABWA Council to bridge the gap in technical accounting training in West Africa led to the production of this Study Text.

The Study Text assumes a minimum prior knowledge and every chapter reappraises basic methods and ideas in line with the syllabus.

READERSHIP

The Study Text is primarily intended to provide comprehensive study materials for students preparing to write the ATSWA examinations.

Other beneficiaries of the Study Text include candidates of other Professional Institutes, students of Universities and Polytechnics pursuing undergraduate and post graduate studies in Accounting, advanced degrees in Accounting as well as Professional Accountants who may use the Study Text as reference material.

APPROACH

The Study Text has been designed for independent study by students and as such concepts have been developed methodically or as a text to be used in conjunction with tuition at schools and colleges. The Study Text can be effectively used as a course text and for revision. It is recommended that readers have their own copies.

FORWARD

The ABWA Council, in order to actualize its desire and ensure the success of students at the examinations of the Accounting Technicians Scheme West Africa (ATSWA), put in place a Harmonisation Committee, to among other things, facilitate the production of Study Texts for students. Hitherto, the major obstacle faced by students was the dearth of study texts which they needed to prepare for the examinations.

The Committee took up the challenge and commenced the task in earnest. To start off the process, the existing syllabus in use by some member Institutes were harmonized and reviewed. Renowned professionals in private and public sectors, the academia, as well as eminent scholars who had previously written books on the relevant subjects and distinguished themselves in the profession, were commissioned to produce Study Texts for the twelve subjects of the examination.

A minimum of two Writers and a Reviewer were tasked with the preparation of Study Text for each subject. Their output was subjected to a comprehensive review by experienced imprimaturs. The Study Texts cover the following subjects:

PART I

1 Basic Accounting Processes and Systems
2 Economics
3 Business Law
4 Communication Skills

PART II

1 Principles and Practice of Financial Accounting
2 Public Sector Accounting
3 Quantitative Analysis
4 Information Technology

PART III

1 Principles of Auditing
2 Cost Accounting
3 Preparation of Tax Computation and Returns

4 Management

Although, these Study Texts have been specially designed to assist candidates preparing for the technicians examinations of ABWA, they should be used in conjunction with other materials listed in the bibliography and recommended text.

PRESIDENT, ABWA

STRUCTURE OF THE STUDY TEXT

The layout of the chapters has been standardized so as to present information in a simple form that is easy to assimilate.

The Study Text is organised into chapters. Each chapter deals with a particular area of the subject, starting with learning objective and a summary of sections contained therein.

The introduction also gives specific guidance to the reader based on the contents of the current syllabus and the current trends in examinations. The main body of the chapter is subdivided into sections to make for easy and coherent reading. However, in some chapters, the emphasis is on the principles or applications while others emphasise method and procedures.

At the end of each chapter is found the following:

- Summary
- Points to note (these are used for purposes of emphasis or clarification);
- Examination type questions; and
- Suggested answers.

HOW TO USE THE STUDY TEXT

Students are advised to read the Study Text, attempt the questions before checking the suggested answers.

ACKNOWLEDGMENTS

The ATSWA Harmonisation and Implementation Committee, on the occasion of the publication of the first edition of the ATSWA Study Texts acknowledges the contributions of the following groups of people. The ABWA Council, for their inspiration which gave birth to the whole idea of having a West African Technicians Programme. Their support and encouragement as well as financial support cannot be overemphasized. We are eternally grateful.

To The Councils of the Institute of Chartered Accountants of Nigeria (ICAN), and the Institute of Chartered Accountants, Ghana (ICAG), and the Liberia Institute of Certified Public Accountants (LICPA) for their financial commitment and the release of staff at various points to work on the programme and for hosting the several meetings of the Committee, we say kudos.

We are grateful to the following copyright holders for permission to use their intellectual properties:

- The Institute of Chartered Accountants of Nigeria (ICAN) for the use of the Institute's examination materials;
- International Federation of Accountants (IFAC) for the use of her various publications;
- International Accounting Standards Board (IASB) for the use of International Accounting Standards and International Financial Reporting Standards;
- Owners of Trademarks and Trade names referred to or mentioned in this Study Text.

We have made every effort to obtain permission for use of intellectual materials in this Study Texts from the appropriate sources.

We wish to acknowledge the immense contributions of the writers and reviewers of this manual;

Our sincere appreciation also goes to various imprimaturs and workshop facilitators. Without their input, we would not have had these Study Texts. We salute them.

Chairman
ATSWA Harmonization & Implementation Committee

A new syllabus for the ATSWA Examinations has been approved by ABWA Council and the various PAOs. Following the approval of the new syllabus which becomes effective from the September 2017 diet a team was constitutes to undertake a comprehensive review of the Study Texts in line with the syllabus under the supervision of an editorial board.

The Reviewers and Editorial board members are:

REVIEWERS

This Study text was reviewed by:

- Mr. Lawal, J.O - Foremost Consulting Associate, Abeokuta
- Dr. Aroh, Chike - Federal Polytechnic, Oko
- Dr. Faniran, Taiwo P - Ondo State University, Akungba Akoko

EDITORIAL BOARD

The editorial Board Members are:

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PAPER 5: PRINCIPLES AND PRACTICE OF FINANCIAL ACCOUNTING

AIM

To develop knowledge and understanding of principles and concepts of Financial Accounting and the ability to apply the principles learned for the preparation of financial accounts for sole traders, partnership, companies not for profit entities and Small and Medium sized Enterprises (SMES).

MAIN CAPABILITIES

On successful completion of this paper, candidates should be able to:

a) Explain accounting concepts and convention adopted in generally accepted financial accounting principles
b) Explain the context and purpose of financial reporting
c) Demonstrate the use of double-entry and accounting systems
d) Record transactions and events
e) Prepare basic and extended trial balance including identifying and correction of errors and other adjustments
f) Prepare financial statements for Incorporated and unincorporated entities
g) Use simple ratio analysis to Interpret financial statements

STRUCTURE OF PAPER

The paper will be a three-hour paper divided into two sections:

Section A (50 Marks):	This shall consist of 50 compulsory questions made up of 30 multiple-choice questions and 20 short answer questions covering the entire syllabus.
Section B (50 Marks):	Six questions, out of which, candidates are expected to answer four, each at 12½ marks.

1. FINANCIAL ACCOUNTING CONCEPTS, FRAMEWORK & PRACTICES (10%)

a. Bases of Accounting & Accounting Concepts
b. Roles of Bodies which set Accounting Standards (IASB/FRCON)
c. Conceptual Frame Work for Financial Reporting
d. Components of Financial Statements

e. Business transactions of sole traders, partnerships, companies, not-for-profit entities and SMEs

2. ACCOUNTING STANDARDS REGULATIONS & GUIDELINES (10%)

a. Principles of Law and Regulations governing Accounting

b. International Financial Reporting Standards:- The following International Financial Reporting Standards are examinable at this level:

   i. IAS 1 – Presentation of Financial Statements
   ii. IAS 2 – Inventories
   iii. IAS 7 – Statement of Cashflows
   iv. IAS 8 – Accounting policies, changes in accounting estimates and errors
   v. IAS 16 – Accounting for property plant and equipment
   vi. IFRS for SME(s) relevant for preparing the financial statements

3. ACCOUNTING PROCESSES, PREPARATION OF ACCOUNTS FROM INCOMPLETE RECORDS AND NOT FOR PROFIT ACCOUNTS (15%)

(a) i. Preparing trial balance and extended trial balance to include

   ii. Correcting Errors

   iii. Suspense Accounts and other adjustments

(b) Preparation of final Accounts from incomplete records to include:

   i. Non-current Assets & Depreciation

   ii. Bad & Doubtful debt, Provisions

   iii. Accrual & Prepayments

   iv. Control Accounts and Control Accounts Reconciliations.

(c) Preparation of Final Accounts of not for profit organization to include:

   i. Receipts and payment accounts

   ii. Income and expenditure accounts

4. PREPARATION OF PARTNERSHIP ACCOUNTS (20%)

a. Features of Partnership to include: Definition formation, Partnership agreement and accounts peculiar to partnership

b. Changes in partnership structure to include;

i. Accounting for Goodwill

ii. Admission of new partners

iii. Death or retirement of a partner (Dissolution of partnership)

iv. Amalgamation of a partnership (with a sole proprietor or another partnership)

v. Conversion of partnership to limited liability company

5. PREPARATION AND INTERPRETATION OF FINANCIAL STATEMENTS OF COMPANIES (25%)

a. Preparation of Financial Statement of Limited Liability companies to include;

i. Statement of Financial position

ii. Statement of changes in Equity

iii. Statement of Profit or Loss and other comprehensive Income

iv. Explanatory notes required for preparation of financial statements for publication

b. Statement of Cash Flows prepared in accordance IAS7 using Direct and Indirect methods

a. Importance and purpose of analysis of financial statements

b. Use of ratios analysis for Interpretation of simple financial statements

c. Accounting for Issue of shares and loan notes

d. Accounting for current Income tax and value added tax.

6. ACCOUNTING FOR SPECIAL BUSINESS TRANSACTIONS & EVENTS (20%)

a. Hire purchase transaction and simple lease accounts

b. Branch Accounting (excluding foreign branches)

c. Accounting for good on sale or return

d. Accounting for inventory valuation including losses and defalcation

e. Contract accounts

f. Joint ventures

g. Accounts for royalties

h. Farmers accounts

RECOMMENDED TEXTS

1. ATSWA Study Pack on PPFA

2. A. O. Akinduko - Basic Accounting, Spetin Akure, Nigeria

3. Arku, J.S &Tengey, - A Company Accounting in Ghana, Text and Problems

OTHER REFERENCE BOOK

1. Vickery B. G. - Principles & Practice of Book-Keeping

   - And Accounts, Donnington Press

CHAPTER ONE

SINGLE ENTRY AND INCOMPLETE RECORD

CHAPTER CONTENTS

a. Introduction
b. Accounting for incomplete records
c. Preparation of financial statements from incomplete records.

1.0 OBJECTIVES

At the end of this chapter, readers should be able to:

a) Use accounting equations to calculate profit where only opening and closing net assets figures are available.

b) Convert single entry and incomplete records into double entry

c) Prepare financial statement from records maintained on double entry basis

d) Determine the figures for purchases and revenue from purchases control account and revenue control accounts

e) Derive expenses and revenue earned from incomplete records.

1.1 INTRODUCTION

The term single entry "is applied to any system, which does not provide for the two fold aspect of transactions; while the alternative term, incomplete records" is often applied to books of account kept on such a single entry or incomplete double entry system. Pure "single entry" recognises only the personal aspect of transactions, with receivables and payables. In practice, however, a cashbook is invariably kept, but, with this exception, the impersonal aspect of transactions is usually left entirely unrecorded.

In this chapter you will learn the procedure involved in preparing the Statement of Profit or Loss and Statement of Financial Position for an enterprise that has only opening and closing net assets and perhaps capital as the only known figures. You will also understand and learn how to ascertain the proprietor's drawings and any additional capital contribution during an accounting period from scanty information provided by a cash book summary.

Questions on incomplete records and single entry are popular for examiners because they enable them to test techniques, which are also relevant for other topics such as ledger control accounts. It also provides the basic information necessary to prepare financial statement but without the examiner presenting it in the form of a Trial Balance.

1.2 THE ASCERTAINMENT OF PROFIT FROM INCOMPLETE RECORDS

Generally speaking, profits (or losses) are ascertained, under the single entry system, by a comparison of the values of the net assets at two specified dates, after taking into account additions to, or withdrawals from, capital during the period. The difference between these two values represents the profit or loss, according to whether there is an increase or decrease in the figures.

The accounting equation states that:

Business Assets = Owner's Capital+ Business Liabilities

The equation above can be restated as:

Owner's Capital = Business Net Assets – Business Liabilities

During an accounting period, the business realized an excess of income over expenditure, the additional cash or assets generated belong to the owner(s), thus increasing the capital. The accounting equation will now become:

Opening capital +profit = opening net assets + increase in net assets.

The introduction or withdrawal of resources by the owner will also increase or decrease the owner`s capital. As a result profit can be calculated using the format below:

	¢ Closing
capital	XXX
Less opening capital	
	XXX
Increase in net assets	XXX
Owners' Drawings	XXX

Additional Capital	(XXX)
Net profit for the year	
	XXX

Illustration1.1

Calculate the net profit for the year ended 31December2016 from the following information:

	31/12/2015	31/12/2016
	¢	¢
Property	200,000	200,000
Equipment	60,000	90,000
receivables	40,000	80,000
Cash	10,000	15,000
Overdraft	60,000	90,000
Trade payables	50,000	30,000

Drawings during the year were ¢45,000 and additional capital introduced during the year was ¢50,000.

Solution1.1

	31/12/2015	**31/12/2016**
	¢	¢
Total Assets	310,000	385,000
Total Liabilities	(110,000)	(120,000)
Net Assets	**200,000**	**265,000**
		¢
Closing capital		265,000
Less opening capital		200,000
Increase in net assets		65,000

Owners' Drawings		45,000
Additional Capital		(50,000)
Net profit for the year		60,000

1.3 PREPARATION OF DETAILED FINANCIAL STATEMENT FROM INCOMPLETE RECORDS

It is understandably certain that calculating the profit of an enterprise using the method Presented above is not satisfactory. It is important for you to note that the accountant does not only prepare the final accounts of an enterprise but also communicates accounting and financial information to stakeholders. It is therefore much more informative when a Statement of Income is drawn. It is important for the accountant to convert these scanty and incomplete records into the acceptable double entry form.

For one to be able to prepare a Statement of Profit or loss and Statement of Financial Position from single entry and incomplete records, the procedures detailed below are recommended:

1.3.1 Preparation of Statement of Affairs

One must first construct a statement of financial position at the beginning of the accounting year. This means that the assets and liabilities of the business must be as curtained and calculated. The statement prepared to show the financial position of the business at the beginning of the year is technically called **statement of affairs**`.

In most practical situations the owner of the business will provide lists of values of non-current assets that he uses in the business together with the dates of acquisition. It should therefore be easy for one to calculate the accumulated provision for depreciation of the non-current assets from the date of their purchase to the date of reporting. Values of such items as inventories in trade, receivables and liabilities may have to be estimated with the help of the owner.

From the above information a journal should be opened and accounting entries with the aim of achieving the dual purpose of recording accounting transactions should be effected. This means that appropriate debit entries must be posted into assets account and credit entries entered into capital or liabilities accounts.

The difference between the assets and liabilities, which usually ends up with the assets exceeding the liabilities may be assumed to be the initial amount that the owner used in starting the business and therefore will be recorded as the capital of the business. It is possible that the owner may be able to mention the initial amount he used in commencing the business. Where this is the case then, any difference between such capital and the net assets estimated may be recorded as the balance on the Statement of profit or loss retained in the business.

1.3.2 Preparation of Cash and Bank Summary

Ascertain the Cash position of the business. This is usually done by carefully examining any available bank statement, any pay-in-slip and the cheque counter foil. The bank statement together with the cheque counterfoil could reveal information concerning

purchases, payment of rent, bank charges, wages, insurance, interest earned the acquisition of non-current assets, and any personal withdrawals. Information extracted from the pay-in-slip will help determine the amount of money paid in by customers to whom goods that were sold on credit and also direct sales by cheque instead of cash. The above information may be used to prepare a cash summary or a receipt and payment account for the business.

1.3.3 Analysis of Unbanked Cash Sales

One must at this stage determine the amount of cash sales which have not been banked by the owner, but which might have been used by the owner to pay for business expenses, cash purchases, and personal drawings. It is possible that the owner might have made use of some of the physical inventory in trade for his or her personal use. In such a situation conducting an informal interview with the owner could confirm the existence on such occurrences and so will help the book keeper make an appropriate estimate for inventory drawings. Physical inventory taking by counting of items in inventory at the close of business will give us the actual closing inventory figures and therefore may not need to be estimated.

1.3.4 Posting from the Cash and Bank Summary

After the analysis above have been made, one can now carry out the following postings into the ledger. Note that in step one opening entries were made through the ledger, and therefore some of these entries will be made into existing ledger accounts irrespective of how inaccurate they may be.

From the analysis of the debit side of the cash and bank summary and information obtained from the pay-in-slips:

a) All cash sales or takings should be credited to the Trade receivables account in the sales ledger;
b) Any proceeds from the sale of non-current assets should be credited to the respective asset account;
c) Any interest or income from investment must also be credited to the appropriate revenue account;
d) Any other item should be posted to the credit of the relevant account;

From the analysis of the credit side of the cash and bank summary and information obtained from the cheque counterfoils:

a) All payments for goods purchased should be debited to the trade payables account in the purchase ledger account;
b) Payment of expenses should be debited to the relevant nominal account;
c) All purchases in connection with non- current assets should be debited to the appropriate asset accounts;
d) Any charges should be posted to debit of the bank charges account;
e) Any other item should be posted to the debit of the relevant account;

Where any difference exists on the cash book summary entries should be posted to make it balance. If the difference is on the credit side then the cash book should be credited and the proprietor`s drawings account debited. If the difference is on the debit side then one can safely presume that the owner of the business has introduced additional capital. This difference should be debited to the cash and credited to the capital account of the business.

1.3.5 Preparation of Trade Receivables and Trade Payables

At a Stage, one will have to determine year-end adjustment and balances. A schedule will have to be compiled detailing all customers who are owing the business, as a result of goods sold to the non-credit. The total of the schedule of Trade receivables therefore represent debts owed to the business and as such must be carried forward to the credit of the total sales ledger control account. There is likely to be a missing figure in the debit side of the total Trade receivable account, which represent total sales on credit for the period and should be transferred to the credit of the Statement of profit or loss as sales or Revenue

Another schedule that must be prepared is a list of amount owing by the business to suppliers for goods purchased on credit. The total of this schedule represent total liabilities by way of trade payables outstanding at the end of the period and should therefore carried forward to the debit of the purchases ledger control account. The total purchases for the period will be derived from the credit side of the purchases ledger control account as a balancing figure and should be transferred to the debit side of the Statement of profit or loss.

1.3.6 Extraction of Trial Balance

This is the final stages as all the transactions would have been recorded and the entry will now have been completed and for that matter the business will be able to extend a trial balance which will form the basis for the preparation of the Statement of profit or loss and Statement of Financial Position.

Illustration1.2

Boakye, a sole proprietor, trading as KKB Enterprise requested Oko & Associates, a firm Chartered Accountants, where you are employed as a trainee Accountant, to prepare the accounts of his business for the year ended 31December, 2016.

Your audit Manager assigned this work to you. Your interview with Boakye revealed the following:

(i) He did not maintain double entry book-keeping system.

(ii) All sales were on credit basis. During the year Boakye received ¢9,025,000, ₵475,000 in cheques and cash respectively from his customers

(iii) Suppliers of goods during the year paid ¢6,840,000 by cheque

(iv) Boakye rented 2 premises at Danso man and High Street for residential and business purposes respectively. In July 2015, he paid ¢480,000 as one year rent in advance for his residence. In July 2016, he again paid a cheque of ¢600,000 to cover year advance for his residence. The rent for the premises at High Street was ¢60,000 per month in 2016. Boakye always paid all his rent by cheque

(v) General business expenses paid by cheque amounted to ¢106,200

(vi) He took cash of ¢38,000everymonth for his private use.

Boakye provided you with the following additional information.

	31/12/16	31/12/15
	₵	₵
Trade Receivables	1,254,000	1,045,000
Trade Payables	617,000	380,000
Rent Owing	60,000	120,000
Bank Balance	3,000,000	1,073,500
Cash in Hand	60,000	76,000
Inventories	1,700,500	1,510,500
Furniture &Fittings	-	920,000

(vii) Depreciation is provided annually at the rate of 20%on Furniture and Fittings.

(viii) Boakye agreed to pay ₵100,000 as Accountancy fees.

(ix) Differences in cash and bank balances at the end of 2016 represents additional drawings/ capital respectively.

Required:

(a) Compute the profit of Boakye.

(b) Prepare cash and bank Summary for year2016

(c) Prepare statement of profit or loss for the year ended 31 December2016

Solution 1.2

(a) **Calculate opening net assets to arrive at opening capital**

We need the opening capital to enable us calculate the closing balance in the statement of financial position. All that is required is to pick up all opening balances not forgetting the balancing figures. The information is presented clearly, with the inclusion of bank and cash balances in the tabulation of the assets and liabilities figures.

STATEMENT OFAFFAIRS

	31/12/2016	31/12/2015
	¢	¢
Furnitures &Fittings(w5)	736,000	920,000
Trade Receivables	1,254,000	1,045,000
Inventories	1,700,500	1,510,500
Bank	3,000,000	1,073,500
Trade Payables	(617,500)	(380,000)
Rent Owing	(60,000)	(120,000)
Accountancy Fees	(100,000)	-
Net worth	5,973,000	4,125,000

Increase in net worth ¢5973,000 less ¢4125,000= ¢1,848,000

C**omputation of profit**

	¢
Increase in net worth	1,848,000
Add Drawings (456,000+600,000+35,000)	1,091,000
	2,939,000
Less Additional Capital	1,227,700
Net Profit	1,711,300

CASH BOOK SUMMARY

	Cash	Bank		Cash	Bank
	¢	¢		¢	¢
Bal b/d	76,000	1.073,500	Suppliers	-	6,840,000
Received from customers	475,000	9,025,000	Drawings	456,000	-
Capital (missing figure)	-	1,227,700	Rent	-	600,000
			Gen. Bus. Exp.		106,200
			Rent (w3)	-	780,000
			Drawings (missing figure)	35,000	
				60,000	3,000,000
	551,000	11,326,200	Balance	551,000	1,326,200
Bal b/d	60,000	3,000,000			

(c) **Statement of profit or loss.**

	¢	¢
revenue		9,709,000
Cost of sales		(6,887,500)
Gross profit		2,821,500
Less Expenses:		
Depreciation	184,000	
Rent	720,000	
General Business expenses	106,200	
Consultancy fees	100,000	
		1,110,200
Net Profit		1,711,300

Workings

(W1) Prepare sale and purchases ledger control accounts

In a double entry-system, control accounts are used to confirm the arithmetical account of the sales and purchases ledger system. This technique will be used to calculate and purchases as a missing figure.

Purchases Ledger Control Account

	¢		**¢**
Bank	6,840,000	Bal. B/d	380,000
		Purchases (missing figure)	7,077,500
Bal. C/d	617,500		
	7,457,500		7,457,500
		Bal. b/d	617,500

(W2) Derive the accruals and prepayments

In addition to these four techniques it will be necessary to calculate figures for the Statement of profit or loss by adjusting cash paid for expenses for opening and closing accruals and prepayment.

(W3) Rent Expense Control

	¢		¢
Bank (missing figure)	780,000	Bal.B/d	120,000
		P& LA/C(12@60,000	720,000
Bal. C/d	60,000		
	840,000		840,000
		Bal. b/d	60,000

(W4) Computation of Cost of goods sold

	¢
Opening stock (1/1/16)	1,510,500
Purchases (w1)	7,077,500
	8,588,000
Less closing stock (31/12/16)	1,700,500
Cost of goods sold	6,887,500

(W5) Computation of Depreciation

	¢
Fixtures and fittings at cost (1/1/16)	920,000
Less Depreciation (20% @ ¢920,000)	184,000
Net book value (31/12/16)	**736,000**

Illustration1.3

Damask is a retailer who deals in spare parts at Kokompe. He pays in to his bank account the amount of his cash takings, after retaining **¢10,000** per week for personal use and after payment of wages and expenses, which for the accounting period of 31December 2016, were as follows:

	¢
Staff wages	1,200,000
Goods	220,000
Cleaning	75,000
Carriage	35,000
Others	20,000

The transactions in his Bank Account during the period were:

	¢
Balance as at 1 January 2016	2,000,000
Lodgements:	
From takings (cash)	30,100,000
Bulk sales account (cheques)	4,800,000
Interest on treasury bills	30,000
	36,930,000

The following information were also provided:

	31/12/2015	31/12/2016
	¢	¢
Receivables –Bulk sales	490,000	430,000
Payables– Goods purchased	2,900,000	3,195,000
- Rent	80,000	30,000
- Electricity	25,000	65,000
- Telephone	45,000	-
- Consultancy fees	40,000	40,000
Inventories in trade	2,050,000	1,875,000
Furnitures and fittings	-	540,000

You are required to prepare a Statement of profit or loss for the year ended 31 December 2016 and a statement of financial position as at that date.

Solution 1.3

(i) Calculate opening net assets to arrive at opening capital

You have to calculate the capital of the business by using the information on asset and liabilities at the opening and closing dates.

This is done by preparing a statement of the business by picking up all opening balances and calculating the net asset business as at 31 December 2016. The information on the bank and cash balances in the presentation of the liabilities.

The statement of affairs of Damask as at 31December2016 is as follows:

STATEMENT OF AFFAIRS

	31/12/15	31/12/16
Assets:	¢	¢
Furniture & Fittings	-	540,000
Trade Receivables	490,000	430,000
Inventories	2,050,000	1,875,000
Cash in the bank	2,000,000	2,900,000
	4,540,000	5,745,000
Liabilities:		
Trade Payables	2,900,000	3,195,000
Rent Owing	80,000	30,000
Electricity Owing	25,000	65,000
Telephone owing	45,000	
Consultancy Fees	40,000	40,000
	3,090,000	3,330,000
Capital	1,450,000	2,415,000

(ii) Prepare sale and purchases ledger control accounts

In a double entry-system, control accounts are used to confirm the arithmetical accuracy of the sales and purchases ledger system. This technique will be used to calculate sales and purchases by way of missing figure. This calculation will explore the horizontal format of determining the sales and purchases figures as missing figures instead of the usual T'account that you are familiar with.

The sales figure will be determined as follows:

	¢	¢
Lodgements:		
Shop takings		30,100,000
Add Proprietor's drawings		520,000
Expenses paid		1,550,000
Cash sales		32,170,000
Bulk sales account	4,800,000	
Add closing balance of Trade Receivables	430,000	
Less opening balance of Trade Receivables	(490,000)	
Credit sales		4,740,000
Total sales		36,910,000

The amount for Purchase is determined as follows:

	¢	¢
Purchases for goods		30,830,000
Add closing balance of Trade Payables		3,195,000
		34,025,000
Less opening balance of Trade Payables		2,900,000
Credit purchases		31,125,000
Add cash payments		220,000
Total purchases		31,345,000

Statement of Profit or Loss for the year ended 31/12/2016

	¢	¢	¢
Sales/Revenue			36,910,000
Less cost of sales:			
Opening stock		2,050,000	
Purchases	31,345,000		
Carriage inwards	35,000	31,380,000	
		33,430,000	
Less closing stock		1,875,000	31,555,000
Gross profit			5,355,000
Interest on treasury bills			30,000
			5,385,000
Less Expenses:			
Staff wages		1,200,000	
Rates		345,000	
Rent		350,000	
Telephone & Electricity		145,000	
Consultancy fees		70,000	
Repairs		150,000	
Air conditioner		200,000	
Fire insurance		60,000	
Cleaning		75,000	
Other expenses (70,000+20,000)		90,000	
Depreciation		60,000	2,745,000
Net profit before tax			2,640,000
Income tax			900,000
Net Profit for the year			1,740,000

Statement of Financial Position as at 31/12/2016

	¢	¢	¢
Non-current assets			
Furniture and fittings			600,000
Less depreciation provision			60,000
			540,000
Current Assets			
Inventories		1,875,000	
Trade Receivables		430,000	
Bank		2,900,000	
		5,205,000	
Current Liabilities			
Trade Payables	3,195,000		
Rent owing (W1)	30,000		
Electric it owing (W2)	65,000		
Accountancy fee owing (W3)	40,000		
		3,330,000	
			1,875,000
			2,415,000
Financed by			
Capital at 1/1/16			1,450,000
Net profit			1,740,000
			3,190,000
Less drawings (W4)			775,000
			2,415,000

(iii) Calculation of accruals and prepayments

Addition to the above techniques it will be necessary to construct figures for the profit and loss account by adjusting cash paid for expenses for opening and closing accruals and payment.

WORKINGS

(W1)

Rent expense Control

	¢		¢
Bank	400,000	Bal b/d	80,000
		P& La/c	350,000
Bal. c/d	30,000		
	430,000		430,000
		Bal. b/d	30,000

(W2) **Telephone & Electricity**

	¢		¢
Bank	150,000	Bal. b/d	70,000
		P& La/c	145,000
Bal. c/d	65,000		
	215,000		215,000
		Bal. b/d	65,000

(W3) **Consultancy fees**

	¢		¢
Bank	70,000	Bal b/d	40,000
		P& La/c	70,000
Bal. c/d	40,000		
	110,000		110,000
Bal. b/d			40,000

(W4) **Drawings**

	¢		¢
Bank 180,000		Bal. b/d	775,000
Cash	520,000		
Rates	55,000		
Air-condition exp	20,000		
	775,000		775,000
Bal. b/d	775,000		

1.4 CHAPTER SUMMARY

In this chapter, we have explained the difference between a double entry accounting system and single entry system. We have also learned how to use the closing and opening capital figures to calculate the net profit of a trader that is not keeping his books accounts on the double entry system.

We have learnt how to convert from a single entry system to a double entry which also aids the preparation of Statement of Profit or loss and Statement of Financial Position from records that were kept on single entry basis. We mentioned that figures such as sales and purchases could be calculated as missing figures from the sales ledger control account and purchases ledger control account respectively.

It is imperative for readers to note that as with all accounting topics, frequent practice of incomplete records questions is essential for skill and confidence required.

MULTIPLE CHOICE QUESTIONS

1. In which ledgers can data relating to discount be found?
   A. Nominal ledger
   B. Cash Book
   C. Sales ledger
   D. Private ledger
   E. Public Ledger

Use the data below to answer Questions 2 to 5

	31/12/15	**31/12/16**
	¢	**¢**
Non-Current assets (cost)	320,000	286,000
Current	750,000	920,000
Current liabilities	150,000	130,000
Provision for depreciation	70,000	74,000

During 2016, a Non-Current asset costing ¢54,000 with a book value of ¢20,000 was sold for ¢15,000

2. What was the capital of the business as at 31 December2015?

   A. ¢920,000

   B. ¢865,000

   C. ¢860,000

   D. ¢850,000

   E. ¢840,000

3. What is the capital of the business as at 31 December 2016

   A. ¢1,076,00

   B. ¢1,002,000

   C. ¢865,000

   D. ¢860,000

   E. ¢850,000

4. What was the value of the net profit or loss for the year ended 31 December, 2016?

   A. ¢152,000 loss

   B. ¢152,000 profit

   C. ¢147,000 profit

   D. ¢120,000 loss

   E. ¢120,000Profit

5. What was the depreciation charge for2016?

   A. ¢74,000

   B. ¢70,000

   C. ¢34,000

   D. ¢4,000

   E ¢1,000

6. A “statement of affair” is similar to

A. Statement of Income

B. Income and expenditure account

C. Statement of Financial Position

D. Trial Balance

E. Ledger Account

7. A Statement of Affairs may include only

A. Accrued expenses, assets, liabilities and outstanding revenues

B. Expenses, assets, accrued revenues and liabilities

C. Assets, liabilities and expenses

D. Expenses, profits, assets and liabilities

E. Net Income, Expanses and Assets.

8. Koki started business on1 January 2016 with ¢200,000. At the end of the year his total assets valued ¢500,000. He did not owe anybody. Throughout the year Koki took ¢70,000 out of the business to maintain his family. In June 2016, he won lotto of ¢150,000 and added the prize to the business capital. Calculate Koki`s profit for2006.

A. ¢370,000

B. ¢300,000

C. ¢280,000

D. ¢220,000

E. ¢120,000

9. If cost price is ¢240,000 and selling price is ¢300,000 then

A. Mark-up is$33^1/_3$%

B. Margin is $33^1/_3$%

C. Margin is 20%

D. Mark-up is20%

E. Make-upis8%

10. What is the cost of goods sold, given the sales figure as ¢800,000 with a mark-up of 25%?

A. ¢640,000

B. ¢604,000

C. ¢540,000

D. ¢504,000

E ¢160,000

EXAMINATION TYPE QUESTIONS

1. Victorosky who does not keep proper books of account has presented the following information for the year eneded 31 December 2014.

	2014(¢)	**2013(¢)**
Inventories	200,000	185,000
Cash at Bank	98,500	56,000
Trade Receivables	100,000	90,000
Office Equipment	450,000	400,000
Cash in hand	25,000	29,000
Trade Payables	250,000	158,000
Motor vehicle	740,000	955,000

You are required to calculate the profit or loss of Victorosky for the year ended 31 December 2014, after taking into consideration the following:

a) Victorosky makes monthly withdrawal of cash and goods valued at ¢50 and ¢15 respectively.

b) Customer with an outstanding bill to the tune of ¢5,400 was declared bankrupt by a court in Accra.

c) Rent prepaid and electricity owing amounted to ¢16,000 and ¢8,500 respectively.

2. Babariga is a trader who does not keep proper books of account. He has however provided you with the following information:

a. He paid ¢10,000 in bank account as his initial capital

b. He banked all sales after withdrawing cash for the following:

Personal use	¢350,000 per week
Staff Salaries and wages	¢500,000 monthly
General expenses	¢11,140,000 monthly

Lodgements made into the Bank amounted to¢450,000,000

Withdrawals from the bank were:	¢
Rent	13,000,000
Insurance	10,000,000
Transport expenses	6,750,000
Payment to suppliers	245,000,000
Purchase of motorcar	63,500,000
Purchase of computers	18,000,000
Telephone expenses	8,698,000

The following balance was also available as at 30September 2016:

Trade Payables	¢134,000,000
Inventories	¢42,000,000
Bad debts	¢4,420,000
Trade receivables	¢25,000,000
Rent prepaid	¢2,800,000
Payables for insurance	¢2,150,000

Depreciation is to be provided on the cost of all non-current assets at the rate of 20%.

You are required to prepare the Statement of profit or loss for the year ended 30 September 2016 and a Statement of Financial position as at that date.

3. Richardosky has kept the following summary of accounts:

Statement of Financial Position as at 1 January 2015

	¢		¢
Sundry creditors	105,000	Office equipment	250,000
Rent and Rates	6,000	Fixtures and Fittings	50,000
		Stocks	120,000
Loan	250,000	Sundry Debtors	235,000
Surplus	404,000	Bank	110,000

Analysis of Trade Payables

	¢	¢
Balance1/1/15		105,000
Purchases		548,000
Cash paid	415,000	
Discounts	7,000	
Returns	4,000	
Balance31/12/15	227,000	
	653,000	653,000

Analysis of Receivables

	¢	¢
Balance1/1/15	235,000	
Sales	980,000	
Cash received		820,000
Discounts		42,500
Bad debts		35,000
Returns		29,000
Balance31/12/06		288,000
	1,215,000	1,215,000

Analysis of Balances as at 31/12/2015

	¢
Inventories	235,000
Rent prepaid	8,000
Rates owing	4,000
General expenses owing	28,000
Office equipments	366,000
Fixtures & Fittings	45,000

Analysis of Cash Book

	Dr.	Cr.
	¢	¢
Balance as at 1/1/15	110,000	
Trade Receivables	820,000	
Creditors		415,000
Cash Sales	95,000	
Office equipment		150,000
Wages and Salaries		150,000
General expenses		32,000
Rent and Rates		42,000
Cash Purchases		48,000
Selling expenses		45,000
Balance as at 31/12/05		95,000

You are required to prepare Richardosky's Statement of Financial Position as at 31 December 2015, together with statement of profit or loss for same year.

Solution to Multiple Choice Questions

1. A
2. D
3. B
4. B
5. D
6. C
7. A
8. D
9. C
10. A

Solution 1

Victorosky

Statement of Affairs

	31/12/13	31/12/14
Assets:	**¢**	**¢**
Office equipment	400,000	450,000
Motor vehicles	755,000	740,000
Trade Receivables	490,000	376,000
Inventories	185,000	200,000
Prepayments	-	16,000
Cash at bank	56,000	98,500
Cash in hand	29,000	25,000
	1,915,000	1,905,500
Liabilities:		
Trade Payables	158,500	160,000
Accruals	-	18,500
	158,000	178,500
Capital	1,756,500	1,727,000

The calculation of profit or loss could be based on the formula below:

Opening Capital + Net Profit (or – Net loss) + Additional Capital – Drawings= Closing Capital

¢1,756,500 + Net Profit + ¢75,000 - ¢276,000 = ¢1,727,000

Solving for Net Profit

Net Profit=¢1,727,000-¢1,756,500 - ¢75,000 +¢276,000

Net Profit=¢171,5000

<u>Solution 2</u>

Babariga

Statement of profit or loss for the year ended30 September2016

	¢	¢
Sales		487,522,000
Less Cost of sales		
Purchases	379,000,000	
Less closing stock	42,000,000	337,000,000
Gross profit		150,522,000
Less Expenses:		
Rent (13m – 2.8m)	10,200,000	
General expenses	11,140,000	
Staff salaries & wages	6,000,000	
Telephone	8,698,000	
Depreciation– Motor car	12,700,000	
Depreciation– computers	3,600,000	
Insurance (10m + 2.15m)	12,150,000	
Transport	6,750,000	
Bad debts	4,420,000	
		75,658,000
Net Profit for the year		74,864,000

STATEMENT OF FINANCIALPOSITION AS AT30 SEPTEMBER2016

	¢	¢	¢
NON-CURRENT ASSETS	Cost	Dep.	NETBOOK VALUE
Motorcar	63,500,000	12,700,000	50,800,000
Computers	18,000,000	3,600,000	14,400,000
	81,500,000	16,300,000	65,200,000
Current Assets:			
Inventories		42,000,000	
Receivables (Wii)		25,000,000	
Prepayment		2,800,000	
Bank (Wi)		67,814,000	
		137,614,000	
Current Liabilities:			
Trade Payables (WIII)	134,000,000		
Accruals	2,150,000		
		136,150,000	
			1,464,000
			66,664,000
Financed by			
Capital			10,000,000
Add Profit for the year			74,864,000
			84,864,000
Less Drawings			18,200,000
			66,664,000

Workings:

(i) Cash book summary

	¢		¢
Capital	10,000,000	Rent	13,000,000
Lodgements	450,000,000	Insurance	10,000,000
Cash sales	8,102,000	Transport	6,750,000
		Payment to suppliers	245,000,000
		Purchases of motorcar	63,500,000
		Purchases of computers	18,000,000
		Telephone expenses	8,698,000
		Cash payments:	
		Drawings	18,200,000
		Staff salaries & Wages	6,000,000
		General expenses	11,140,000
		Balance c/d	67,814,000
	468,102,000		468,102,000
Balance b/d	67,814,000		

(ii) Sales Ledger Control Account

	¢		¢
Credit sales (missing figure)	479,420,000	Bank	450,000,000
		Bad debts	4,420,000
		Bal. c/d	25,000,000
	479,420,000		479,420,000
Bal. b/d	25,000,000		

Total sales = ¢479,420,000 +¢8,102,000 = ¢487,522,000.

(iii) Purchases Ledger Control Account

	¢		¢
Bank	245,000,000	Purchases (missing figure)	379,000,000
Bal. c/d	134,000,000		
	379,000,000		
			379,000,000
		Bal, b/d	134,000,000

Solution 3

Richardosky

Statement of Income for the year ended 31 December 2015

	¢	¢	¢
Revenue (95 +980)			1,075,000
Less returns			29,500
			104,500
Less Cost of sales:			
Opening stocks		120,000	
Purchases (548+48)	596,000		
Less returns	4,000	592,000	
		712,000	
Less closing stock		235,000	477,000
Gross profit			568,500
Discount received			7,.000
			575,500
Less Expenses:			
Rent (42.5 – 6 – 8 +4)		32,500	
General expenses (32 + 28)		60,000	
Salaries &Wages		150,000	
Bad debts		35,000	
Discount allowed		42,500	
Depreciation– Plant & Machinery		34,000	
Depreciation– Fixtures &Fittings		5,000	
Selling expenses		45,000	404,000
Net Profit			171,500

Richardosky

Statement of Financial Position as at 31 December 2005

	¢	¢	¢ Non-	
Current Assets:	**Cost**	**Dep.**	**Net**	
Office equipment	400,000	34,000	366,000	
Fixtures &Fittings	50,000	5,000	45,000	
	450,000	39,000	411,000	
Current Assets:				
Inventories		235,000		
Trade Receivables		288,000		
Prepayment		8,000		
Bank		95,000		
		626,000		
Current Liabilities:				
Trade Payable	227,000			
Accruals (4 +28)	32,000			
			259,000	367,000
				778,000
Less loans				250,000
				528,000
Financed by:				
Capital				404,000
Add Profit for the year				171,500
				575,500
Less Drawings				47,500
				528,000

CHAPTER TWO

ACCOUNTING FOR NOT-FOR PROFIT ORGANISATIONS

CHAPTER CONTENTS

a. Introduction
b. Receipt and Payment Account
c. Income and Expenditure Account
d. Membership subscription
e. Bar Trading Account
f. Life Membership
g. Accumulated Fund/ Equity Reserve Fund

2.0 Objectives

At the end of this chapter, the reader should be able to:

(a) Explain what a not- for- profit organization is
(b) State the difference between a receipts and payments account and an income and expenditure account;
(c) Explain the difference between the final accounts of not-for profit organizations as those of sole traders and partnerships;
(d) Prepare receipts and payments account;
(e) Prepare income and expenditure account;
(f) Prepare subscription account making the necessary adjusting entries with respect to amount in arrears and payments in advance; and
(g) Prepare the accumulated fund or Equity Reserve of a not-for profit organization

2.1 Introduction

There are many types of not-for profit organizations. They include government owned hospitals and voluntary health and welfare organizations. In Ghana and Nigeria and other west African countries, citizens depend heavily on such entities for religious, educational, social and recreation needs. Examples of other not-for profit organizations include the following:

(a) Private and community foundations
(b) Professional
(c) Research and scientific organizations
(d) Social and country clubs
(e) Trade associations
(f) Labour organizations
(g) Political parties

It is not only profit making organizations that need accounts. Organisations set up for purposes other than profit, also need to tell their stakeholders how they have dealt with the funds they have contributed.

The legal status of such entities is usually spelt out in club rules or regulations. Students must however remember that external financial information provided by such organizations must be inconformity to generally accepted accounting principles.

The accounts of clubs, societies and charitable organizations may consist of the following:

(i) Receipts and payment account
(ii) Income and expenditure account and
(iii) Statement of financial position.

2.2 **Receipts and Payments Account**

This is a statement of cash actually received and paid during a given period. Receipts being debited and payments credited. It is, in effect, a summary of the cash book, and therefore shows the opening and closing balances of cash in hand, and receipts and payments of any kind and on any account made during the period.

An example of a receipts and payments account is shown in below:

Receipts	¢‟000	Payments	¢‟000
Bank balance1/6/2011	118,000	Printing & stationery	228,000
Sponsored walk	23,000	Management expenses	109,000
Subscription	580,000	Caterer for president ball	113,250
Sundry income	57,000	Electricity and water	78,500
Sale of clubs manual	230,000	Bar Payables	278,500
Sale of equipment	254,000	Bank balance31/5/2012	454,750
	1,262,000		1,262,000

FEATURES OF RECEIPTS AND PAYMENTS ACCOUNTS

- It is a summary of all cash receipts and payment whether it is capital or revenue in nature
- It shows the opening and closing cash and bank balance
- It does not distinguish between capital and revenue items as in the case of income and expenditure accounts
- It is easy to prepare as it does not require the complex application of double entry principle or accounting conventions

2.3 Income and Expenditure Account

Income and expenditure account is the equivalent of Statement of profit or loss account of a non trading concern. It contains only revenue items, being debited with all expenditure, and credited with all income of a period, whether or not it has actually been paid or received within that period. The final balance of an income and expenditure account represents the excess of income over expenditure (surplus) or the excess of expenditure over income (deficit), as the case may be, for the period. This balance is similar to the net profit or loss of a trading concern.

Readers must note that an income and expenditure account differs from the receipts and payments account. The latter records only cash movements, the former takes into consideration non-cash adjustments for amounts owing and owed at the period end and for depreciation. It also recognizes the accounting distinction between revenue and capital expenditure. The important point that readers must note is that the income and expenditure account is prepared on an accrual basis.

2.4 Membership Subscription

A club or society receives payments from members for benefits, which members have enjoyed. Annual membership subscriptions of clubs and societies are usually payable one year in advance. Such payments in advance by members is shown as liability in the Statement of financial position. This is because the year's membership has still to run as at the year end. A large number of club subscriptions in arrears may never be received and the financial position of the club or association could be distorted, since such amounts are usually shown as assets in the Statement of financial position.

Illustration2.1

Receipts and payments account fortheyearended31may2011

Receipts	¢	**Payments**	¢
Bank balance 1/6/2011	118,000	Printing & stationery	228,000
Sponsored walk	23,000	Management expenses	109,000
Subscription	580,000	Caterer for President's ball	113,250
Sundry income	57,000	Electricity and water	78,500
Sale of club's manual	230,000	Bar creditors	278,500
Sale of equipment	254,000	Bank balance31/5/2012	454,750
	1,262,000		1,262,000
Bank balance1/6/2012	454,750		

Extracts from the membership subscription book revealed that subscriptions due from members amounted to ¢80,000 on 31December 2010 and ¢120,000 on 31 December 2011. The accounts clerk recorded subscription of ¢21,500 and ¢109,000 in respect of subscriptions that have been paid by members in advance for2011and 2012 respectively. The subscription account will be prepared as follows:

Subscription Account for theyearended31Dec. 2011

	¢"000		¢"000
Balance b/f	80,000	Bal b/f	21,500
Income and Expenditure a/c	532,500	Receipts & Payment a/c	580,000
Balance c/f	109,000	Balance c/f	120,000
	721,500		721,500
Balance b/f	120,000	Balance b/f	109,000

By carrying forward subscription in advance, the accountant is applying the matching concept. This is because the payment of ¢109,000 in 2011 represents income meant for 2012 accounting year. This must therefore be removed from the current year's income and expenditure account, hence the debit balance carry forward.

From the above solution subscription in arrears have been treated as an asset. This will hold true as a result of the accrual concept since the subscription in arrears are income that have been earned for the accounting year of 2011 but for which cash has not been received.

In practice however, subscriptions in arrears are often excluded from the Statement of Financial Position on grounds of the prudence concepts. This is due to the fact that subscriptions that are owed by members for a long time end up not being paid eventually.

In examination situations, however, readers are reminded to follow the policy of the club or society as provided by the examiner.

2.5 Bar Trading Account

It is not uncommon for clubs/ associations to engage in other income generating activities to raise additional revenue for the effective running of the club.

These other activities are done with the sole aim of making profit. For instance the aim of a local trade union is not to make profit but the union may operate a bar

A long side its activities with the object of making profit. The profit will not be distributed among the members but rather used for the purpose of the union.

If a club has a bar, a separate Statement of profit or loss account will be prepared for its trading activities. The net profit from the bar activities is then included as income in the income and expenditure account of the club or association. Any loss on the bar activities will be shown in the expenditure side of the income and expenditure account.

2.6 Life Membership

Subscriptions are often received from life members who paid at once and for subscription which entitles them to membership facilities for the rest of their lives. The once and-for-all payments from life members are not income relating to the year in which they are received by the club, because the payment is for the life of the member's subscriptions are small, they are credited to income as received but if they are significant in amount, then they should be credited in equal proportion over the estimated active club membership of such members.

2.7 Accumulated Fund OR Equity reserve fund.

This represents the opening capital of a not-for profit making organization. It has the same meaning ascribed to the capital accounts of a sole trader and partnership and is calculated as the difference between total assets and liabilities. It is usually common to see most not-for profit organizations keeping accounts on single entry basis. For this reason the procedure for preparing the accumulated fund of a not-for profit organization is the same as that of statement of affairs as obtained under incomplete records and single entry discussed in other chapter.

Illustration 2.2

The following is the Receipts and Payments Account for the Victorosky Fun Club for the year ended 31October2015.

RECEIPTS	¢‟000	**PAYMENTS**	¢‟000
Subscription	1,643,560	Printing & Stationery	59,160
Sponsored walk	478,802	Bar steward's salary	69,600
President's Ball connections	408,000	Caterers for President's ball	250,000
Sundry income	75,000	Light, cleaning etc	32,640
Bar takings	510,000	Petty cash	65,000
Sale of equipment	7,923	Bar payables	280,000
Raffle	183,030	Investment in ABC limited	450,000
		Donation	50,000
		Sundry President's ball exp.	5,275
		Prizes of raffle	21,600
		Building project (materials)	839,000
		Rent	360,000
		Secretary's salary	120,000
		Sundry bar expenses	3,360

Bank charges	36,000
Hiring of hall for Pres. Ball	20,000
Building project (wages)	525,000

Insurance	18,000
New equipment	67,800

the following additional information has been given:

1. Current Assets and Liabilities were:

	2014	2015
	¢‘‘000	¢‘‘000

Bar Inventories	27,000	36,000
Bar Payables	18,000	33,000
Subscriptions in arrears	240,000	360,000
Subscriptions in advance	150,000	210,000
Light and cleaning owing	4,200	6,800
Insurance prepaid	4,200	5,200
Petty cash float	3,000	1,000
Cash in hand	15,565	14,340
Bank balance	246,500	281,105

2. The petty cash float is used exclusively for telephone and postages
3. The club started constructing its club House during the year. The project will take four years to complete. Amount owed for building materials supplied at 31October 2015 was ¢511,500,000. Wages owed for October 2015 was ¢175,000,000. Inventory of materials at the end was ¢220,500,000.
4. Tickets for the President's Ball were sold at ¢300,000 each. The club engaged the services of a caterer who agreed to charge on the number of plates served under the following conditions:
    - Below 1,500 plates, amount to be charged per plate was ¢250,000.
    - From 1,501 to 2,000 plates, amount to be charged per plate was ¢220,000.
    - Above 2,000 plates, amount to be charged per plate was ¢200,000.of the2,400 tickets sold, 90% attended the function and were served.
5. Depreciation of equipment is to be calculated at10% per annum on written down value. The Club's equipment was disposed of during the year had a carrying value of ¢9,905,000 on 1November 2014.
6. Subscriptions in arrears for more than one year are to be written off.
7. An amount of ¢1,000,000,000 is to be transferred from accumulated fund to building fund.
8. Investment in ABC limited is expected to be held for at least five years.
9. Included in subscription is an amount of ¢192,000,000 in respect of 2014.
10. Rent paid represents one and half years to 30April, 2017

Required:

(a) Accounts showing the profit or loss on Bar operation and president's Ball

(b) The accumulated fund as at 1November2014.

(c) The income and expenditure account of Victorosky Fun Club for the year ended 31 October 2015and statement of financial position as at that date.

(a) **Solution to illustration2.2**

Victorosky Fun Club

(i) President ball Income statement Account for the year ended31December 2015

	¢'000	¢'000
Sale of tickets (2,400@¢300,000)		720,000
Less: Cost of meals served [2,400x90%@¢200,000]		432,000
		288,000
Less Expenses:		
Hiring of Hall	20,000	
Sundry Expenses	5,275	25,275
Profit to I & E a/c		262,725

(ii) Bar Trading Account for the year Ended 31October, 2015

	¢‶000	¢‶000
Takings		510,000
Opening Inventory	27,000	
Add purchases (w1)	295,500	
	322,500	
Less closing Inventory	36,000	286,500
		223,500
Less Expenses:		
Stewards salary	69,600	
Sundry expenses	3,360	72,960
		150,540

(b) **ACCUMULATED FUNDAS AT 1 NOVEMBER, 2014**

	¢‶000	¢‶000
Equipment		9,905
Cash in hand		15,565
Bank		246,500
Inventory		27,000
Subscriptions		240,000
Prepaid insurance		4,200
Petty cash		3,000
		546,170
Bar Payables	18,000	
Light and cleaning owing	4,200	
Subscriptions	150,000	172,200
ACCUMULATED FUND/ EQUITY RESERVE FUND		373,970

Victorosky funclub

Income and expenditure account

For the year ended31 October2015

INCOME:	¢‟000	¢‟000
Subscription (W2)		1,751,560
Sponsored walk		478,802
Sundry income		75,000
Raffle (¢183,030-¢21,600)		161,430
Profit on Bar Trading		150,540
Profit on president Ball		262,725
		2,880,057
Expenditure:		
Bank charges	36,000	
Insurance (¢4,200+¢18,000-¢5,200)	17,000	
Printing & Stationery	59,160	
Light & cleaning (6,800+32,640-4,200)	35,240	
Telephone & PostageW3	67,000	
Depreciation (10%@¢67,800)	6,780	
Donation	50,000	
Secretary's Salary	120,000	
Rent [12/18@¢360,000]	240,000	
Bad debt (W1)	48,000	
Loss on sale of equipment (¢7,923-¢9,905)	1,982	681,162
Surplus of income over expenditure		2,198,895

VICTOROSKY FUN CLUB

STATEMENT OF FINANCIAL POSITION AS AT 31 OCTOBER, 2015

ASSETS EMPLOYED		¢"000		¢"000	
NON- CURRRENT ASSETS:					
Equipment at cost		67,800			
Less depreciation		6,780		61,020	
				1,830,000	
				1,891,020	
Investment in ABC Shares				450,000	
				2,341,020	
Current Assets:					
Inventory (¢220,500+¢36,000)			256,500		
Receivables-President's ball (w4)			312,000		
Subscription in arrears			360,000		
Insurance prepaid			5,200		
Rent prepaid			120,000		
Bank balance			281,105		
Cash (¢14,340+1,000)			15,340		
			1,350,145		
Current Liabilities:					
Creditors: Building project	511,500				
Bar	33,000				
Caterer (¢432,000-250,000)	182,000				
Subscription in advance	210,000				
Light & cleaning owing	6,800				
Wages outstanding	175,000				
		1,118,300			
Net current Assets					231,845
Net Assets					**2,572,865**

WORKINGS

(W1) Bar Purchases:	¢'‘000
Payables 2015	33,000
Receipts & Payment a/c	280,500
	313,500
Less Payables 2015	18,000
	295,500

(W2). Subscription Account

	¢'‘000		¢'‘000
Balance b/f	240,000	Balance b/f	150,000
Income & Expenditure a/c	1,751,560	Receipts & Payment a/c	1,643,560
		Bad debt (240-192)	48,000
Balance c/f	210,000	Balance c/f	360,000
	2,201,560		2,201,560

(W3)	Telephone & Postages	¢'‘000
	Petty cash 2014	3,000
	Receipts &Payment	65,000
		68,000
	Petty cash 2015	1,000
	Income &Expenditure a/c	**67,000**

(W4)	Receivables on President's Ball:	¢'‘000
	Tickets sold	720,000
	Less Amount Paid	408,000
	Amount to be collected	312,000

(W5)	**Work in progress-Club House**	¢''000	¢''000
	Payment for materials		839,000
	Add Amount owed (2015)		511,500
			1,350,500
	Less closing stock		220,500
	Materials used on project		1,130,000
	Wages paid	525,000	
	Add amount owed (2015)	175,000	700,000
	Cost to date		1,830,000

(W6)	Accumulated Fund	¢''000
	Balance as at 1/11/2014	373,970
	Transfer from I & Ea/c	2,198,895
		2,572,865
	Amount transferred to building fund	1,000,000
		1,572,865

2.8 Chapter Summary

The chapter explained the difference between a receipt and payment account and an income and expenditure account and that the receipts and payments account does not show the true financial position of an organization.

The profit or loss account of a not-for profit organization is called income and expenditure account from which any surplus (profit) or deficit (loss) is calculated and also the accumulated fund is similar to the equity account of a trader.

We also learned that where the club or society engaged in any activity with the aim of earning income for the attainment of the objectives organization, a separate profit or loss account should be prepared and the resulting profit or loss transferred to the income and expenditure account.

The treatment of subscription owing should be seen as part of the earnings or in accordance with accounting policy of the organization.

Similarly, life membership and entrance fees should be accounted for bearing in mind the accounting policy of the organization.

2.9 MULTIPLE CHOICE QUESTIONS

Use the data below to answer Questions 1– 4

Receipts and Payments Account for the year ended 31December, 2016

	¢‟000		¢‟000
Balance b/f	8,000	General expenses	7,800
Subscriptions	50,000	Equipment	9,000
Bar Sales	36,000	Clubhouse furniture	27,000
		Bar purchases	30,000
		Bar keeper’s wages	4,000

The treasurer also stated that on 1 January 2016, the club had ¢24,000 worth of equipment and owed ¢500 for electricity. Bar Inventory on 1January and 31December valued ¢10,000 and ¢13,000 respectively. Non-current assets are depreciated at 10% per annum.

1. Bar operation’s surplus for the year was
   a. ¢36,000
   b. ¢6,000
   c. ¢5,000
   d. ¢3,000

2. The accumulated fund at the beginning of the year was

a. ¢42,500

b. ¢41,500

c. ¢42,000

d. ¢32,000

3. The net value of the club's non-current assets as at 31 December, 2016 was

a. ¢60,000

b. ¢36,000

c. ¢54,000

d. ¢32,400

4. The cash balance at the end of the year was

a. ¢16,200

b. ¢18,200

c. ¢16,000

d. ¢16,700

5. In the final accounts of non-profit making organization, capital expenditures are recorded in

a. Income and expenditure account

b. Subscription account

c. Statement of financial position

d. Profit or loss account

6. Revenue receipts of a not-for profit making organization are recorded in the

a. Profit or loss account

b. Income and expenditure Account

c. Statement of Affairs

d. Bar Purchases Account

7. Which of the following statements is NOT true about the accounts of clubs and societies?
   a. A deficit of income and expenditure account reduces accumulated fund.
   b. Income and expenditure account does not contain capital receipts and expenditure.
   c. The excess of total assets over liabilities represents accumulated fund
   d. The closing balance receipt and payments account is transferred to income and expenditure account.

8. With regard to a not-for-profit organization, a debit balance on the subscription account is reported on
   a. Income and Expenditure Account
   b. Statement of Financial Position (SFP)
   c. Accumulated Fund
   d. Receipts and Payments Account

Details of subscription account of "Big Men KeepFit Club" areas follows:

		¢''000
Subscription owing	1/1/17	30,000
Subscription received 2017		320,000

Subscription received in 2017 included ¢40,000 in respect of 2018 financial year.

9. What is the subscription to be transferred to income and expenditure account for 2017?
   a. ¢390,000
   b. ¢330,000
   c. ¢310,000
   d. ¢250,000

10. A club received the following life membership fees in each of its first two years:

Year 1¢300,000

Year 2¢160,000

The club's policy is to take credit for life membership fees in equal amounts over 10years. Determine the amount to be transferred to income and expenditure account in year 2.

a. ¢16,000

b. ¢43,000

c. ¢46,000

d. ¢32,000

2.10 EXAMINATION TYPE QUESTIONS

1. The information below relates to the Madonna Youth Club for the accounting period of 2016.

	¢"000
Cash in hand 1/7/15	1,800
Subscription received:	
2016	2,000
2017	18,000
Receipts for renting of park	1,000
Receipts refreshing guest	6,000
Sundry receipts	12,500
Payments:	
Repairs	1,200
Salaries and wages	10,000
Printing and Stationary	3,000
Caretakers wages	6,800
Refreshment materials	8,500
Electricity expenses	4,500
Vehicle running expenses	5,000

Payables for repair	800
Payables for vehicle running expenses	400
Payables for refreshment materials	2,200
Subscription owingfor2016	3,000

You are required to prepare:

a) Receipts and payments accounts

b) Income and expenditure account for the year ended 30 June2016.

2) The Financial Treasurer of Ayoyo Fun Club has presented the following summary of receipts and payments account for the year ended 31 December 2014.

Receipts and Payments Account for the year ended 31 December 2014

	¢‟000		¢‟000
Balance b/f	4,900	Rent and rates	804
Membership Subscription	5,760	Social activities expenses	3,000
Membership admission	840	Bar purchases	3,580
Bar receipts	7,500	Bar wages	1,104
Other receipts	3,800	General wages	2,560
		Equipment	5,720
		Electricity expenses	208
		Postage &Telephone	352
		Bank charges	116
		Insurance	604
		Balance c/f	4,752
	22,800		22,800

The following additional information is available:

	31/12/03	31/12/04
Premises	60,000	60,000
Furniture and fittings	4,400	2,840
Bar Inventory	1,040	1,420
Subscription in arrears	80	120
General wages owing	180	-
Subscriptions in advance	400	-
Insurance prepaid	136	180

Depreciation of 20% is to be written off equipment.

You are required to prepare:

a) Bar Profit or loss Accounts

b) Income and expenditure account for the year ended 30June2014.

c) Statement of financial position as at 31December 2014

2.11 SOLUTION TO MULTIPLE CHOICE QUESTIONS

1. C
2. B
3. D
4, A
5. C
6. B
7. D
8. B
9. C
10. C

CHAPTER THREE

ACCOUNTING PROCESSESS

CHAPTER CONTENTS

a. Introduction
b. Bases and Concept of Accounting
c. Business transactions
d. Accounting System
e. Double Entry System
f. Ledger Accounts
g. Accounting Cycle
h. Trial Balance
i. Adjusting Process
j. Extended Trial Balance
k. Simple Financial Statement

3.0 OBJECTIVES

At the end of this chapter, readers should:

a) Know the role of source documents and the needs for books of prime entry
b) Understand the double entry book keeping system
c) Know how to prepare initial trial balance make necessary accounting adjustments and prepare the final trial balance.
d) Be able to prepare simple financial statements of sole proprietorship or trader.

3.1 INTRODUCTION

Accounting is typically of two types, these are Financial Accounting and Management Accounting. However, financial accounting is a method of reporting financial performance and financial position of an entity. An entity is any type of business organisation such as sole trader, partnership, limited liability company etc.

3.2 Bases and Concepts of Accounting

3.2.1 Bases of Accounting

There are three bases of accounting and they are:

i) Accrual basis'
ii) Cash basis; and
iii) Break up basis

Of these three basis, the accrual basis it the most useful when preparing general purpose financial statements.

Accrual Basis

The accrual basis of accounting also referred to as accrual concept and accrual accounting, recognize transactions, other events and conditions in the accounting period. They occur and not when the associated cash is received or paid.

Hence, revenue from sales and other incomes are reported in the period when the income arises and not in the period when the cash is received. Also an expense should be charged in the period to which it relates and not the period when the payment is effected or made.

The accrual basis provides the reason for making adjustments for accrued and prepaid expenses when preparing financial statements.

Cash Basis

Cash bass accounting recognises transactions, other events and conditions in the periods in which cash receipts and payments occur.

Thus, revenue from credit sales and other incomes are reported in the period when the cash involved are received and not in the period when the cash involved are received and not In the period when the sales were made or the income earned. Also all expenses are recognised and reported in the period when payment s were made rather than in the period when the expenses were incurred.

Break up basis

The other two bases of accounting (Cash basis and accrual basis) assumed that every business is a going concern. That is, that the business will continue to operate far into the future periods. However experiences have shown the business do collapse as a result of financial difficulties occasioned by poor management of resources.

The break up basis of accounting is applied to business which has lost their going concern status. In this situation the business assets and liabilities are measured at the amount of cash they can be sold for or settled

Accounting Concepts

Accounting concepts are basic assumption, postulations or ideas adopted and used in accounting practice for the preparation of financial statements. They include the following:

i. Entity Concept
ii. Dual Aspect concept
iii. Matching concept
iv. Accrual concept
v. Money measurement concept
vi. Realisation concept
vii. Historical cost concept
viii. Going concern concept
ix. Substance over form

Entity Concept

The entity concept is also known as legal entity or business entity concept. Under this concept, the business is treated for the purpose of financial reporting as an institution separate and distinct from the legal owners. For this reason, transactions and to the events are recorded from the point of view of the business and the presence or existence of its owners is reflected only in the capital account.

The essence of the entity concept is to distinguish the income and expenses of the business from the private income and expenses of the owner or his drawings from the business. The application of this concept is important in sole traders and partnership businesses where the owner/partners actively participate in the business affairs. For a limited liability company, the legal entity is established by law.

Dual Aspect Concept

The dual aspect concept states that there are two aspects to every business financial transaction. One is the giving of value, while the other is the receiving of the same value. The receiving of value gives rise to assets while the giving of value gives rise to capital and liabilities. Under this concept the two aspects are always equal to each other. This gave rise to the accounting equation.

Capital + liabilities = Assets

The dual aspect concept is the basis of the double-entry book keeping in modern accounting.

Matching Concept

The matching concept holds that in determining profit or loss for an accounting period. The income earned in the period should be matched with the expenses or cost incurred in the same period to earn the income. Where income is deferred from one period to another, all elements of cost or expenses relating to the deferred income will be carried forward. The concept is important because any error in the matching of the income and expenses will result in the financial statement being misleading and unreliable.

Accrual Concept

This concept is closely related to the matching concept. The accrual concept states that income should be recognized and accounted for when they are earned and not when they are received.

Similarly, expenses should be recorded and accounted for when they are incurred and not when they are paid. It is the application of this concept that gives rise to prepayments and accrued expenses (accruals) normally adjusted for when preparing financial statements

Money Measurement Concept

The money measurement concepts demands that only financial transactions and other events which can be measured in monetary terms should be recorded and accounted for . This means that accounting does not provide complete information about an entity since qualitative useful information bordering on the continuous operations or otherwise of an entity are not recorded.

The limitation of this concept is that sometimes the value of money is not stable like in inflationary periods and also the issue of time value of money will affect measurement.

Realization Concept

The realization concept is concerned with ascertaining when revenue or income is earned. The concept advocates that revenue and incomes should not be recognized until they have been realized or earned. It also hold s that revenue should be recognized at the time goods are sold and services are rendered, that is, at the pint the customer has accepted liabilities for the goods. Rent income is realized with passage of time and not when the rent is received.

Historical Cost Concept

This concept holds that all assets acquired by an entity should be recorded in the accounting books at their historical or original costs paid to acquire them. The justification for the historical cost concept is its objectivity, that is the cost can be verified or traced to the source documents and that other measure of value would be subjective and questionable. A known criticism against this concept is that with passage of time, cost would no longer represent the fair value of an asset especially in inflationary period. The historical cost is the basis for calculating annual depreciation charge on assets.

Going concern concept

The going concern concept is an assumption in accounting that a business entity will continue to operate indefinitely. That is, the entity has neither the intention nor the necessity of liquidation or refund significantly the scale of its operation. When circumstances detect the need for liquidation of a business entity, the going concern concept will cease to apply.

Under going concern status, assets and liabilities are valued on historical cost basis but when the going concern is in doubt, assets are valued on break-up value basis. Going concern concept helps investors and to the stakeholders in making economic decisions about the entity.

Periodicity Concept

Periodicity concept requires that the assessment of the operations and performance of a business entity should be based on a specified period usually referred to as the accounting or reporting period. It could be weekly, monthly but should not exceed one year. Periodicity concept is justified based on the fact that the actual net return from operations of an entity cannot be fully determined until the end of the life of the entrepreneur when its assets are realized and liabilities paid off. The periodic review would help to assess management efficiency and the planning and control of future operations.

Substance over form

Business transactions are usually governed by legal principles, nevertheless they are accounted for and presented in accordance with their financial substance and reality and not merely their legal form.

Examples are found in sales and re-purchase agreements, lease contracts and consignments

3.3 Business Transactions

3.3.1 Business

The term business means different things to different persons. It can be used to describe an economic process and to describe entities that participate in that process.

Business can be defined as an economic system where goods and services are exchanged for one another or for money. A business entity is a commercial organization that aims to make a profit from its operations.

Characteristics of Business

The following characteristics are applicable to all businesses

i. Businesses are formed with a profit motive. That is all business exists to make profit.

ii. Business makes profit by supplying goods or rendering services to others called customers.

iii. Businesses might make the goods they supply or buy the goods from other outside parties.

iv. Business takes risk to survive. So profit is the reward for accepting risk.

v. The profit made by a business belongs to its owners. A share of the profit might be paid to the owners periodically as dividend or share of profit.

Types of Business Entity

Ordinarily there are three main types of business entity:

- A sole trader or sole proprietorship

- A partnership business
- A company or limited liability company

3.3.2 Sole Trader Or Sole Proprietor

Any business owned and managed by one person is referred to as a sole trader or sole proprietor. Any individual who sets up a business on his own without form a company is a sole trader.

Important features of a sole trading business are as follows:

a. There is no legal distinction between the proprietor and the business. Thus he is personally liable for an unpaid debt and other obligations of the business and also when a sole trader dies the business cease to exist.

b. The profits of the business belong to the sole proprietor.

c. The assets of the business belong to the sole proprietor.

d. The sole trader can extract cash and other asset from the business for personal use and this called drawings when preparing financial reports.

e. The business may be financed by the owners' capital as well as by personal and business loans introduced.

f. A sole proprietorship business can be sold as a going concern by its owner.

3.3.3 Partnership

If partnership business is an enterprise in which two or more persons called partners share the ownership of a business. Each partner will be expected to contribute agreed sum of money to set up the business.

A partnership is defined as the relationship between persons who have agreed to share the profit of a business carried on by all or any of them acting for all. Important features of a partnership are as follows:

i. It must be an association of two or more persons to carry on a business

ii. The partners are the owners of the business are personally liable as individuals for the unpaid debts and other obligations of the business.

iii. When a partner dies the partnership comes to an end and is dissolved. That is there is no perpetual succession.

iv. The profits of the business belong to the partners in an agreed ratio

v. The assets of the business belong to the partners in agreed ratio.

vi. The partners, if allowed by the partnership deed, can extract cash and other assets from the business as drawings.

vii. The business may be financed by both the partners capital and loans

viii. A partnership can be sold as going concern by its owners.

3.3.4 Company/Limited Liability Company

A company is a special form of business entity. Almost all the companies in business are limited liability companies with liability limited by shares. Important features of Limited Liability Company are as follows:

a) Ownership of the company is represented by ownership of shares. A company might issue any number of shares, depending largely on its size. Large companies usually have large number of shares in issue and consequently large number of shareholders. The number of shares acquired by a shareholder determines his stake or ownership interest in the company

b) Unlike a sole trader or partnership, a company has the status of "legal system" in the eyes of the Law. Thus

    i. A company can be legal owner of business assets, and can sue and be sued in its own right in the law.

    ii. A company is taxed separately from its owners for ht profits made by the company. This is not so with sole traders and partnership as the business profit is taxed in the hands of the partners or the sole proprietor.

    iii. A company is liable for its on debts and not the shareholders. When the shareholders are not the managers of their company, it becomes essential that information about the position and performance of the company should be reported regularly by the management to the shareholders. This is the main purpose of financial reporting

3.3.5 Not-for-profit Entries

These are entities which are established with the aim of providing social and welfare services and not necessarily for profit motive. Such entities includes: clubs, societies, voluntary associations, benevolent and similar institutions. Some important features of not-for-profit entities are:

i. Members pay subscription to maintain their membership

ii. They sometimes carry out activities which yield profit like running a bar, organizing fee pay competitions.

iii. The entities do not prepare statement of profit or loss, rather income and expenditure account is prepared.

Advantages and disadvantages different types of business entity

The advantages and disadvantages of operating as each type of business entity may be summarized briefly as follows:

	Subject Matter	**Sole Trader**	**Partnership**	**Company**
	Ownership	Owned by one person	Several individual working together	Shareholders
2.	Liability for the unpaid debts and other obligations of the business	Personal liability of owners	Personal liability of partners	Limited
3.	Management	Business managed by its owner	Business managed by its owners-the partners	Larger companies are managed by professional managers
4.	Raising Capital	Capital for business is provided by its sole owner. Often Limited in amount	Capital for the business is provided by its owners. Likely to limited in amount	Capital for the business is provided by shareholders. Public companies can raise new capital from investors in the stock market most very large businesses are companies
5.	Financial accounting and auditing	Some financial accounts needed for tax purposes	Financial accounts needed for the benefit of the partners and for tax purposes	Fairly strict regulation of financial reporting by companies. Also legal requirements for audit

3.4 <u>Financial reporting by sole traders and partnerships</u>

The financial statements of a sole trader are private and do not have to be disclosed, except to the tax authorities and possibly also to a lending bank. These must be prepared according to accepted accounting principles and practice, but need not conform to all the requirements of accounting standards.

Similarly, the financial statements of a partnership business are private and do not have to be disclosed.

3.5 Financial reporting by companies

The financial statements of a company are prepared for the shareholders of the company and are usually subject to audit.

Audit is the examination of the financial statements by an independent expert who expresses an opinion as to whether they are fairly presented (show a true and fair view).

Company law requires the financial statements are filed with a government agency, where they can be accessed and read by any member of the general public.

Companies whose shares are traded on a major stock market make their financial statements generally available to the public often on the company's website.

The financial statements of a company are subject to more regulation than those of a sole trader or partnership.

Financial accounting may also be of importance to management of companies. The most important need of financial accounting is that it provides information needs of persons not involved in running the business. That is they provide historical information needs.

3.6 ACCOUNTING SYSTEM

Business entities operates system to record business transactions in accounting records. This system is called book keeping system. All companies small or large have book keeping system for recording financial details of the business on regular basis

The book keeping records of a business are often referred to as the accounts of the business. The content of financial statement might vary depending on whether the business is a sole trader, partnership or limited liability company.

The basic process used to record transaction is however similar for all types of entities. The technique used is called DOUBLE ENTRY BOOK KEEPING, this will explained later in this chapter.

SOURCE DOCUMENTS OF FINANCIAL TRANSACTIONS

When a business transaction takes place they are usually recorded using source documents. These source documents are the source of all financial information recorded by a business.

The documents used to record business transactions in the books of accounts of a business include:

RECEIPTS: This document confirms that payments have been received. This is usually in respect of cash sales

PAYMENT VOUCHERS: This is document that is used for recording payments made to third parties such as suppliers, customers etc.

REMITTANCE ADVICE; A document sent to suppliers with a payment details. A remittance advice allows the suppliers to update the customers' records to show which invoice has been paid and which ones are still outstanding.

DEBIT NOTES: It is a formal request for suppliers to issue a credit note. It is a document sent by a customer to a supplier in respect of goods return or overpayment made.

CREDIT NOTES: It is a document sent by supplier to customer in respect of goods retuned. It is also referred to as a NEGATIVE INVOICE.

INVOICE: An invoice is a document that establishes indebtedness to the effect that money has not being paid or received for goods or services bought or sold. An invoice therefore evidences credit transactions which consist of credit sales and credit purchases

SALES ORDER: This is a document in which a customer places order for goods or services. We also have purchases order.

STATEMENTS: This is a document sent out by a supplier to a customer listing the transactions on the customer's account. The statement is useful as it allows customers to reconcile the amount that they believe they owe the suppliers to the amount that the supplier believes they are owed. Any difference noted can then be investigated and resolved.

GOODS RECEIVED NOTES: this is the document that serves as evidence that goods were received into the warehouse. Even where goods received notes are not issued on regular basis, the details of the consignment from suppliers which arrives without an advice note must always be recorded.

BOOKS 0F PRIME ENTRY

Business transactions are usually recorded in source documents as earlier explained above. The recordings in the sources documents are then entered in to the books of prime entry in other to further process the business transactions before the financial statement can be prepared.

Therefore books of prime entry are the books in which we first record the business transactions, before they are further processed in order to produce the financial statement.

The main books of prime entry are as follows:

- SALES DAY BOOK
- PURCHASES DAY BOOK
- SALES RETURN BOOK
- PURCHASES RETURN BOOK

- GENERAL JOURNAL

- CASH BOOK
  PETTY CASH BOOK.

SALES AND PURCHASES DAY BOOKS

SALES DAY BOOK: this is a record that relates to transaction relating to goods sold on credit. The sales day book is used to keep the list of all invoices sent to customers each day. A typical sales day book will contain the following information:

DATE	INVOICE	CUSTOMERS	AMOUNT INVOICED (₦)
20 Jan 2017	340	Jare dada	250,000
23 Jan 2017	341	Taiwo kehinde	155,000
25 Jan 2017	342	Janet Paul	140,000
2 Feb. 2017	343	Samson Ajayi	165,000
TOTAL			710,000

PURCHASES DAY BOOK

This is a record that relates to all transactions relating to goods that are purchased on credit. A business keeps a record in a purchase day book of all invoices received. A typical purchase day book is shown below:

DATE	SUPPLIERS	AMOUNT (₦)
30 Jan 2017	Kofi & co	50,000
31 Jan 2017	Ahamed nig ltd	175,000
4 Feb 2017	Maxi Ltd	155,000
5 Feb 2017	Wike & co	205,000

It should be noted that there is no invoice number column in the purchase day book above because the day book records other peoples invoices which would have all sorts of different numbers

SALES AND PURCHASES RETURN DAY BOOK

A business may maintain a separate sales return day book or purchases return day book. Alternatively any return in respect of sales or purchase may be treated as a reversal entry in the respective sales and purchase day books earlier explained above. This is because the returned items are not usually much.

GENERAL JOURNAL

The General Journal is also a book of prime entry that is used to record transactions that are not in any other book of original entry. It is also used to record complex transactions that would require explanations. The journal might also be used to provide explanation for simple transactions.

Some of the uses of journal include the following:

- Postings from books of prime entry
- Financial year- end adjustments
- Corrections of errors and omissions
- Any other adjustments

Example of a general journal is shown below:

	DEBIT (DR)	CREDIT (CR)
Name of account to be debited	X	
Name of account to be credited		X

CASH BOOK AND PETTY CASH BOOK

CASH BOOK: is a special journal that is used for recording all cash receipts and cash payments. If a cash book is maintained there is no need for preparing a cash account in a general ledger except if It is required for the purpose of control. The cash book is also a book of original entry where transactions are recorded for the first time from the source document. A cash book serves the dual role of a journal and a ledger.

PETTY CASH BOOK: Majority of small and large business maintain petty cash book for recording small and frequent transactions of the business. Most petty cash books are operated under the IMPREST SYSTEM.

Under the imprest system a petty cash is kept at an agreed sum, such that each topping up of the agreed balance is equal to the amount paid out in the period.

The petty cash is meant to receive and pay small amount of cash on regular basis.

MAIN FEATURES OF CASH BOOK

- It performs both the functions of journal and the ledger at the same time.
- Only cash transactions are recorded in the cash book
- All cash receipt are recorded on the debit side while cash payments are recorded on the credit side

FORMS OF CASH BOOK

A cash book can be in several forms

- Single column cash book – recording cash transactions only
- Double column cash book- for recording gain or loss on account of discount
- Triple column cash book – for recording cash and bank transactions involving gain or loss on account of discount.
- Petty cash book- for recording petty cash expenses.

SINGLE COLUMN CASH BOOK

This single column cash book has one column for amount on each side. All cash receipt are recorded on the left side (debit side) and all cash payment are recorded on the right side (credit side). It is strictly a cash account. There may be no need to open a cash account in the ledger except for control purposes. An example of the format of a single column cash account is shown below:

DATE	PARTICULARS	REF.	AMOUNT	DATE	PARTICULARS	REF.	AMOUNT

The debit side or the left side which is the receipt could consist of cash proceeds from sales , capital, trade receivables, loan received etc. while the right side or the payment side could consist of cash purchases, purchase of property plant and equipment., drawings, payment for trade payables, and other cash withdrawals.

DOUBLE COLUMN CASH BOOK

This cash book has two amount columns i.e. one for cash and the other for discount on each side. It is normal for business to allow discount when payment is received from customers promptly and before due date. It is equally so when payments is made in respect of trade payables accounts before the due dates All cash receipts and discount allowed will appear on the debit side and all cash payments and discount received will be shown on the credit side of the cash book. The format of a double column cash book is shown below:

DATE	PARTICULARS	REF	CASH	DISCOUNT ALLOWED	DATE	PARTICULARS	REF	CASH	DISCOUNT RECEIVED

3.7 DOUBLE ENTRYSYSTEM

This is a technique of recording transactions which recognizes <u>two</u> sides of each transactions i.e. DOUBLE ENTRY SYSTEM.

Double Entry System employs the concept of DEBIT (DR) and CREDIT (CR). The receiving of value requires a debit entry to be made in the account of the person receiving the value (if an individual) or of the thing receiving if an object (e.g. Land, Furniture, cash) or to nominal account in respect of which value is received (e.g. rent and rates, postages, salaries and wages).

A corresponding credit of an equal amount will at the same time be made in the account of the giver of the benefit.

Thus every transaction triggers off two entries, one a DEBIT and the other a CREDIT, of EQUAL AMOUNTS.

For Example:

If Uche purchased goods worth ₦20,000,000 from Adamu on credit it means that purchases accounts will be debited by ₦20,000,0000. While Adamu's account will be credited by ₦20,000,000. However, if Uche purchased goods worth ₦20,000,000 from Adamu on cash basis the double entry would be:-

Purchases account will be DEBITED Cash
account will be CREDITED
If Uche is recording the Entries.
However, if it is Adamu that is recording the transactions the credit transaction would be recorded as;
CREDIT SALES ACCOUNT with₦20,000,000.
DEBITUCHE ACCOUNT with ₦20,000,000. While
cash transaction would be
DEBIT CASH ACCOUNT CREDIT
SALES ACCOUNT

As a form of practice, students should endeavour to determine the double entry of the following transactions as a way of reviewing the principle of Double Entry.

a) Purchase of Plant and Equipment at a cost of ₦5,000,000 from XYZ & Co. Ltd. on credit.

b) Sold goods for cash at ₦800,000

c) Paid salaries and wages amounting to ₦1,500,000 in cash

3.7.1 The General Rule of Keeping to the Double Entry System

A part from the explanation given above, readers will find it helpful to make use of the following general rule.

All that is required is for readers to be able to remember simply that Assets and Expenses are DEBITED, while Liabilities and Income are CREDITED.

This rule can further be expanded as follows:

Debit Items which:	Credit Items which:
- Increase Assets	Increase Liabilities
- Increase Expenses	Increase Income/Capital
- Decrease Liabilities	Decrease Assets
- Decrease Income/Capital	Decrease Expenses

The Skill required in order to be able to apply this rule is the ability to analyse transactions and determine their impact whether they increase or decrease assets expenses, liabilities or income/ capital.

ILLUSTRATION 3.1

How would each of the following be reflected as a double entry:

i. N1,800,000 cash paid to supplier for amount outstanding

ii. Cash sales of N2,000,000 to customers

iii. Purchase of goods from supplier worth N2,500,000 issuing cheque

iv. Telephone bills of N5,000 was paid cash

SOLUTION TO ILLUSTRATION 3.1

i.	Decrease in Liability (trade payables)	DR N1800,000
	Decrease in Assets (cash)	CR N 1,8000,000
ii.	Increase in Income (sales)	CR N2,000,000
	Increase in Assets (cash)	DR N2,000,000
iii.	Increase in Expenses (purchases)	DR N2,500.000
	Decrease in Assets (bank) CR N2,500,000	
v.	Increase in Expense (telephone bill) DR N5,000	
	Decrease in Assets (cash) CR N5,000.	

3.8 LEDGER ACCOUNTS

A typical ledger account is referred to as T account.

A ledger accounts summarises all the individual transactions listed in the books of prime entry

The principal accounts are contained in a ledger which could be namely:

NOMINAL LEDGER OR GENERAL LEDGER

Entries are posted into this ledger accounts based on double entry principles. That is for every debit entry there should be a corresponding credit entry, a typical ledger accounts normally have two sides which represents the debit side and the credit side. Usually the right hand side represent the debit side of the ledger while the left hand side represent the credit

ILLUSTRATION OF A TYPICAL LEDGER ACCOUNTS

ACCOUNTS NAME

DEBIT SIDE		CREDIT SIDE	
	₦		₦

3.9 ACCOUNTING CYCLE

The preparation of financial statements (i.e. Statement of profit or loss, statement of changes in equity, statement of cash flows and statement of financial position) requires the understanding of all phases of the accounting cycle as an essential foundation.

The following outline summarises the basic phases of the accounting cycle.

a. Transactions should be recorded in books of prime entry and analysed

b. Transactions should be journalized where necessary

c. The journal entries should be posted to the ledger accounts.

d. The ledger accounts are balanced off.

e. Trial balance should be prepared from the ledger accounts. (Initial Trial Balance)

f. Data needed to adjust the Initial Trial bal. should be obtained

g. A works sheet inform of Extended Trial Balance is prepared (to obtain the final T/balance)

h. Financial Statements in form of statement of profit or loss, statement of financial position and other relevant financial statement is then prepared.

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3.1.0 TRIAL BALANCE

A Trial Balance is simply a listing, divided into Debit and Credit columns of the balances on all the accounts in a double entry system. The objective of a trial balance is to determine or prove the arithmetical accuracy of the double entries.

3.10.1 Objectives of Trial Balance

Under the double entry system, the total debits in the ledger must be equal to the total credits. The Trial Balance, as earlier mentioned, is the recognized method of ascertaining whether this is so or not.

The trial balance being a summary of the ledger is also used for preparing statement of profit or loss and statement of financial position (Final Accounts)

3.10.2 Types of Trial Balance

In practical terms there are two types of Trial Balance.

(i) Initial Trial Balance:- This is simply the list of Debit and Credit balances extracted from the General Ledger and it the most common type of Trial Balance.

(ii) Extended Trial Balance:- As the name implies, this is simply an extension of the Initial Trial Balance into Final Trial Balance and statement of Profit or Loss and Statement of Financial Position.

Extended Trial Balance is normally used by the practicing accountants when carrying out Audi t/Accounting assignments as it facilitates the preparation of Audited Statement of Profit or Loss Accounts and Statement of Financial Position.

A typical Extended Trial Balance normally contains the following columns.

S/N	Particulars	Initial Trial Balance		Accounting Adjustments		Final Trial Balance		Profit or Loss A/C		Statement of Financial position	
		DR	**CR**	**DR**	**CR**	**DR**	**CR**	**DR**	**CR**	**DR**	**CR**

3.10.3 Trial Balance As a Means of Detecting Errors

Differences can be encountered on extraction of a Trial Balance (i.e. Debit Side of a Trial Balance may not agree with Credit Side). The reason why totals of a Trial Balance may not agree in the first instance may be due to any of the following errors:-

(a) ERRORS THAT ARE REVEALED BY TRIAL BALANCE

(i) Errors in Extraction of Trial Balance:

- ❖ Debit balance in the General Ledger having been entered in the Credit column of the Trial Balance and vice versa.
- ❖ Balance omitted in extracting list of Debits and Credits

(ii) Errors in computation of the balances of the accounts

(iii) Errors of transposition of figures e.g.N18 orN81or N7.81 forN1.87.

(iv) Non-correspondence of debit and credit entries by omission of one side, both entries on one side or difference in amount between entries.

(b) ERRORSTHAT ARENOT REVEALED BYTRIAL BALANCE

These are errors that will not be revealed by the trial balance. That is errors that still exist despite the fact that both credit and debit sides of the trial balance agree with each other.

(i) **Errors of Omission:-** If there is omission of the same amount on both the debit and credit sides of the trial balance.

(ii) **Compensating Errors:-** If errors on one side of the Trial Balance have the same effect as errors on the other side. This will not prevent the agreement of the Trial Balance.

(iii) **Errors of Commission:-** When the correct amount is entered but in the wrong account; e.g.N1,000 was posted to the credit side of Kofi‟s Account instead of the credit side of Kojo‟s Account.

(iv) **Errors of Principle:-** When an item is entered in the wrong class of account e.g. if an expense is debited to an Asset Account.

(v) **Errors of Original Entry:-** When the errors are made in a book of prime entry and posted wrongly to the ledger.

(vi) **Errors of Complete Reversal of Entries:-** When the entries meant to be credited are debited and those meant to be debited are credited for the same transaction. This will not affect the trial balance.

3.10.4 Construction of Trial Balance from List of Balances

List of balances used for the construction of a trial balance is obtained from the closing balances in the general ledger, private ledger and nominal ledger. However, when students are asked to prepare a trial balance from a given list of balances, this means that items have to be sorted into Debits and Credits and the total of both Debit and Credit must agree. The procedure requires students to identify which items would fall into Debit or Credit side of the Trial balance.

The following rules will be found useful.

(i) Assets, Losses and Expenses are debit balances.

(ii) Liabilities, Equity, Gains and Profit are credit balances.

ILLUSTRATION 3.2

The following is the list of balances extracted from the ledger of CHINEDU & COMPANY, a sole Practitioner that is an Audit Firm as at 31 December, 2016.

	₦
Audit Fee Income	1,000,000
Consultancy Fee Income	2,000,000
Cash in Bank	1,650,000
Sundry Income	300,000
Capital	750,000
Administrative Expenses	600,000
Salaries & Allowances	800,000
Subscriptions	10,000
Retained profit Brought Forward	1,150,000
Professional Licence Renewal Fees	5,000
Rent	150,000
Stationery	250,000
Sundry Receivables	850,000
Transport & Travelling	75,000
Furniture & Fittings (Cost)	300,000
Motor Vehicle (Cost)	550,000
Newspapers & Journals	80,000
Rates	50,000
Provision for Depreciation– (M/V)	110,000
Provision for Depreciation (Furniture & Fittings)	60,000

Provision for Depreciation- (M/V) 110,000

Provision for Depreciation– (Furniture and Fittings) 60,000

You are required to prepare a Trial Balance of the firm as at 31December, 2016

SUGGESTED SOLUTIONSTO ILLUSTRARION 3.2

CHINEDUANDCOMPANY

TRIAL BALANCE AS AT 31 DECEMBER 2016

-classification	**DR**	**CR**
	₦	₦
Audit Fees Income - income		1,000,000
Consultancy Fee Income - income		2,000,000
Cash in Bank - Assets	1,650,000	
Sundry Income - income		300,000
Capital - equity		750,000
Administrative Expenses -Expense	600,000	
Salaries & Allowances - Expense	800,000	
Subscriptions -Expense	10,000	
Profit & Loss Account B/Fwd -Equity		1,150,000
Professional Licence Renewal Fees -Expense	5,000	
Rent - Expense	150,000	
Stationery - Expense	250,000	
Sundry receivables - Asset	850,000	
Transport &Travelling - Expense	75,000	
Furniture & Fittings (Cost) -Asset	300,000	
Motor vehicle (cost) - Asset	350,000	
Newspaper & Journals -Expense	80,000	
Rates -Expense	50,000	
Provision for Depreciation M/V - liability		110,000
Provision for Depreciation– Furniture & Fittings- liability		60,000
	5,370,000	5,370,000

3.11 ADJUSTING PROCESS

After the extraction of the initial Trial Balance from the ledger of the enterprise or firm, there is the need at the end of the accounting year to record some end of period adjustments in order to ensure that the ledger balances show a true and fair position (e.g. ensuring that revenue is matched with costs).

The adjusting entries are posted into the ledger through the use of Journals or by direct postings into the ledgers. The latter is not recommended.

These adjustments usually follow systematic and fairly consistent procedure. The adjustments are usually made in the following instances.

a) Where benefits have been received by the firm but have not been paid for at the end of the Accounting year or period (ACCRUED EXPENSES OR ACCRUALS)

b) Where payments had been made for certain services which had not yet been received or enjoyed by the end of the accounting period (PREPAID EXPENSES OR PREPAYMENTS).

c) Where the firm has recorded some income which has not yet been earned (RECEIPT INADVANCE OR UNEARNED INCOME).

d) Where the firm has rendered some services to other organizations that as at the close of the relevant accounting period have not yet been paid for such services (ACCRUED INCOME)

e) Losses which are anticipated or expected to have occurred by the exact amount of which is not yet known and may remain unknown for sometime in future (e.g. BAD & DOUBTFUL DEBTS, OBSOLETE OR DETERIORATING STOCK etc).

f) Anticipation for diminution in value of Assets as a result of wear and tear and other physical factors (e.g. PROVISION FOR DEPRECIATION AND AMORTISATION OF INVESTMENTS).

3.11.1 Accounting Procedure for the End of the Period Adjustments

ACCRUING FOR ACCRUED EXPENSES

These are benefit or services received during the accounting period but which are either not billed or not paid for in that period. An ACCRUED EXPENSE is therefore an expense which has been incurred but not billed or paid for. Accruals are usually noted in connection with Electricity costs, Salaries & Wages and cost of professional services such as Accountancy and Audit Fees, Legal Fees etc, where services are rendered and payment made at a later date.

ILUSTRATIONS 3.3

Asejere Enterprises Financial year ends on 31 December every year. The firm paid for electricity bill up to 31 July, 2016. The monthly electricity bill rate is N1,500. As the firm did not receive the next bill until 28 February, 2017, no payment was made for the period from August to December, 2006.

Required:

(a) Determine the amount of electricity expenses for the year ended 31December, 2016.

(b) The amount of electricity expenses that should be accrued for in the year 2016.

(c) The Journal entries to be raided to reflect the accruals.

(c) The postings of the entries into necessary ledger accounts

SUGGESTED SOLUTION TO ILLUSTRATION3.3

(i) ELECTRICITY EXPENSES FOR THE YEAR ENDED 31 DECEMBER, 2016

	₦
Payment made up to 31July 2006 (7 x1,500)	10,500
Amount due not yet paid for:	
1 August 31 December, 2006 (5 x1,500)	7,500
	18,000

(ii) AMOUNT ACCRUEDFOR IN YEAR 2016

This is the amount of services enjoyed but not yet paid for

	₦
1 August 2016 to 31December, 2016 (5 x1,500)	7,500

(iii) JOURNAL ENTRIES

	DR	CR
Electricity Expenses Account	**7,500**	
Accrued Electricity Expenses Account		**7,500**
(Being value of electricity consumed but		
Not yet paid for during the year)		

(d) ELECTRICITY EXPENSES ACCOUNT

	₦		₦
31July2016 Cash	10,500	31Dec. Profit & Loss A/c	18,000
31Dec. 2016 Accrued			
Electricity Expenses	7,500		
	18,000		18,000

ACCRUED ELECRTRICITY ACCOUNT

			₦
		31Dec. 2016 Elec. Exp.	7,500

PROFIT& LOSSACCOUNT

	₦		
31Dec. 2016 Elec. Exp.	18,000		

3.11.2 TUTORIAL NOTE

You will observe in our posting to various ledger accounts in question (c) above that the accrued amount of N7,500 increase the Electricity Expenses for the year to N18,000 whilst the credit to the accrual accounts establish the liability for the amount (i.e₦7,500).

PREPAYMENTS OR PRE-PAID EXPENSES

Prepayment is just the opposite of accruals. Simply put, prepayment is payment made in advance for services or benefit that has not been received or enjoyed.

Prepaid expenses a rise when at the end of an accounting period it is found that the benefit accruing from some of the operating expenses paid for during the period have not been exhausted. A portion of the benefit that is already paid for but not utilized is carried forward as an ASSET to be enjoyed in future.

Prepayment usually arise in connection with such expenses as Rent, Insurance, Telephone, where payments are sometimes made in advance for a period exceeding one year or for a period covering part of the current and future financial year of an entity.

ILLUSTRATION 3.4

WAZOBIA VENTURES a Sole Proprietor firm with financial year ending 31 December 2016 carried out the following transactions.

(i) The firm paid for office rent for three (3)years to the land lord at the rate of N25,000p.a. The rent is expected to cover years 2016, 2017 and 2018. The total amount paid was charged into rent account.

(ii) The firm also paid for insurance of its motor vehicle amounting to N144,000 on 2 July 2016. The Insurance premium covered the period 1 July 2016 to 30 June 2017.

Required:

(a) Make necessary adjustments to close the books of WAZOBIA VENTURES for the year ended 31 December 2016.

(b) Determine the amount that should be treated as Rent & Insurance Expenses for the year ended 31 December 2016.

SUGGESTED SOLUTION TO ILLUSTRATION 3.4

(a)(i) RENT EXPENSES

Total amount of Rent paid during the year ended 31December 2006 is

	₦25,000 x3	=	₦75,000
Rent due in the year 2016	(₦25,000 x1)	=	₦25,000
Rent paid in advance(for2017 &2018)			₦50,000

JOURNAL ENTRIES

	DR	CR
Pre-paid Rent Account	50,000	
Rent Account		50,000
Being rent paid in advance for years 2017&2018		

LEDGER POSTINGS

RENT ACCOUNT

	₦		₦
31Dec. 2016 Cash	75,000	Prepaid Rent	50,000
		Profit & Loss A/c	25,000
	75,000		75,000

PREPAIDRENT ACCOUNT

	₦		₦
1Dec. 2016 Rent Account	50,000	31st Dec. 2016 C/d	50,000
1Jan. 2017 B/d	50,000		

PROFIT& LOSSACCOUNT

	₦	
31Dec, 2016 Rent Account	25,000	

(a)(i) INSURANCE EXPENSES

Amount paid on 2 July, 2016	₦144,000
Amount due during the year (6/12x144,000)	(72,000)
(1 July2016 to 31 Dec.,2016)	
Amount paid in advance6/12 x144,000	72,000
(i.e. 1 Jan. 2017 to 30 June2017)	

JOURNAL ENTRIES

	DR	CR
Prepaid Insurance Account	72,000	
Insurance Account		72,000
Being prepaid insurance for the period		
1 Jan. 2017 to 30June 2017		

LEDGER POSTINGSINSURANCE ACCOUNT

	N		N
2July2016 cash	144,000		
		31Dec. 2016 Prepaid Insurance	72,000
		31Dec. 2016 Profit& Loss A/c	72,000
	144,000		144,000

PREPAID INSURANCE ACCOUNT

	₦		₦
31st Dec. 2016InsuranceA/c	72,000	31st Dec. 2016 C/d	72,000
1stJan. 2017	72,000		

PROFIT& LOSSACCOUNT

31st Dec. 2016InsuranceA/c	72,000	

(b) AMOUNT THAT SHOULD BE TREATED AS RENT AND INSURANCE EXPENSES FOR THE YEAR ENDED 31 DECEMBER 2016

RENTEXPENSES:-

This is the amount due in the year

Total amount paid for3years	=	₦75,000
Amount due for one year(1/3x75,000)	=	₦25,000

INSURANCE EXPENSES:-

Total amount paid for Insurance for the year is ₦144,000 covering the period from 1 July 2016 to 30 June 2017. Period relating to year 2006 is 1 July to 31 Dec. 2016 (i.e. 6 months).

TUTORIAL NOTES

- ❖ The amount calculated mathematically in part `b'' of the question agrees with amount Charged as expenses to the Profit & Loss Account for the year ended 31 December 2016.
- ❖ In financial year 2017 ₦25,000 would be charged as rent for the year out of the balance of N50,000 outstanding as at 31 December 2016 while the remaining ₦25,000 would be carried forward to year 2018.

Therefore in year 2017 the accounting entries would be.

	DR	CR
	₦	**₦**
Rent Account	25,000	
Prepaid Rent Account		25,000
(Being prepaid rent transferred to rent account during the year).		

This same process would be repeated in year 2018 to completely utilize the balance in the prepaid rent account.

(c) **ALLOWANCE FOR BAD & DOUBTFUL DEBTS**

In business, goods are sometimes sold on credit. Ownership and possession of the goods is transferred at the time of sale and the vendor is left with debit due from the customer. The vendor hopes that this will be paid for with in a reasonable time.

However, some customers may not pay up when due, nor the others, resulting in what is called a doubtful debt or may not pay up at all which may subsequently lead to what described as a "Bad debt".

The Prudence concept in accounting requires that debts which are "Doubtful" should be valued at Net realizable value. In view of this, deductions should be made from Receivables so that receivables are shown at the amount that is expected to be received. This deduction is known as the "**ALLOWANCE FOR DOUBTFUL DEBTS".**

At the end of each financial year RECEIVABLE ACCOUNTS should be reviewed and any debt that is definitely uncollectible or Bad should be WRITTEN OFF to Bad Debt Account. However, some debts may not be definitely bad, but may be doubtful. In such cases a provision for Doubtful Debt should be made.

In practice every organisation develops its own policy for categorizing debts. However, the following factors are generally considered

- ❖ Age of Debts
- ❖ Currency of Receivable Accounts
- ❖ Customers current financial standing

The accounting entries relating to Bad Debts would be approached from two points of view. When definitely Bad Debts they written off and when provisions are made for debts considered being doubtful of recovery.

(i) BAD DEBTS WRITTEN OFF

Where bad debts are written off, the accounting entries are as follows:

Debit: Bad Debt Account

Credit: Receivable Acct.

This will involve reducing the Receivable balance and treating the amount written off as an expense in the Profit or Loss account.

(ii) ALLOWANCE FOR DOUBTFUL DEBTS

The accounting entries in respect of Doubtful Debts are:

Debit: Doubtful Debts Expenses Account

Credit: Allowance for Doubtful Debts

Unlike the entries for writing off bad debts, this entry only sets up a precautionary amount which could be subsequently used to offset any specific debt that becomes bad. Therefore it is an additional precautionary measure designed to protect firms against loss of Trade Receivables.

However, the ultimate implication of this provision are deduction of the total Receivable figures in order to determine the value of net good debt that is to be carried forward to the new accounting year. Thus, while Doubtful Debts Expense account is debited to Profit or Loss Account the credit balance in the provision account is deducted from trade Receivables (in statement of financial position).

ILLUSTRATION 3.5

The Trial Balance extract of JOHNBULL as at 31 March 2016 includes the following:

	₦
Receivables	431,920,000
Bad debts	6,380,000
Allowance for Doubtful Debts as at 31 March 2016	15,219,000

At the yearend JohnBull decided that:

(i) A further N1,520,000 of the Trade receivable are Bad.

(ii) A general allowance of1% was required against the remainder of the debts.

Required:

Show Journal Entries and Ledger entries to reflect these decisions.

SUGGESTED SOLUTION TO ILLUSTRATION 3.5

		DR	CR
		N"000	**N"000**
(i)	Bad Debts Account	1, 520	
	Trade receivable Accounts		1,520
	Being additional Bad Debt written off		
	During the year		
(ii)	Doubtful Debts Account	4,304	
	Allowance for Bad Debt		4,304
	Being1% allowance made for doubtful debts		

BADDEBT ACCOUNT

	₦`000		₦`000
31/3/2016	6,380	Profit&Loss Account	7,900
31/3/2016	1,520		
	7,900		7,900

DOUBTFUL DEBTSACCOUNT

	N‟000		N‟000
31/3/2016 Provision for Bad Debt	4,304	Profit&Loss A/c	4,304

PROVISIONFOR BAD &DOUBTFUL DEBTS

	N‟000		N‟000
Balance C/d	19,523	31/3/2016	15,219
		Doubtful Debt A/c	4,304
	19,523		19,523

3.12 EXTENDED TRIAL BALANCE

Extended Trial Balance can be drawn with the use of a "WORKSHEET‟. A Work Sheet Is an analysis sheet in columnar form in corporating on the same page, the following:

a) Trial Balance (Initial)

b)Adjustment

c) Adjusted Trial Balance OR Final Trial Balance

d)Income Statement (Statement of profit or loss)

e) Statement of Financial Position.

Therefore, a worksheet can be said to be an extended draft of the final accounts indicating all the entries which have been made in order to obtain the financial statements.

3.12.1 TYPICAL WORKSHEET OR EXTENDED TRIAL BALANCE

Opening Trial Balance		Adjustments Balance		Final Trial Statement		Statement of profit or loss		Statement of financial position	
DR	CR	DR	CR	DR	CR	DR	CR	DR	CR

3.12.2 PROCEDURE FOR SETTING UP A WORKSHEET OR EXTENDED TRIAL BALANCE

Step1: Extract the opening Trial Balance from the ledger of the firm (these are unadjusted balances).

Step2: With each adjustment necessary, enter in the appropriate column (Debtor Credit entries) against the relevant account affected. This is necessary in order to adjust the balances extracted from the ledger in Step 1 above.

Step3: Extend for each account the amount in the "Trial Balance‟ (Opening) and adjustment column into the ADJUSTED TRIAL BALANCE OR FINAL TRIAL BALANCE COLUMN adding together credit or debit balances as the case may be.

Total both the Debit and Credit Sub Columns of the ADJUSTED TRIAL BALANCE OR FINAL TRIAL BALANCE and ensure that both sides agree to confirm arithmetical accuracy of the adjustments and the Double Entry principle.

Step4: Extend the adjusted trial balance column into the income statement column for items that relate to trading activities, operational income, expenses, into the appropriate Debit and Credit Columns.

Excess of credit over Debit usually indicates Net Profit and the reverse indicates net loss.

The difference should be inserted into the column that is short and extended to the opposite side in STATEMENT OF FINANCIAL POSITION COLUMN. The two sides of income statement column will thus agree.

Step5: All balances which are still outstanding in the Adjusted Trial Balance or final Trial Balance will therefore be extended in to the STATEMENT OF FINANCIAL POSITION COLUMN.

The two sub columns in the statement of financial position will agree if all the preceding steps have been correctly followed.

The two sub columns in the statement of financial position will agree if all the preceding steps have been correctly followed.

This would thus complete the preparation of the work sheet or the Extended Trial Balance.

3.13 FINAL ACCOUNTS OF SOLE TRADERS

The preparation of the final accounts of a sole trader requires knowledge of all the accounting principles that have been discussed so far in this chapter. In addition readers need to have knowledge of the following as this is peculiar to this type of business of organization (Sole Trader)

3.13.1 EQUITY OF SOLE TRADERS

The Equity of a sole Trader in made up of the capital contributed either in the form of cash or in kind at the beginning plus profit earned in the business which has not been with drawn.

	N
Capital	X
Add Retained Profit	X
Less Drawings	(XX)
Equity	(X)

3.13.2 DRAWINGS

A Sole Trader may decide to earn a regular salary or alternatively he may decide to make periodic drawings i.e. withdrawals in anticipation of profit.

The basic differences between salaries and drawings are as follows:

a) Salaries is a charge against profit while drawings is a withdrawal of income.

b) Salaries reduce the amount of net income while drawings do not affect Net Income but only reduce equity.

c) Salaries may be constant and regular from month to month. Drawings are usually un regulated and they tend to fluctuate from month to month depending on the proprietor‘s personal commitments.

d) Salaries are subject to tax at source e.g. Pay As You Earn (PAYE) or Personal Income Tax while drawings are not subjected to tax at source.

e) A common feature of drawings is that it may sometimes be taken in kind when the owner takes out some goods from the firm for personal use. Salaries on the other hand is taken in cash.

The Accounting Entries required for reflecting drawings in the Books of the Sole Trade areas follows:

	DR	**CR**
Drawings	X	
Cash (if cash is withdrawn)		X
Purchases (if goods are withdrawn)		X

3.13.3 TAXATION AND SOLE TRADER ACCOUNTS

A business firm that is a separate entity in law normally pays tax on its income as any natural person does. This position is however different in the case of a Sole Trader since the firm is not a legal entity. It is therefore not liable to tax. The income of the Firm is not subjected to Tax since the firm is not a legal entity. It is therefore not liable to tax. The Sole Trader is required to declare such income in his yearly tax return and where practicable he should attach the firm "s financial statements in support of his declaration.

In view of the above, no specific provision is made for Tax in a Sole Trader Account unlike Limited Liability Company Account.

However, where the owner of the business withdraws cash from the firm for the purpose of paying Income Tax Liability, such payment is treated as Drawings from the business.

3.13.4 STATEMENT OF PROFIT OR LOSS/ STATEMENT OF COMPREHENSIVE INCOME

Where a Sole Trader engages in trading activities the firm would be required to prepare Statement of Profit or Loss account

Statement of profit or loss account: This is an account where Revenue is compared with cost of sales with the aim of determining the GROSS PROFIT OR LOSS of the firm. Gross Profit results where there is excess of Revenue over cost of sales and Gross Loss where the reverse is the case.

After obtaining the Gross Profit or Loss in the the account other operating expenses and income will be considered before arriving at profit or loss for the year.

Statement of changes in equity: the profit for the year is transferred to this statement. The statement is expected to reconcile the carrying amount of equity at the beginning with the carrying amount at the end of the year. Which must agree with the balance of equity shown in the statement of financial position.

3.13.5 STATEMENT OF FINANCIALPOSITION

A Statement of financial position is a position statement showing the state of affairs of the firm at any point in time.

Technically, it is better described as a classified summary of the debit and credit balances existing in the ledger or Trial Balance after statement of profit or loss has been constructed.

A typical Statement of Financial Position of a sole trader is made up of the following:

a) ASSETS

b) CAPITAL and

c) LIABILITIES

(a) ASSETS

Assets are classified under two headings:-

(i) **NON-CURRENT ASSET POSSESS THE FOLLOWING FEATURES**:

(i) They have a lifespan which is longer than one year

(ii) They are used for the purpose of business

(iii) They are not bought for the purpose of resale.

Examples of Non-current assets include motor vehicles, land & buildings, furniture and fittings, plant and machinery. They are generally referred to as property plant and equipment (PPE).

(ii) **CURRENT ASSETS**

These are assets which are held for resale at profit or items that have lifespan that is short. Examples of current assets include inventory, trade receivables, cash at bank, and cash in hand.

TUTORIAL NOTE

Readers should note that an item which is a non-current Asset in one firm may be a current asset in another firm. For example where a firm is a motor vehicle dealer and therefore purchases motor vehicles as inventory, motor vehicles purchased for resale will be treated as Current Assets but if the vehicle is purchased for use of business and not for resale the motor vehicle will be treated as non current ASSET.

(b) **LIABILITIES:-** This is an obligation which a business is legally bound to pay. It is a claim by an outsider on the asset of the business. Liabilities can be classified into:

CURRENT LIABILITIES: These are short term liabilities i.e. liabilities due for payment with in a period of one year. Examples of current liabilities are trade payables, accruals etc.

NON-CURRENTLIABILITIES: These are liabilities payable in future i.e. liabilities payable within a period which is longer than one year. Examples of non-current liabilities are loan notes, debentures.

(c) **CAPITAL**

This is the amount injected by the owner of the business to finance the operations of the firm. It is used for acquiring the non- assets and current assets of the firm

.**ILLUSTRATION 3.6**

YAHO Ventures is a trading organisation. The trial balance of the firm for the year ended 31 December 2016 is as follows:-

	DR ₦	CR ₦
Inventory(01/01/2016)	61,290	
Revenue		489,600
Purchases	320,560	
Salaries & Wages	99,925	
Motor Vehicles	129,375	
Furniture & Fittings	55,620	
Motor Vehicle Expenses	17,190	
Insurance	2,025	
Office Expenses	5,580	
Rates	7,775	
Lighting Expenses	4,295	
Trade receivables & Payables	100,800	44,800
Cash &Bank	12,465	
Drawings	31,050	
Capital		313,550
	847,950	847,950

You are also provided with the following additional information.

(i) Inventories as at 31 December2016 ₦76,230.

(ii) Rates outstanding as at 31 December, 2016 amounts to₦1,555.

(iii) Insurance expenses include ₦315 meant for the next period up to 31 March, 2017

(iv) Accrued expenses on lighting amounts to₦835.

(v) Depreciation provisions are as follows: Motor Vehicles 20%
Furniture & Fittings 10%

(vi) 2½%should be provided on Receivables for doubtful debts.

You are required to:

(a) Make necessary adjusting entries in the ledger

(b) Extract the Adjusted Trial Balance or Final Trial Balance

(c) Present Statement of Profit& Loss and Statement of Financial Position as at 31 December, 20116 using T account and vertical format.

SUGGESTED SOLUTION TO ILLUSTRARION 3.6

a JOURNAL ENTRIES

	DR	**DR**
RATES	₦	₦
Accrued Rates Account	1,555	
Being rates outstanding as at 31/12/2016		1,555
(ii)	DR	CR
INSURANCE	₦	₦
Prepaid Insurance	315	
Insurance Account		315
Being Insurance paid in Advance up to 31 March,2017		
(iii)		
LIGHTING EXPENSES		

Accrued Lighting Expenses		835
Being Accrued Expenses on lighting for the year		
(iv)		
DEPRECIATION PROVISION		
(a) Motor Vehicles		
Depreciation Account	25,875	
Provision for Depreciation on motor vehicle		25,875
Being provision for Depreciation on Motor vehicles at the rate of 20% on cost.		
(b) Furniture & Fittings		
Depreciation Account	5,562	
Provision for Depreciation Account		5,562
Being provision for Depreciation on Furniture & Fittings at the rate 10%on cost		
(v)		
DOUBTFUL DEBT PROVISION		
Bad & Doubtful Debts A/c	2,520	
Allowance for Bad & Doubtful Debts		2,520
Being 2½% Allowance for Bad & Doubtful Debts on Receivables		
Lighting Expenses	835	

(b) **EXTRACTS OF FINAL TRIAL BALANCE**

	Opening Trial Balance		Adjustments		Final Trial Balance	
	DR	**CR**	**DR**	**CR**	**DR**	**CR**
Inventories	61,290				61,290	
Revenue		489,600				489,600
Purchases	320,560				320,560	
Salaries &Wages	99,925				99,925	
Motor Vehicles	129,375				129,375	
Furniture & Fittings	55,620				55,620	
Motor Veh. Exp.	17,190				17,190	
Insurance	2,025			(ii)315	1,710	
Office Expenses	5,580				5,580	
Rates	7,775		(i) 1,555		9,330	
Lighting Expenses	4,295		(ii) 835		5,130	
Receivables	100,800				100,800	
Payables		44,800				44,800
Cash &Bank	12,465				12,465	
Drawings	31,050				31,050	
Capital		313,550				313,550
Accrued Rates				(i)1,555		1,555
Prepaid Insurance			(ii)315		315	
Accrued Light Exp.				(iii)835		835
Depreciation Account						
M/V			(iva)25,875		25,875	
Provision for						
Depreciation MV				(iva)		
Depreciation A/c				25,875		25,875
Furniture & Fittings				(iv(b)5,562		5,562
Provision for			5562		5,562	
Depreciation F&F						

Bad & Doubtful Debt			25201	(v)2,520		
Allow. For Bad & Doubt Debt			2520	(v)2,520		2,520
	847,950	847,950	36,662	36,662	884,297	884,297

TUTORIAL NOTES

- The Opening Trial Balance Columns contain figures obtained directly from the Trial Balance in the question.
- The Adjustment Columns contain figures obtained from the Adjusting Entries (i.e .the Journal & Ledger Entries).
- Final Trial Balance or Adjusted Trial Balance Columns contain the Net Sum of the figures in Opening Trial Balance Columns and the Adjustment Columns while taking note of debit and credit entries.
- The figures in the final Trial Balance or Adjusted Trial Balance will now be used to prepare the financial statements.

(ai) **STATEMENT OF PROFIT OR LOSS**

	₦	₦		₦
Opening inventories	61,290		Revenue	489,600
Purchases	320,560			
	381,850			
Less:				
Closing inventories (31/12/2006)	(76,230)			
Cost of sales		305,620		
Gross Profit C/d		183,980		
		489,600		489,600

EXPENSES	₦		₦
		Gross Profit B/d	183,980
Salaries &Wages	99,925		
Motor vehicles Exp.	17,190		
Insurance	1,710		
Office Exp.	5,580		
Rates	9,330		
Lighting Expenses	5,130		
Depreciation Exp (M/V)	25,875		
Depreciation Exp (Furniture & Fitting)	5,562		
Bad & Doubtful Debt	2,520		
Net Profit for the year	11,158		
	183,980		183,980

USING HORIZONTAL FORMAT YAHO VENTURES STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2016

ASSETS

	₦	₦		₦	₦	₦
CAPITAL			Non-current Assets			
Capital A/c		313,550	Motor Vehicle (Cost)		129,375	
			Less:			
Add: Net Profit		11,158	Prov. Deptn.		(25,875)	
		324,708				
Less: Drawings		(31,050)	Net Book Value			103,500
		293,618	Fur.& Fitt. (Cost)		55,620	
			Less:			

CURRENT LIABILITIES	Prov. For Deptn. (5,562)				
		Net Book Value			50,058
Payables	44,800				153,558
Accrued Rate	1,555	**CURRENT ASSETS:**			
Accrued Lighting Exp.	835	Inventories		76,230	
		Receivables	100,800		
		Less Provision for Doubtful Debt	(2,520)	98,280	
		Prepaid Insurance		315	
		Cash &Bank		12,465	
			187,290		
	340,848				340,848

(aii) **PRESENTATION OF THE FINAL ACCOUNTS IN VERTICAL FORMAT**

YAHO VENTURES

INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2016

	₦	₦
Revenue		489,600
Opening inventory	61,290	
Add: Purchases	320,560	
Cost of goods available for sale	381,850	
Less		
Closing inventories	(76,230)	
Cost of sales		(305,620)
Gross Profit		183,980
Less: Expenses		
Salaries &Wages	99,925	
Motor vehicle Expenses	17,190	
Insurance	1,710	
Office Expenses	5,580	
Rates	9,330	

Lighting Expenses	5,130	
Depreciation Exp. (Motor Vehicle)	25,875	
Depreciation Exp. (Furniture & Fittings)	5,562	
Bad & Doubtful Debt	2,520	172,822
Profit for the year		11,158

YAHO VENTURES

STATEMENT OF FINANCIAL POSITION AS AT31 DECEMBER 2016

Non-current Asset	₦	₦	₦
Motor vehicle at cost			
Less		129,375	
Provision for Depreciation (25,875)			
Carrying Value			103,500
Furniture & Fittings at cost			
		(55,62	
0) Less			
Provision for Depreciation		5,562	50,058
			153,558
CURRENT ASSETS			
Inventories		76,230	
Receivables	100,800		
Less			
Allowance for Doubtful Debt	(2,520)	98,280	
Prepaid Insurance		315	
Cash & Bank		12,465	
		187,290	
CURRENT LIABILITIES			
Payables	44,800		
Accrued Rates Expenses	1,555		
Accrued Lighting Exp.	835	(47,190)	
			140,100
			293,658
CAPITAL			313,550
Capital Account			11,158
Add: Net Profit			324,708
			31,050
Less: Drawings			293,658

3.14 Chapter Summary

This chapter dealt with accounting process and documentations that leads to preparation of Financial statement, with particular emphasis on how to make necessary Adjusting entries for prepayment, accruals, provision for depreciation and allowance for Bad & Doubtful Debts.

It also deals with the preparation of Work Sheet or Extended Trial Balance as a means of preparing financial statement of Sole Proprietorship .

3. 15 REVISION QUESTIONS

3.15.1 MULTIPLE CHOICE AND SHORT ANSWER QUESTIONS

1. Accrued Salaries of ₦18,000 due to employees for December 31 2015 was omitted and not included in the financial statements prepared for the year ended 31 December 2015.

   Which of the following will be correct?

   A. Assets of the company would be over-stated byN18,000

   B. Liabilities of the company would be over-stated byN18,000

   C. Net profit of the company would be over-stated byN18,000

   D. Liabilities of the company would be under-stated byN18,000

   E. Capital of the company would be over-stated byN18,000

2. A sole proprietor paid his personal Income Tax by withdrawing cash for the payment from his business. The double entry posting in ledger with respect to the above transaction is:

   A. DR Taxation A/C; CR cash A/C

   B. DR Personal Tax A/C; CR Bank A/C

   C. DR Drawings A/C; CR Cash A/C

   D. DR Cash A/C; CR Drawing A/C

   E. CR Cash A/C; DR Taxation A/C

3. The Agreement of a trial balance will not disclose **ONE** of the following fundamental errors in the accounting books.

   A. Error in computation of balances
   B. Transposition of figures
   C. Errors of wrong posting in the debit and credit columns
   D. Errors of principle
   E. Double entry errors

4. The opening inventory of a firm at the beginning of the financial year isN30,0000 and at the end of the financial year it isN20,000 while the sales and purchases are N350,000 and N250,000 respectively.

   What is the Gross Profit or Loss?

   A. ₦90,000 Loss
   B. ₦50,000 Profit
   C. ₦10,000 Loss
   D. ₦20,000 Profit
   E. ₦90,000 Profit

5. The Depreciation methods that ensure that the depreciation charged against income reduces as the year of usage of the non- current assets increases is known as?

   A. Straight Line Method
   B Revaluation Method
   C. Sinking Fund Method
   D. Reducing Balance Method
   E. Depletion method

6. Error of Commission is ONE of the errors that will not be disclosed with Agreement of a Trial Balance. State **TWO** other errors of this nature.

7. What is an Extended Trial Balance?

8. State the various phases of an Accounting Cycle.

9. State **FOUR of** the various methods of providing for Depreciation on Property plant and equipment.

10. State TWO acceptable methods of presenting the financial statement of a Sole trader.

3.15.2 SOLUTION TO MULTIPLE CHOICE AND SHORT ANSWER QUESTIONS

1. D
2. C
3. D
4. E
5. D
6. (i) Error of principle,
   (ii) Compensating error.
7. An Extended Trial Balance is an extension of the initial trial balance. It incorporates details of accounting adjustments made to the initial trial balance, in order to arrive at the final trial balance required for the preparation of the financial statement.
8. (i) Transaction should be analysed
   (ii) Transaction should be journalized.
   (iii) Journal entries should be posted into the ledger.
   (iv) Trial balance prepared from the ledger accounts
   (vi) Data needed to adjust the accounts should be obtained.
   (vii) Work sheet in form of extended trial balance is prepared.
   (viii) Financial Statements are generated.
9. (i) Straight line method
   (ii) Reducing balance method or declining balance method
   (iii) Sum-of-the-years digit method.
   (iv) Production unit method
10. (i) Horizontal method or T accounts
    (ii) Vertical method.

CHAPTER FOUR
VALUE ADDED TAX (VAT)

CHAPTER CONTENTS

a. Introduction
b. Accounting for VAT
c. Incidence of VAT

4.0 OBJECTIVES

At the end of this chapter, readers should be able to:

a) Explain the meaning of Value Added Tax;
b) Should be able to differentiate between input VAT and output VAT;
c) Explain the administration and coverage of VAT;
d) To prepare accounts for VAT; and
e) Know the effect of VAT on sales revenue and purchases.

4.1 INTRODUCTION

Value Added Tax (VAT) is a tax that is imposed on spending, that is, on the consumption of goods and services, on which it is imposed. The burden is borne by the final consumer of the product or service. The VAT rate since it was introduced in 1994 in Nigeria had been and is still 5%. VAT was introduced to replace sales tax, because VAT covers a wider range of goods and services and easier to collect. For instance VAT covers both local and imported goods and service whereas sales tax covers only locally produced goods and services.

a. Administration of VAT

VAT is administered by the Federal Government on behalf of the Federal Inland Revenue Services (FIRS) in Nigeria by business organizations which are registered with them for that purpose. They are called VAT Registered persons.

b. **Exemption from VAT**

Basic food items, pharmaceutical and medical products, baby products, books and educational materials and agricultural equipment are exempted from VAT.

c. **Zero Rated VAT**

Zero rated goods comprise exported goods. VAT is not imposed on zero-rated goods. However, import tax suffered is recoverable by a VATable person.

d. **Computation of VAT**

The VAT rate is applied on the invoiced price of the goods purchased or sold, then, the invoice price, the VAT computed and the total of the cash due from the customer or to the supplier are stated in the invoice.

The invoice must contain the following details:

iv. The names, address and VAT registration number of the VATable person
ii. The taxpayer‟s identification number (TIN)
iii. The customer‟s name and address
iv. A description of the goods and services supplied
v. Quantity of goods or the extent of service
vi. The charge made exclusive of VAT
vii. The rate and amount of VAT charged
viii. The rate of cash discount offered
ix. The total amount payable to the customer inclusive of VAT

4.2 Accounting for VAT

Every registered person is required to maintain adequate records to facilitate accurate calculation of input VAT and output VAT.

The registered person is required among others, to maintain up-to-date cash book, purchases and sales day books. It is also necessary to maintain VAT account in the ledger to which recoverable input tax is debited and to which output tax are credited.

Treatment of VAT in Final Accounts

The following are the methods prescribed for treatment of VAT in the final accounts. Manufacturing account purchases would be stated exclusive of VAT with the exemption of purchases of inputs for the manufacturer of exempted goods.

a. Income Statement

i. Sales would be state exclusive of VAT

ii. Cost of services such as electricity and repairs enjoyed/received as a final consumer would be shown inclusive of VAT

b. Statements of Financial Position

i. Trade receivables and payables will be stated inclusive of VAT

ii. The balance due from the VAT directorate would be carried under current liabilities

Accounting Entries

1. Purchase of goods/services in respect of which input tax is recoverable:
   Dr. Purchases/expenses a/c – with the cost exclusive of VAT
   Dr. VAT a/c – with the VAT included in purchase price
   Cr. Trade payables/cash book – with the cost inclusive of VAT

2. Purchase of goods/services in respect of which input tax is irrecoverable:
   Dr. Purchases/expenses a/c with the cost exclusive of VAT
   Cr. Trade payables/cash book

3. Sales of VATable goods/services
   Dr. Trade receivables/cash book – sales value inclusive of VAT
   Cr. Sales/income a/c – sales value exclusive of VAT
   Cr. VAT a/c – output VAT

4. Bad debt relief
   Dr. VAT account with the VAT included in debt already written
   Cr. Bad debt a/c off as bad

5. Payment of balance of VAT due to VAT directorate

   Dr. VAT a/c } with the amount paid
   Cr. Cash book

6. Receipt of balance of VAT due from VAT directorate

   Dr. Cash book } with the amount received
   Cr. VAT a/c

4.3 Incidence of VAT

The burden of VAT is on the final consumer of the product or service on which it is imposed.

Illustration 4.1

Soya purchase some goods at a cost of ₦150,000 from Rosco. Soya sold the goods to Mary for ₦180,000 and Mary again sold it to Dauda for ₦210,000. Dauda was the final consumer and the price quoted did not include VAT rate is 5%.

You are required to compute the incidence of VAT.

VATABLE person	**Sale price**	**Output VAT**	**Input VAT**	**VAT paid to Govt.**
	Ex-VAT	**₦"000**	**₦"000**	**₦"000**
Rosco	150,000	7,500	-	7,500
Soya	180,000	9,000	7,500	1,500
Mary	210,000	10,500	9,000	1,500
	Total	27,500	16,500	10,500

The final total VAT paid to the government amounted to ₦10,500 is equal to the VAT paid by Dauda to Mary. This proves that the incidence of VAT is indeed on the final consumer.

Illustration 4.2

The following information relates to the transaction of Willy Joe Enterprise for the year ended 30 September 2010.

i. Sales invoice, ₦25 million, excluding VAT
ii. Cash sales, ₦5 million, including VAT
iii. Purchase invoice, ₦19 million, excluding VAT
iv. Purchase invoice for goods that are zero rated - ₦5.8 million including VAT
v. Motor vehicle expenses ₦550,000 excluding VAT
vi. Purchases invoices for inputs for production of exempted goods, ₦11 million
vii. Sales invoices for zero rated goods, ₦16.5 million

Required

a. Record the transaction in the relevant books
b. how much VAT is due to (or from) the VAT authority at 30 September 2010

Solution to Illustration 4.2

Sales Account

	₦'000		**₦'000**
Income statement	46,262	Trade receivables	25,000
		Cash $\frac{100}{105}$ x ₦5m	4,762
	---------	Trade receivables	16,500
	46,262		46,262

Purchases Account

	₦'000		**₦'000**
Trade Payables	19,000	Income Statement	36,024
Trade Payables ($\frac{100}{105}$ x ₦5.8m)	5,524		
Trade Payables ($\frac{100}{100}$ x ₦11m)	11,500		--------
	36,024		36,024

Motor Expenses Account

	₦"000		₦"000
Cash Book $\frac{105}{100}$ x 550,000	558	Income Statement	588

VAT Account

	₦"000		₦"000
Trade Payables 5% x ₦19m	950	Trade receivables	1,250
Trade Payables 5/105 x ₦5.8m	276	Cash sales 5/105 x ₦5	238
Bal c/f	262		--------
	1,488		1,488
		Bal b/f	262

Cash Account

	₦"000		₦"000
Sales	4,762	Motor expenses	588
VAT	238	Bal. c/f	4,412
	5,000		5,000

Trade receivable

	₦"000		₦"000
Sales	25,000	Bal. c/d	42,750
VAT	1,250		
Sales	16,500		--------
	42,750		42,750

Trade Payables

	₦"000		₦"000
Bal. c/d	36,750	Purchases	19,000
		VAT	950
		Purchases	5,524
		VAT	276
	---------	Purchases	11,000
	36,750		36,750

b. The amount of VAT payable to government is ₦262,000, that is, the credit balance in the VAT account.

4.4 CHAPTER SUMMARY

Explanation and meaning of Value Added Tax was dealt with. Also, the Accounting treatments of VAT in the Ledgers were treated with particular emphasis on the double entry bookkeeping system.

4.5 Multiple Choice Questions and Short Answers Questions

1. The incidence of VAT is borne by
   - a. The wholesaler
   - b. The supplier of inputs
   - c. The producer of goods
   - d. Final consumer of goods
   - e. Consumer of raw materials

2. Which of the following statements are true for the sale of zero-rated goods under VAT?
   - i. The price exclusive of VAT is credited to sales account
   - ii. The price inclusive of VAT is debited the receivables account
   - iii. The price inclusive VAT is credited to sales account
   - iv. The price exclusive of VAT is debited to receivable

a. I and II
b. I and III
c. I and IV
d. II and III
e. II and IV

3. The final amount of VAT due to the relevant tax authority is a ………….balance in ……………. account
   a. Debit - Cash
   b. Credit – Cash
   c. Debit - VAT
   d. Credit - VAT
   e. Credit – Sales

4. Cost of services such as electricity and repairs received as a final consumer would be shown ………………. of VAT in income statement.

5. Revenue should be shown in the income statement ……………… VAT

6. Sales of VATable goods and services are ……………… to receivable account inclusive of VAT

4.6 SOLUTIONS TO MULTIPLE QUESTIONS AND SHORT ANSWERS

1. D
2. C
3. D
4. Inclusive
5. Exclusive
6. Debited

CHAPTER FIVE

ACCOUNTING STANDARDS REGULATIONS AND GUIDELINES

CHAPTER CONTENTS

a. Introduction

b. Regulations governing accounting and financial reporting

c. International financial reporting standards IFRS/IASB

d. Presentation of Financial statement IAS 1

e. Accounting Policies, changes in accounting estimates and error .IAS8

f. Inventory IAS2

g. statement of cash flows IAS7

h. Property, Plant and Equipment IAS16

i. IFRS for SME(s)

5.0 OBJECTIVES

At the end of the study of this chapter, readers should be able to;

(a) Explain the need for regulation in Accounting and financial reporting.

(b) State the importance of IFRS and International Accounting Standard Board (IASB)

(c) Prepare financial statements in accordance with the requirements of accounting standards

(d) Know the provisions and simple applications of specific accounting standards IAS 1,2,7,8 and16

(e) Know the requirements and simple applications of IFRS for SME(S)

5.1 INTRODUCTION

Due to advancement in information technology, the world has become a global village. In order to be able to prepare financial statements that could be acceptable internationally, countries around the world are adopting the International Financial Reporting Standards (IFRS). IASB is responsible for issuance of the standards.

5.2 THE REGULATIONS GOVERNING ACCOUNTING AND FINANCIAL REPORTING

Users rely on the financial statements to take investment decisions hence their presentations need to be regulated to ensure credibility and fairness.

For example Banks lend money to companies on the basis of their financial statement also in the event of merger of companies financial statements also form the basis for valuation. While profit reported by a company also forms the basis for charging income tax. In view of these there must be appropriate laws and regulations that would guide against creative accounting as much as possible. Accounting standards provides guidance on common transactions thus ensuring uniformity in the preparation and presentation of financial statements.

The preparation and presentation of financial statement is based on large number of concepts, principle and detailed rules. Some of these are contained in law and others are in financial reporting standard. Many of the most fundamental concepts are not contained in any law or regulations or standards, but are simply accepted accounting principles and conventions

All the concepts principles conventions, laws, rules and regulations that are used to prepare and present financial statements are known as Generally Accepted Accounting Principles or GAAP. Generally Accepted Accounting Principles vary from country to country because their legal and regulatory systems are not the same.

However many countries all over the world have now accepted a uniform accounting standards which is known as International Financial Reporting Standards IFRS OR IAS. It is this standards and use of appropriate local GAAP that are applied when preparing and presenting financial statements.

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5.3 INTERNATIONAL FINANCIAL REPORTING STANDARDS /IASB

5.3.1 INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB)

The IASB is the board charged with responsibility for developing international accounting standards. The board is made up of 14 members that are highly skilled in accounting and each member contribute to the issue and publications of the following documents issued by the board:

- an exposure draft of the standard
- a revised International Accounting Standards (IAS)
- an International Financial Reporting Standards(IFRS)
- a final Interpretation of the IFRS interpretation committee(IFRSIC)

The IASB has full responsibility for all technical matters and they have issued IASB – CONCEPTUAL FRAME WORK which set out the concepts that underlie the preparation and presentation of financial statements for users. The details of this has been dealt with in other chapter.

5.3.2 INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

The term IFRS is normally used to refer to the whole body of the standards (i.e IAS and IFRS). The IFRS is made up of the following:

	Published by IASC(up to 2001)	Published by IASB (from 2001)
Accounting Standards	IASs	IFRSs
Interpretations	SICs	IFRSICs

5.3.3 ROLES OF ACCOUNTING STANDARD SETTING BODIES

The responsibility for setting Accounting Standards at global level rests with the International Accounting Standards Board (IASB). There are also National Accounting Standards setting bodies in different countries like the Financial Reporting Council of Nigeria (FRCON), which now ensure compliance of entities' financial statement with the International Financial Reporting Standards (IFRS).

5.3.4 <u>International Accounting Standards Board (IASB)</u>

The fore bearer of the IASB is the International Accounting Standards Committee (IASC) which was established in 1973 to develop international accounting standards with the aim of harmonising accounting procedures worldwide. The first set of International Accounting

Standards (IASs) was issued in 1975. The IASC was supported by another body called the Standing Interpretation Committee (SIC) which issued interpretations of rules in standards when practitioners have divergent opinion in treatment of items.

Following the change in the constitution of IASC in 2001, two new bodies were established to replace the IASC and its supporting body, the SIC. The bodies were International Accounting Standards Board (IASB) and the International Financial Reporting Interpretations Committee (IFRSIC). The IASB adopted all the standards (IASs) and Interpretations by SIC that were extant at the time, but pronounced that all new standards written from that time were to be called "International Financial Reporting Standards" (IFRS) and that all interpretations by IFRSIC are to be known as International Financial Reporting Interpretations Committee pronouncements or IFRICS.

Thus, when IFRS is mentioned, it means:

(i) All Accounting Standards (IASs) and Interpretations by SIC published by the IASC up to 2001 (those not yet replaced) and;

(ii) All Accounting Standards (IFRSs) and Interpretations (IFRICs) published by the IABS from 2001.

Since 2001, the IASB has published the following standards using the new nomenclature IFRS:

- IFRS 1 - First time adoption of IFRS
- IFRS 2 - Share-based payment
- IFRS 3 - Business combination
- IFRS 4 - Insurance contracts
- IFRS 5 - Non-current assets held for sale and discontinued operations
- IFRS 6 - Exploration for and evaluation of mineral resources
- IFRS 7 - Financial Instruments: Disclosure
- IFRS 8 - Operating segments
- IFRS 9 - Financial instruments
- IFRS 10 - Consolidated Financial Statements
- IFRS 11 - Joint arrangements
- IFRS 12 - Disclosure of interests in other entities
- IFRS 13 - Fair value measurement
- IFRS 14 - Regulatory deferral accounts
- IFRS 15 - Revenue from contracts with customers
- IFRS 16 - Leases
- IFRS for SMEs

So far, many IASs and SIC pronouncements have been repealed or amended by IASB since its establishment in 2001.

However, at this level of the ATSWA examination, candidates are required to study properly the following accounting standards:

(i) IAS 1 - Presentation of Financial Statements
(ii) IAS 2 - Inventories
(iii) IAS 7 - Cash flow statements
(iv) IAS 8 - Accounting policies, changes in Accounting Estimates and Errors
(v) IAS 16 - Property, Plant and Equipment

Candidates should also pay attention to IAS 11 on construction contracts, IAS 17 and IAS 41 on Lease on Agriculture to enable them appreciate and understand the preparations of simple lease accounts, construction contracts accounts and Farmers account examinable in the Principles and Practice of Financial Accounting paper of this examination.

5.3.5 Financial Reporting Council of Nigeria

The Financial Reporting Council of Nigeria (FRCON) is the national accounting standards setting body in Nigeria, it replaced the Nigerian Accounting Standards Board (NASB) in June 2011.

The FRCON was established by the Financial Reporting Council of Nigeria Act, No. 6, 2011 which repealed the Nigerian Accounting Standard Boards Act No. 22 of 2003. The FRCON is an agency (parastal) of the federal government which is directly supervised by the Federal Ministry of Industry, Trade and Investment.

According to the Act, the main objects of FRCON are:

(a) To protect investors and other stakeholders interest;

(b) To give guidance on issues relating to financial reporting and corporate governance to professional, institutional and regulatory bodies in Nigeria;

(c) To ensure good corporate governance practices in the public and private sectors of the Nigerian economy;

(d) To ensure accuracy and reliability of financial reports and corporate disclosures, pursuant to various laws and regulations currently in existence in Nigeria;

(e) To harmonise activities of relevant professional and regulatory bodies as relating to corporate governance and financial reporting;

(f) To promote the highest standards among auditors and other professionals engaged in the financial reporting process;

(g) To enhance the credibility of financial reporting; and

(h) To improve the quality of accountancy and audit services, actuarial, valuation and corporate governance standards.

For effective operations, the FRCON is structured into seven directorates which are:

(i) Directorate of Accounting Standards – Private sectors
(ii) Directorate of Accounting Standards – public sectors
(iii) Directorate of Auditing Practice Standards
(iv) Directorate of Actuarial standards
(v) Directorate of Valuation Standards
(vi) Directorate of Inspection & Monitoring
(vii) Directorate of Corporate Governance

In order to achieve its purpose of developing and publishing accounting standards in Nigeria, the FRCON Directorate of Accounting Standards is assigned the following responsibilities:

(a) To develop accounting and financial reporting standards to be observed in the preparation of financial statements in the private sector and small and medium scale enterprises;

(b) To promote the general acceptance and adoption of such standards by preparers and users of financial statements;

(c) To promote compliance with the accounting standards developed or reviewed by the Directorate;

(d) To review from time to time the accounting standards developed in line with prevalent social, economic and political environment;

(e) To promote compliance with accounting and financial reporting standards adopted by the Council;

(f) To promote in the public interest, accounting and financial reporting standards to be observed in the preparation of financial statements of public interest entities; and

(g) To perform such other duties which in the opinion of the Board are necessary or expedient to ensure the efficient performance of the function of the Council.

It should be noted that international accounting standards cannot be used or applied in any country without the involvement and approval of the national regulators in that country. Every country has its peculiar approval process or road map which must be followed before IFRS can be applied in such country. In Nigeria, the FRCON constructed a plan, called a road map, which was used in driving the convergence of Nigerian GAAP to IFRS from January 2012 to 2014. Effectively Nigeria adopted IFRS from January 1, 2012.

The standards that are examinable at this accounting technician level are as follows:

- IAS 1- Presentation of Financial Statements
- IAS2- Inventories
- IAS 7-Statement of Cashflows
- IAS8- Accounting policies ,Changes in Accounting Estimates and Errors

However, candidates should also appreciate that references could made to some IAS which are relevant to some topics under Accounting for special business transactions and events in section six of the ATSWA syllabus.

Few examples include IAS 11 on construction contracts, IAS 17 on lease, and IAS 41 on Agriculture (farmers accounts).

5.4 CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

5.4.1 INTRODUCTION

A conceptual framework is a set of concepts and principles which underpin the preparation of financial statements. It is a framework upon which IFRSs are based and so determined the information contained in financial statements. The International Accounting Standards Committee (IASC), the fore bearer of the IASB issued a document in 1989 called "FRAMEWORK FOR THE PREPARATION AND PRESENTATION OF FINANCIAL STATEMENT". This "Framework" which is not an accounting standard in itself was adopted by the International Accounting Standards Board (IASB) when it came on board in 2001.

The framework comprised of the following sections:

a) The objective of financial statements

b) Underlying assumptions of financial statements

c) The qualitative characteristics that determines the usefulness of information in financial statements

d) The definition of the elements of financial statements

e) The recognition of the elements of financial statements

f) The measurements of the elements of financial statements

g) Concepts of capital and capital maintenance

The IASB in collaboration with the Financial Accounting Standards Board (FASB), the national standard setters of the United State if American, is currently working to develop a conceptual framework common to each Generally Accepted Accounting Principles (GAAP). The new conceptual framework is being developed on a chapter by chapter basis.

For now, only two chapters have been finalised and released to replace the sections (a) and (c) in the 1989 "Framework" described above. To ensure effective replacement of the two sections and probably avoid possible confusion, the IASB issued a new document called "THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING" which is made up of the following chapters:

i)	Chapter 1	-	The objective of general purpose financial reporting
ii)	Chapter 2	-	The reporting entity (to be added – yet to be finalised)
iii)	Chapter 3	-	Quantitative characteristics of useful financial information
iv)	Chapter 4	-	The Framework (1989): That is the remaining sections of the 1989 document not yet replaced, comprising:

(a) Underlying assumption of financial statements
(b) The elements of financial statements
(c) Recognition of the elements of financial statements
(d) Measurement of the elements of financial statements
(e) Concepts of capital and capital maintenance

However, the changes between the "Framework" 1989 and the "Concept framework" are not fundamental in terms of their impact on IFRS.

Purpose of Conceptual Framework

The need for a formal conceptual framework is recognised by most preparers and users of financial statements as it will enhance uniformity in the treatment and presentation of financial issues and reports. The conceptual framework outlines the concepts which underlie the preparation and presentation of financial statements especially for external users. Thus, the purposes of conceptual framework include:

i. it assist preparers of financial statements in applying IFRSs and in dealing with matters not yet covered by any IFRS.

ii. It assists users when interpreting the information contained in IFRS complaint financial statements.

iii. It assists auditors informing an opinion on whether or not the financial statements adequately complied with IFRSs.

iv. It assists national standard setting bodies when developing their national or local standards.

v. It assists the IASB when developing new IFRSs and in the review of existing ones.

vi. It assists the IASB by providing a basis for the reduction of the number of alternative accounting treatments permitted by IFRSs and therefore promoting harmonisation of regulations and procedure for presentation of financial statements.

vii. It provides information about the approach to the formation of IFRSs to parties interested in the work of the IASB.

It should be noted that where there is a conflict between the conceptual framework and an IFRS, the requirements of the IFRS will prevail over those of the Conceptual Framework in all cases.

5.4.2 Underlying Assumptions of Financial Statements

The Conceptual Framework identified two important assumptions for financial statements and thee are (1) the going concern concept and (3) the accrued basis/concept.

Going Concern Concept

The going concern concept is an assumption in accounting which states that an entity will continue to operate for the foreseeable future and his neither the intention not need to go into liquidation or reduce materially the scale of its operations. The concepts assume that, when preparing the financial statements, the entity will continue to operate in approximately the same manner for at least the next twelve (12) months. The going concern assumption is particularly relevant for the valuation of assets.

Where the going concern assumption is not followed in preparing a financial statements, the fact must be disclosed and in addition the following information:

i) The basis used in preparing the following statements
ii) The reasons why the entity is not treated as a going concern

Accrual Basis/Concept

The accrual basis is an assumption in accounting which states that in preparing the statement of profit or loss and other comprehensive income, that the revenue earned must be matched against expenditure (costs) incurred in earning it. The basis advocates that entities should prepare their financial statements on the basis which transactions are recorded in them, that is as revenue or expenses are earned or incurred in the relevant accounting period co due to their ncerned and not in the period when the cash is paid or received. The assumption is also referred to as the matching concept.

5.4.3 Users and their Information needs

The main aim of accounting is to provide information which is useful for persons within and outside the organisation users outside the organisation include investors (existing potential), creditors and lenders, government, research scholars and consumers while users within the organisation are management and employees. The information needs of these users differs substantially due to their different roles and interest in the organisation.

Many shareholders and potential investors, lenders and other creditors do not have statutory, power to compel reporting entities to provide information directly to them and thus must rely on general purpose financial statements for much of their financial information need. These group constitute the primary users for whom general purpose financial statements are produced. They should however, not that:

- General purpose financial statements cannot provide all the information needed by them and so will need to consider relevant information from other sources.

- General purpose financial statements only provide information to help users estimate the value of a reporting entity as its absolute value is not revealed in the statements.

- The aim of IFRS complaint financial statement is to provide information that will meet the needs of the maximum number of primary isers and not the need of an individual primary user.

Other categories of users, other than the primary users earlier mentioned, such as government regulators, management, employees and members of the public may also find general purpose financial statements useful but these statements are not primarily directed to them.

An entity's management and employees union are interested in financial information but they do not need to rely on general purpose financial statements.

5.4.4 Objective of general purpose financial statements

The objective of general purpose financial statements, is to provide information about the financial position, performance and cash flows of an entity the is useful to existing shareholders and potential inventors, lenders and other creditors in making economic decisions. These groups of users make decisions to provide resources to the entity through buying, selling or holding equity and debt instruments and providing or settling loans and other credits. For the purpose of making these decisions, the users need information to help in assessing the prospects for future cash inflows of the entity and thus will need information about the resources of the entity, the claims against such resources and the efficiency and effectiveness of the entity's management in using the entity's resources.

The general purpose financial statements provide information about:

i) The entity's financial position. That is information about economic resources and the claims against them.

ii) Changes in the entity's financial position which could be as a result of:
- financial performance; and /or
- other events or transactions such as share issue

iii) The entity's inflows and outflows of cash and cash equivalents.

The information about the nature and amounts of an entity's economics resources and claims will be helpful to users in assessing the reporting entity's liquidity and solvency and its additional financial needs. It will also help to identify the strength and weaknesses of the reporting entity.

Also the information about the rankings and payment requirements of the entity's existing claims is helpful to users in predicting how future cash flows will be equitably distributed among the reporting entity's claims beneficiaries.

The information about changes in the entity's financial position as a result of performance is revealed through accrual accounting which depicts the effects of transactions, other events and circumstances on the entity's economics resources and claims in the period in which those effects occur and not when the cash is paid or received. Such information is important because it provides a more useful basis of assessing the reporting entity's past and future performance rather them relying or cash receipts and payments for the period.
The information about reporting entity's financial performance assists users to understand the return generated from its economic resources and to appreciate the capacity of the entity to generate net cash inflows through its operations rather than borrowing from outside lenders.

Financial performance is also revealed through management of cash flow. The information about a reporting entity's cash flow for a period helps users to understanding how the entity obtains and spends cash, its borrowing and repayment of debts and settlement of cash dividends and other cash distribution to investors. Also, information on an entity's cash flows helps users in their evaluation of the operations, investing and financing activities of the entity for the reporting period.

5.4.5 QUALITATIVE CHARACTISTICS OF USEFUL FINANCIAL INFORMATION

The chapter 3 of the IASB conceptual framework dealt on the qualitative characteristics of useful financial information. The conceptual framework identified two classes of qualitative characteristics as "Fundamental" and "Enhancing" characteristics

a) Fundamental qualitative characteristics – are strong attributes or qualities which make financial information useful. They consist of:

  i) Relevant; and
  ii) Faithfull representation

b) Enhancing qualitative characteristics – are qualitative characteristics which enhance the usefulness of information that is relevant and faithfully represented. They consist of:

  i) Comparability
  ii) Verifiability
  iii) Timeliness; and
  iv) Understandability

Thus, for financial information to be useful, it has to be relevant and faithfully represent what it ought to represent. All enhancing qualitative characteristics together cannot make financial information useful if that information is irrelevant or not faithfully represented.

Relevant
The conceptual framework stipulates that the information provided in financial statements must be relevant to the decision-making needs of users. Information has the quality of relevance when it is capable of influencing the economic decisions of users by helping them evaluate past, present or future events or confirming or correcting, their past evaluations. Thus, relevant information must predictive and confirmatory values.

Materiality effects the relevant of financial information
Financial information is material if its omission or misstatement could influence decisions that users make on the basis of the financial statements on the reporting entity. Materiality is an entity – specific aspect of relevance based on the nature, size or both of the items to which the information relates in the context of each individual entity's financial statements.

Faithful representation
Financial statements represent a depiction in words and numbers of the economic resources, claims against the reporting entity and the effects of transactions and other events and conditions that change those resources and claims. That is, they represent economic phenomena in depicted in words and numbers.

For financial information to be useful, it must not only represent relevant phenomena but must also faithfully represent the phenomena that it purports to represent. A perfectly faithful representation would have the following attributes;

a) Compete – all the information necessary for users to fully understand and make decision on the phenomena are included.

b) Neutral – the preparation of the financial statements is without bias in the selection and presentation of financial information,

c) errors free – there should be no errors or omissions in the description of the phenomena and in the process of production of the financial statements.

Enhancing qualitative characteristics

Comparability

This qualitative characteristic helps users to indentify and understand the similarities in and the difference among items disclosed in financial statements. The financial information of a reporting entity will be more useful if it can be compared with similar information about other entities in the same industry and or with similar information about the same entity but for different periods or years.

Consistency enhances comparability as it encourages the use f the same methods treatments for similar items over a period of time.

Verifiability

This qualitative characteristic assists users to confirm that financial information fatefully represents the phenomena it purports to represent. Verifiability here implies that different knowledgeable and independent parties could confirm on their own that a particular item, transaction or event is faithfully represented. The verifiability or a financial information may require more than a sign point estimate.

Timeliness

The usefulness of financial information is enhanced if it is timely. That is , making information available to decision-makers in time is capable of influencing their decisions.

Understandability

The information contained in financial statement should be classified and presented in a clear and concised manner so as to make it comprehensible by users who have reasonable knowledge of business and economic activities. However, no relevant information should be omitted on the grounds that it may be very difficult for users to understand.

5.4.6 COMPONENTS OF FINANCIAL STATEMENTS

Before the adoption of IFRS in Nigeria in 2012, the preparation of entities financial statements were guided by the companies and Allied Matters Act 2004 and existing local and international accounting standards. The component of financial statements under that jurisdiction were:

1. Profit and loss account
2. Balance sheet
3. Cash flow statement

4. Value Added Statement
5. Statement of accounting policies
6. Notes to the accounts

With the adoption of IFRS as the financial reporting standards in Nigeria, entities financial statements are now required to comply with the provisions and requirements of applicable IFRSs. A complete set of IFRS financial statements consists of the following components:

a) Statement of profit or loss and other comprehensive income
b) Statement of changes in equity
c) Statement of financial position'
d) Statement of cash flows
e) Notes to the financial statements, comprising a summary of significant accounting policies and other explanatory information

a. <u>Statement of profit or loss and other comprehensive income</u>

This statement presents the financial performance on an entity for a reporting period. It is the IFRS statement which replace the old trading, profit and loss account. In this statement items of income and expenses are classified and present either by nature or by function (cost of sales method) and will require disclosure either in the face of the statement or the notes.

The statement sometimes is prepared in two spate sections as:

i) Statement of profit or loss
ii) Statement of other comprehensive income

b. <u>Statement of changes in equity</u>

This statement is introduced as a new component of an entity's financial statements under IFRS. It replaced the appropriation section of the trading, profit and loss accounts.

The statement shows an entity's profit or loss for a reporting period, items of income and expenses recognised in other comprehensive income for the period, the effects of changes in accounting policies and corrections of errors recognised in the period, and the amounts of investments by, and dividends and other distributions to, entity investors during the period. In summary, it shows the movement in the equity section of the statement of financial position.

c. <u>Statement of financial position</u>

The statement of financial position is the IFRS name for balance sheet. It shows the assets, liabilities and equity of an entity at the end of a reporting period or year. The assets and liabilities are sub-classified into non-current and current in the statement.

d. Statement of cash flows

The statement of cash flow gives information about the changes in cash and cash equivalents of an entity for a reporting period. In the statement, cash flows and outflows are classified according to activities which are operating, investing and financial activities. The statement attempts to reconcile the opening balance of cash and cash equivalents to its closing balance. Cash equivalents are short-term highly liquid investments held to meet short-term cash commitments rather than for investments or other purposes.

e. Notes to the financial statements

Accounting statements permits information to presented either in the face of financial statements or in the notes. The notes may contain significant accounting policies and other explanatory information. Financial statements are better understood when taken together with the accompanying notes.

5.4.7 THE ELEMENTS OF FINANCIAL STATEMENTS

The elements of financial statements are contained in the statement of financial position and statement of profit or loss and other comprehensive income. The elements are: assets, liabilities and equity for reporting of statement of financial position and income and expenses for statement of profit or loss. These elements are defined in the conceptual framework as follows:

i. Assets

An asset is a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity. Something valuable which a business entity owns and can use is an asset. Many assets have a physical form, but this is not an essential requirement for the existence of an asset.

Assets are classified into two main categories as non-current and current assets. Examples of non-current assets include: factories, office building, plant and machinery, motor van, office furniture, computer equipments etc. Current assets includes, inventories, trade and other receivables, cash and bank balances, prepayment etc.

ii. Liabilities

A liability is a present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Like assets, liabilities are classified into non-current and current liabilities. Non-current liabilities are those obligation due for settlement within period which is more than twelve (12) months after the reporting year end. Example include long term loans/borrowing, loan notes etc. Current liabilities on the other hand are liabilities die or expected to be settled within an entity's normal operating cycle or within twelve (12) months after the reporting year end. Examples of current liabilities include: trade and other payables, bank overdrafts, accrued expenses, etc. Some liabilities which can be measured only with a substantial amount of estimation are often referred to as provisions.

iii. Equity

Equity is the residual interest in an entity after the value of all its recognised liabilities has been deducted from the value of all its recognised assets. It represents the net assets of the entity value at the carrying amount.

Entity should be sub-classified to show its components in the statement of financial position of corporate entities, such as equity share capital, share premium, retained earnings and other reserves.

iv. Income

Financial performance is measured as the relationship of the income and expenses of an entity during a reporting year, the final result being a profit or loss. Income is defined to include both revenue and gains.

- Revenue is income which arising in the course of the ordinary activities of the entity. It includes sales revenue, royalties income, rental income, fee income, interest and dividend income from investments.

- Gains are other items which can be defined as income but are not revenue. Examples include gains on the disposal or on revaluation of non-current assets.

v. Expenses

The definition of expenses includes losses and other business expenses arising in the normal course of an entity's ordinary activities.

- Expenses are outflows of economic resources of an entity arising in the normal course of business activities, such as the cost of sales, wages, rent, electricity, office expenses, depreciation of non-current assets and other operating expenses.
- Losses are other items which meet the definition of expenses but may or may not arise in the normal course of business activities. Examples include trading losses, loss on the disposal of a non-current assets, losses arising from damages of assets due to fire and flooring disaster.

Recognition of Elements of Financial Statements

For IFRS, recognition is the process of incorporating in the financial statement an item that meets the definition of an asset, liability, income or expense and satisfies the underlisted criteria:

1) It must be probable that the future economic benefits associated with the item will flow to or from the entity, and

2) The item has a cost or value that can be measured reliably.

Probability of future economic benefit flowing in or out

The concept of probability mentioned in the first criterion relates to the degree of certainty or uncertainty that the future economic benefits associated with the item will flow into or out of the entity. The assessments of the degree of certainty or uncertainty should be based on the evidence available at the time the financial statements are prepared. Assessments should made individually for each of the items.

This trade receivables with high degree of certainty of collections would be treated as assets in the statement of financial position while those with high degree of failure of collection should be expended as bad debts in the statement of profit or loss and other comprehensive income.

Reliability of measurement

The reliability criterion requires that only items whose cost or value can be measured with reliability should be recognised in the financial statements. Sometime, the cost or value of an item may not be known and therefore, will need to be estimated. The use of reasonable estimates is an essential part of preparing financial statements and provided the estimates are reasonably, they are appropriate for recognising items in the financial statements. When it is not possible to make a reasonable estimate, the item should not be recognised either in the state of financial position or in the statement of profit or loss and other comprehensive income. Items which fail recognition at certain point in time, may be recognised in future period when the cost or value can be reasonably measured

Recognition of assets

An assets is recognised in the statement of financial position of an entity when there is high degree of certainty that the future economic benefits will flow to the entity and the asset has a cost or value which can be reliably measured. An asset is not recognised in the statement of financial position when expenditure has been incurred but it is unlikely that any future economic benefits will flow to the entity. In this case, the item should be recognised as an expense in statement of profit or loss.

Recognition of liabilities

An entity should recognise a liability in the statement of financial position when is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount of the obligation can be reliably measured.

Recognition of Income

Income is recognised in the statement of profit or loss of an entity when an increase in future economic benefit is as a result of an increase in an asset or a reduction in a liability and this can be reliably measured.

Recognition of Expenses

An entity should recognise expenses in the statement of profit or loss when a decrease in future economic benefit is as a result of a decrease in an asset or an increase in a liability which can be reliably measured.

Measurement of Element of financial Statements

Measurement as described in IFRS is the process of determining the monetary amounts at which an entity measures assets, liabilities, income and expense in its financial statements. The IASB conceptual Framework described several measurement bases used for measuring elements of financial statements. The bases are:

a) **Historical cost –** entities measure assets at the amount of cash paid or at the fair value of the consideration given to buy them while liabilities are measured at the amount of cash that will be paid or spent to satisfy the liability.

b) **Current cost or current value –** here assets and liabilities are measured at their current values. That is, assets are measured at the amount that would be paid to purchase the same or a similar asset at current time. Also liabilities are measured at the amount which would be required to settle such liabilities at the current time.

c) **Realisable value –** this measurement basis is very relevant when an entity is no longer or going concern or is undergoing a liquidation. An entity's assets are measured at the amount that could be obtained by selling them in the open market. Liabilities are measured at the amount that would be required to settle them at the prevailing time.

d) **Present value –** this basis of measures reckons that the assets of an entity can be measured at the discounted value of the future net cash inflows which the asset is expected to generate.

   Also the entity's liabilities may be measured at the discounted present value of the expected cash out flows that will be made to settle those liabilities.

   The most commonly used basis of measurement in practice is the historical basis

5.5 PRESENTATION OF FINANCIAL STATEMENTS – IAS1

IAS1 on presentation of financial statement should be applied when entities are preparing Financial statements for publication. In view of this the standard prescribe provisions that should be followed when preparing **published general purpose financial statements**

The objectives general purpose financial statements is to provide information on financial position , financial performance, cash flows to the various users of the financial statements when taking business decisions.

5.5.1 A COMPLETE SET OF GENERAL PURPOSE FINANCIAL STATEMENTS

A complete set of general purpose financial statement according to IAS1 is made up of the Following:

- Statement of Financial Position at the end of the period
- Statement of Profit or loss and Other Comprehensive Income for the period
- Statement of Changes in Equity for the period
- Statement of Cashflows
- Notes to the Financial statements including summary of Significant Accounting Policies and Other explanatory notes
- A Statement Financial Position at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively.

5.5.2 ADDITIONAL REQUIREMENTS OF IAS1 ON PRESENTATION OF FINANCIAL STATEMENTS

a. IAS1 require fair presentation of the financial position, financial performance and cash flow of an entity.

b. If an entity has complied with IFRS in the presentation of its financial statement, it should state it explicitly.

c. The going concern basis must not be used when management is of the view that the entity would cease trade.

d. The accrual basis must be applied in preparing financial statement except in the case of statement of cash flows.

e. Each class of item that is material must be presented separately

f. An entity is required to present comparative information in respect of previous periods

g. When there are changes in the presentation and classification of items in the financial statements, the entity shall reclassify comparative amount.

h. An entity is required to present a complete set of financial statements at least once a year.

i. The line items that are required to be presented on the face of the statements of financial position are assets, liabilities, equity, and asset and liabilities held for sale.

j. Each component of the financial statements must be properly identified with the following information displayed prominently

- Name of the reporting entity
- Date of the end of the reporting entity or the period covered by the financial statements(whichever is appropriate)
- Currency of figures reported e.g whether in naira or cedis
- Level of rounding up of the figures used in the financial statements e.g N,000 or N'm.

5.5.3 CONTENTS OF FINANCIAL STATEMENTS

IAS 1, prescribed the structure and contents of the following financial statements:

(i) STATEMENT OF FINANCIAL POSITION

CURRENT AND NON- CURRENT ASSETS

Current and **non –current assets** should normally be disclosed separately on the face of statement of financial position. Current assets are deemed to be assets that can easily be realised within 12 months from the year end of the financial statement,

IAS 1 further states that an asset should be classified as **current** if it satisfies the following criteria:

- The asset is held for trading purpose
- The entity expects to realise the assets, or sell the assets or consume it in the normal operating business cycle
- The entity expects to realise the assets within 12 months after the reporting period
- It is cash or cash equivalent unless the assets is restricted from being used for at least 12 months after the reporting date of the entity.

  Examples of current assets include cash and bank balances, trade receivables, inventories etc

Non- current assets include property plant and equipment which would be discussed under IAS 16. They are assets with the following characteristics:

- They are expected to be used for more than one year or 12 months period

- They are held for use in the production or supply of goods or services or for administrative purpose.

Examples of non- current assets include, plant and machinery, motor vehicles investments, intangible assets etc

CURRENT AND NON- CURRENT LIABILITIES

IAS 1 also states that **current and non- current liabilities** should be disclosed separately on the face of the statements of financial position

An item should be classified as current liability if it satisfy any of the following criteria:

- It is due to be settled within 12 months after the end of the reporting period of an entity.
- The entity expects to settle the liability in its normal business operating cycle.
- The liability is held primarily for the purpose of trading. This means that all trade payables are current liabilities even when they settled after more than 12 months.
- The entity does not have the un conditional right to defer settlement of the liability for at least 12 months after the end of the reporting period.

  Example of current liabilities include trade and other payables, short term borrowings (overdraft), current portion of long term borrowings, accruals etc.

All other liabilities that do not meet the above criteria should be classified as **non- current liabilities.**

Examples of non- current liabilities are long - term borrowings, loan notes, etc.

5.5.4 INFORMATION TO BE PRESENTED ON THE FACE OF STATEMENT OF FINANCIAL POSITION.

IAS 1 states the items which as a minimum must disclosed as a line item on face of the statement of financial position. This includes the following:

ASSETS:

Property plant and equipment

Investment property

Intangible assets

Long term financial assets

Other investments

Biological assets

Inventories

Trade other receivables

Cash and cash equivalents

Total assets classified as held for sale

LIABILITIES

Trade and other payables

Provisions

Financial liabilities

Current income tax

Deferred tax liabilities

Long term liabilities

EQUITY

Issued share capital

Retained earnings attributable to owners

Tutorials:

Information disclosed on the face of the statement of financial position could be sub divided to give more details and better sub classification. While other information that can be disclosed on the face of the statement should be shown in note forms to the financial statements

Find below a typical statement of financial position presented in accordance with the requirements of IAS 1.

STATEMENT OF FINANCIAL POSITION FORMAT

ASSETS	N	N
NON-CURRENT ASSETS		

Property plant and equipment	X	
Intangible assets	X	
Financial assets	X	
Investment	X	
Total non- current assets		X
CURRENT ASSETS		
Inventories	X	
Trade receivables	X	
Other current assets	X	
Cash and cash equivalent	X	
Total current assets		X
Total assets		XX
EQUITY AND LIABILITIES		
EQUITY		
Share capital	X	
Share premium	X	
Retained earnings	X	
Other components of equity	X	
Total equity		X
NON-CURRENT LIABILITIES		
Loan notes	X	
Long-term borrowings	X	
Deferred tax	X	
Total non- current liabilities		X
CURRENT LIABILITIES		
Trade and other payables	X	
Short term borrowings	X	
Current portion of long term borrowings	X	

Current tax payable	X	
Provisions	X	
Total current liabilities		X
TOTAL EQUITY AND LIABILITIES		XX

5.5.5 PRESENTATION OF STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

IAS 1 Stipulates that statement of profit or loss can be prepared using the following methods:

- Single statement method : that is where the profit or loss part in merged with the other comprehensive income section
- Two statement method: where the profit or loss part is prepared as a separate part and the other comprehensive income part is also prepared separately

The statement of profit or loss part is made up of income and expenses which would finally result in a profit or loss for the year while other comprehensive income part list other gains or losses that arisen in the period.

CONTENT OF STATEMENT OF PROFIT OR LOSS

The statement of profit normally begin with revenue and ends with profit or loss for the year.

The expenses are deducted from revenue and other income to arrive at the profit or loss for the year. IAS1, however permits the classification of expenses in the statement of profit or loss using **two** methods:

1. **Analysis of expenses by functions**: when expenses are analysed according to their function, the functions are usually
    - Cost of sales
    - Distribution cost
    - Administrative expenses
    - Other expenses

These methods of classifying expenses is more common with most entities

2. **Analysis of expenses by their nature:** when expenses are analysed according to their nature the categories of expenses will vary according to the nature of the business.
   for example for manufacturing business expenses will be classified as follows:
   - Raw materials and consumables used
   - Staff/ personnel cost
   - Depreciation
   - Other expenses

INFORMATION TO BE PRESENTED ON THE FACE OF THE STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

IAS 1 Require as a minimum that the following information should be disclosed on the face of the statement of profit or loss and other comprehensive income during each financial period:

- Revenue
- Finance cost (e.g interest expense)
- Tax expense
- Profit or loss for the year
- Other comprehensive income
- Total comprehensive income.

Readers should note that additional line times can still be disclosed on the statement provided that they are relevant to better understanding of the entities financial performance

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FORMAT (using single format and analysis of expenses by functions)

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

	₦	₦
Revenue	X	
Cost of sales	(X)	
Gross profit		X
Other income		X
Administrative expenses	(X)	
Distribution cost	(X)	
Finance costs	(X)	
Other expenses	(X)	
Total expense		(X)
Profit before tax		X
Taxation		(X)
Profit for the year		XX
OTHER COMPREHENSIVE INCOME		
Gains on property revaluation		X
Other comprehensive income		XX
TOTAL COMPREHENSIVE INCOME		XXX

5.5.6 STATEMENT OF CHANGES IN EQUITY

IAS 1 states that a set of financial statement must include statement of changes in equity.

A statement of changes in equity shows the components of equity at the beginning of the period, changes during the period, and its amount at the end of the period.

CONTENTS OF STATEMENTS OF CHANGES IN EQUITY

Share capital

Share premium

Retained earnings

Revaluation reserve

Prior period adjustments.

Other gains and losses.

For each of the items above the statements of changes in equity would show changes resulting from profit or loss, each item of other comprehensive income (gains or losses) and transaction with owners of business

Transaction with owners of business may arise through the following:

- Issue of new share capital
- Payment of dividend

STATEMENT OF CHANGES IN EQUITY FORMAT

	SHARE CAPITAL	REVALUATION RESERVE	RETAINED EARNINGS	TOTAL
	N	N	N	N
Opening balance	X	X	X	XX
Profit or loss			X	XX
Other comprehensive income		X		XX
TRANSACTION WITH OWNER OF BUSINESS:				
Increase in share capital	X			XX
Payment of dividend			(X)	(XX)
CLOSING BAL,	X	X	X	XXX

5.5.7 NOTES TO THE FINANCIAL STATEMENTS

IAS 1. Also indicates that information that cannot be disclosed on the face of the financial statements should be disclosed by way of notes to the financial statements. Similarly information that are on the face of the financial statement of the financial statement should be further explained in the notes.

The following explanatory notes should be disclosed in the notes to the financial statements:

- Basis of preparation of the financial statements
- Significant accounting policies adopted in the preparation and presentation of the financial statements
- Information required to be disclosed specifically by IFRS/ IAS e.g that the financial statement complied with provision of IFRS.
- Supporting/ detailed information for significant items presented on the face of each of the financial statements
- Key measurement assumptions made in preparing and presentation of the financial statements.
- Dividend proposed or declared during the year.
- Other disclosures such as description of the nature of the entity's operations and its principal activities, the domicile and legal for of the entity.

ILLUSTRATION 5.1

BUTAINE Nig limited extracted the following trial balance from its ledgers as 31 December 2016.

	DEBIT(N'000)	CREDIT(N'000)
Cash at bank	25,000	
Inventory at 1jan. 2016	600,000	
Administrative expenses	551,500	
Distribution cost	162,500	
Non-current assets at cost:		
Building	2,500,000	
Plant and equipment	350,000	
Motor vehicles	80,000	
Suspense		375,000
Accumulated depreciation		
Buildings		1,000,000

Plant and machinery		120,000
Motor vehicles		300,000
Retained earnings		140,000
Trade receivables	219,000	
Purchases	1,050,000	
Dividend paid	50,000	
Revenue		2,938,000
Tax payable		347,500
Trade payables		262,500
Share premium		125,000
Ordinary share at N1 each		250,000

The following additional information is relevant:

I. Inventory as at 31 December 2016 was valued at N400,000000. While carrying out the inventory taking exercise, an error in the previous year inventory count was discovered. The inventory brought forward at beginning of the year has been N550m and not N600m as above.

II. No dividend is being proposed

III. 250 million ordinary shares were issued at N1.50 on 1 December 2016. The proceeds have been left in suspense account.

IV Income tax for the year is N162,500,000.

You are required to prepare:

(a) Statement of profit or loss and other comprehensive income for the year ended 31 December 2016

(b) Statement of changes in equity for the year ended 31 December 2016.

(c) Statement of financial position as at that date

Note: your solution must be in line with the provisions of IAS 1.

SOLUTION TO ILLUSTRATION 5.1

(a) BUTAINE NIG LIMITED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2016

	N'000	**N'000**
Revenue		2,938,000
Cost of sales		**(w1)** (1,250,000)
Gross profit		1,688,000
EXPENSES:		
Administrative expenses	551,5000	
Distribution expenses	162,500	
Total expenses		**(**714,000)
Net profit before tax		974,000
Income tax		**(** 162,500)
Net profit for the year		811,500
OTHER COMPREHENSIVE INCOME:		
Other comprehensive income		Nil
TOTAL COMPREHENSIVE INCOME		811,500.

WORKINGS:

(W1) COST OF SALES:

	₦'000
Opening inventory	600,000
Purchases	1,050,000
Less:	
Closing inventory	(400,000)
Cost of sales	1,250,000

(b) **STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 2016.**

	Share capital	Share premium	Retained earnings	Total
	N'000	N'000	N'000	N'000
Bal. at I Jan. 2016	250,000	125,000	140,000	515,000
Prior period adjustment	-	-	(W2) (50,000)	(50,000)
Restated balance1 Jan 2016	250,000	125,000	90,000	465,000
Profit for the year	-	-	811,500	811,500
Dividend paid	-	-	(50,000)	(50,000)
Share issued	250,000	(w3) 125,000	-	375,000
Bal. 31 Dec. 2016	500,000	250,000	851,500	1,601,500

WORKINGS:

(W2) INVENTORY ADJUSTMENTS

Wrong balance b/d N600m - N550m = N50m

(W3) SHARE PREMIUM

N250m x 1.5 = N375m

Hence share premium = N375m – N250m = N125m

(C). BUTAINE NIGERIA LIMITED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2016.

	₦'000	₦'000
NON CURRENT ASSETS		
Buildings	2,500,000	
Accm depreciation	(1,000,000)	
Carrying amount		1,500,000
Plant and machinery	350,000	
Accm depreciation	(120,000)	
Carrying amount		230,000
Motor vehicle	80,000	
Accm depreciation	(30,000)	
Carrying amount		50,000
TOTAL NON- CURRENT ASSETS		1,780,000
CURRENT ASSETS		
Inventories(400- 50)	350,000	
Trade receivables	219,000	
Cash at bank	25,000	
Total current assets		594,000
TOTAL ASSETS		**2,374,000**
EQUITY AND LIABILITIES		
Share capital		500,000
Share premium		250,000
Retained earnings		851,500
Equity		1,601,500
CURRENT LIABILITIES		
Tax payable(347500+162500)	510,000	
Trade payables	262,500	
Total current liabilities		772,500
EQUITY AND LIABILITIES		**2,374,000.**

5.6 INVENTORIES IAS2

IAS 2 prescribes the basis for determining and accounting for inventories as an asset until the related revenues are recognized. Inventories are described as assets that are held for sale in the ordinary course or consumed in the production process or in rendering of services. Examples are finished goods, raw materials and work-in-progress and stores, spare parts and consumables.

5.6.1 BASIS OF VALUATION

Inventories are required to be valued at lower of cost and net realizable value.

(a) Cost includes the purchase cost and all other costs incurred in bringing the inventories to their present location and condition such as import duties, transport and handling charges.

(b) Cost of finished goods will also include the cost of converting (conversion cost) the raw materials to finished goods. Conversion costs include the cost of direct labour and systematic allocation of overhead cost.

(c) **inventory cost do not include:**

i. General and administration cost, selling and distribution cost, abnormal cost and storage cost that are not related to production.

ii. Interest and other borrowing costs

iii. Foreign exchange fluctuation on inventories purchased with foreign currency

v. The difference between the cost of purchase and the normal credit terms.

5.6.2 <u>COST MEASUREMENT</u>

a. Cost is measured using either the specific identification method, the first-in-first-out method and the weighted average cost method.

b. Specific identification is used when the inventories are not interchangeable and are segregated for specific project.

c. In all other cases an entity can use either the FIFO or weighted average method to measure cost of inventories

(i) FIFO Method

The FIFO method assumes that inventories purchased or produced first are sold first such that remaining inventories are those that have been most recently purchased or produced.

(ii) Weighted Average Method

The cost of each item is determined from the weighted average of the cost of similar items existing at the beginning of a period and the cost of those items purchased or produced during the period.

(iii) Net Realisable Value

Net realizable value (NRV) refers to estimated selling price in the ordinary course of business, less the estimated cost to completion and estimated that are necessary to achieve sale. The estimation of the NRV should be made at the statement of financial position date.

(iv) Measurement of Net Realisable Value

The Net Realisable Value of the materials and other supplies held for use in production of finished goods is less than the cost of the finished product in which the raw materials are used is sold at less than the cost. When the NRV is lower than the cost, the difference should be recognized as expense in the statement of profit or loss.

5.6.3 Disclosure requirements for inventories under IAS2

a. The accounting policies that are adopted for measuring inventories including the cost measurement employed.

b. The total carrying amount of inventories along with their appropriate classification e.g finished goods, work in progress raw materials e.t.c

c. The amount of inventory recognized as expense during the period

d. The amount of write-down recognized as expense during the period

e. The amount of any reversal of any previous write-down of inventory

f. The carrying amount of inventories pledged as security for liabilities

5.6.4 METHODS OF RECORDING INVENTORIES

There are two methods of recording inventories. These are :

- Periodic inventory method
- Perpetual inventory system.

5.6.5 PERIODIC INVENTORY METHOD

This is system is based on the use of ledger accounts:
Purchase account which is used to record all purchases during the year;
Inventory account which is used to record the value of inventory at the beginning /end of the financial year.

It should be noted that in a periodic inventory system, the double entry applied are between the inventory account and statement of profit or loss. i.e the cost of the opening inventory is included in the cost of sales. This is because it is an expense and an expense is a debit entry. It debited to the statement of profit or loss (and credited to the inventory account) with cost of the opening inventory

One the other hand the cost of the closing inventory is included in the statements of financial position as an asset, so there must be a debit balance of the closing inventory. i.e debit inventory account (and credit statement of profit or loss) with the valuation of the closing inventory.

Closing inventory double entry is :

	DR	CR
INVENTORY (Statement of financial position)	X	
COST OF SALES (statement of profit or loss)		X

5.6.6 PERPETUAL INVENTORY METHOD

Under the perpetual inventory method a single account is used to record inventory movements. The account is used to record purchases in the period and the inventory is brought down on the account at the end of each year. The account is also used to record all issues out of the inventory and this constitute the cost of sales

When a perpetual inventory method is used, a record is kept of all receipt of items into the inventory (at cost) and all issue of inventory to cost of sales. Usually a bin card is maintain manually for this record.

Under this method it means that the purchase account becomes unnecessary because all purchase are recorded in the inventory account. Therefore all transactions involving receipts or issue of inventory must be recorded, and at any time, the balance on the inventory account should be the value of inventory currently held.

ILLUSTRATION 5.2

(a) The accounting policies of MAMA LTD state that inventories are valued at lower of cost and net realisable value. The company engages a perpetual method for recording its inventories. A recent inventory taking exercise establishes that the amount of inventory currently held at cost are as follows

TYPE OF INVENTORY	COST	SALES PRICE	SELLING
	₦	₦	₦
Inventory AA	200,000	195,000	12,500
Inventory XY	350,000	450,000	5,000
Inventory JO	400,000	425,000	5,000
Inventory BA	150,000	1875,000	3750

Required:

Determine the value of the inventory that will be included in the statement of financial position of MAMA Ltd at the end of the year.

(b) On I Jan. 2016 MAMA Ltd. had an opening balance of inventory of 200 units which cost N 50 each.

During the month the company made the following purchase 2 Jan. 600 units at N60 each 15 Jan. 1000 units at N70 each

During the month it sold 1,200 units as follows:

5 Jan, 400 units
17 Jan. 400 units
26 Jan. 400 units

You are required to calculate the value of the closing inventory using FIFO method at end of the month of January.

SOLUTION TO ILLUSTRATION 5.2

(a)	**INVENTORIES**	**LOWER OF:**	**₦**
	AA	200,000 OR(195,000-12,500)	182,500
	XX	350,000 OR(450,000-5,000)	350,000
	JO	400,000 OR (425,000-5,000)	400,000
	BA	150,000 0R (187,500- 3750)	150,000
INVENTORY VALUE			1,082,500

(b) VALUE OF INVENTORY USING FIFO AT END OF JANUARY.

R ECEIPT				ISSUE			BALANCE		
Date.	Qty.	pr.	₦	Qty.	pr.	N	Qty.	pr.	₦
1Jan.	200	50	10,000				200	50	10,000
2 Jan.	600.	60	36,000				800	50/60	46,000
5 Jan.				200	50	10,000			
				200	60	12,000	400	60	24,000
15 Jan.	1,000	70	70,000				1,400	60/70	94,000

17 Jan.	400	60	24,000	1,000	70	70,000
26 Jan.	400	70	28,000	600	70	42,000

5.7 STATEMENT OF CASH FLOWS

IAS 1 States that a complete set of financial statements should include a STATEMENT OF CASH FLOWS. While IAS 7 which is on cash flows set out detailed requirements for the format and content of the statement. A statement of cash flows provides information about where the business obtain its cash during the financial period and how it made use of the cash

A statement of cash flows categories inflows and out flows of cash, under three main headings namely:

- Cash flows from operating activities
- Cash used in or obtained from investing activities
- Cash paid or received in financing activities.

Statement of cash flows can be prepared using two methods, these are:

- Indirect method
- Direct method.

The details relating to preparation and presentation of statement of cash flows in accordance with IAS 7 provisions are dealt with in detail in other chapter.

5.8 ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS –IAS 8

5.8.1 INTRODUCTION

a). IAS8 deals with the selection and changes in policies and disclosure thereof

b). It also sets out the requirements and disclosure for changes in accounting estimates and correction of errors.

The objectives of the standard are:

(i) To enhance relevance and reliability of financial statements

(ii) To ensure comparability of the financial statements of an entity over time as well as with financial statements of other entities

5.8.2 SELECTION OF ACCOUNTING POLICIES

An entity is required to apply the standard that applies to a transaction, item or event. If no standards exist presently for the item management shall develop and apply a policy that is reliable and relevant to the decision making needs of the user. The policy shall be considered reliable if it:

(a) Represents faithfully the financial position, the performance and cash flows

(b) Reflects the economic substance of transactions, other events and conditions

(c) Is neutral

(d) Is prudent

(e) Is complete in all material respects

In applying the judgments, management is required to consider two things in order of importance.

(i) The requirements and guidance in the standards and interpretation dealing with similar and related losses.

(ii) The definition and recognition criteria and measurement concept of assets, liabilities, income and expenses in the framework of the IASB.

The entity may also consider the most recent pronouncement of other similar standards, accounting literature and accepted industry performance.

5.8.3 CONSISTENCY OF ACCOUNTING POLICIES

Entities are required to apply the accounting policies selected consistently for similar transactions, events and conditions.

If a standard permits categorization of items, an accounting policy shall be selected and used consistently.

Once an accounting policy is selected it may be changed only if the change is required by the standard or it results in providing more reliable or relevant information in the financial statements.

5.8.4 CHANGES IN ACCOUNTING POLICY

An example of changes in accounting policy is when an entity changes its method of inventory valuation. When an entity changes an accounting policy voluntarily it must account for it retrospectively (i.e as if the policy has always been applied) unless there is a transitional provision when the policy shall be applied according to the provision.

The impact of the new policy on the retained earnings prior to the earliest period should be adjusted against the opening balance of retained earnings.

If it is impracticable to determine the effects of the change, the entity shall apply the change prospectively from the start of the earliest period. The change and the reason for the change must be disclosed.

ITEMS THAT ARE NOT CONSIDERED AS CHANGES IN ACCOUNTING POLICIES

(1) The application of an accounting policy for transactions, other events or conditions which substance differ in form from those that occur previously.

(2) The application of new accounting policy for the transactions, other events or condition that did not occur previously or immaterial.

DISCLOSURE OF ACCOUNTING POLICIES

a) If the change in accounting policy is due to the initial application of standard, the entity must disclose the change when it has an effect on current and prior periods or it would have an effect in future periods. If it is impracticable to determine the impact, the entity must disclose the title of the standard and the nature of the change.

b) When the change is voluntary and the entity would be unable to determine the future or past impact, the entity shall also disclose the nature of the change and the reason for the new policy providing reliable and more relevant information.

CHANGES IN ACCOUNTING ESTIMATES

Accounting estimates may change as a result of business environment. Such change in estimate does not require restating the financial statements of a prior period, because they do not amount to correction of errors.

Examples are:

a) Estimating allowances for doubtful debts

b) inventory obsolescence

c) Estimating the useful lives of PPE

d) Determining the fair values of financial assets and financial liabilities

e) Estimating the amount of warranty obligations

The effect of a change in accounting estimate shall be recognized prospectively by including it in the profit or loss in the period of the change only or if it affects future periods in both the period and future periods.

The effect of the change (if any) on assets, liability and equity shall be adjusted on their carrying amount in the period of change.

DISCLOSURE OF ACCOUNTING ESTIMATES

The active and financial effect of the change in accounting estimate of current and future periods.

Errors

When the financial statements contain errors that are material, the entity shall correct errors retrospectively in the financial statements authorized for issue when the error is discovered.

(a) The entity shall restate the comparative amounts for the period(s) presented for which the error occurred.

(b) If the error occurred before earliest period presented, the entity shall restate the opening balances of assets, liabilities and equity of the earliest period presented.

Disclosure requirement of prior period errors.

(i) The nature of the error

(ii) The amount of the error and the line item affected in a financial statement

(iii) Basic and diluted earnings per share

(iv) The amount of the correction at the beginning of the earliest period presented

ILLUSTRATION 5.3

The financial Accountant of BOURNVILLA Ltd encountered the following during the process of preparing the financial statement of the company

(I) In preparing the financial statement for year 31 December 2014 the Accountant discovers an error affecting the 31 December 2013 financial statement.

(II) During the year 31 December 2015 the company changes its accounting policies

Required:

State how the Accountant should treat the situation above while complying with the provisions of IAS 8 on Accounting policies, changes in accounting estimates and correction of errors.

SOLUTION TO ILLUSTRATION 5.3

(I) The error should be corrected in the 31 December 2014 financial statement by restating the comparative figures for 31 December 2013 at their correct amount.

(II) Since there is a change in accounting policy the company must also present a statement of financial position as 1 January 2014 the beginning of the earliest comparative period.

This means that the change should be applied to the balance as at 1 January 2014 as if the new policy had always been applied.

5.9 PROPERTY, PLANT AND EQUIPMENT- IAS16

5.9.1 INTRODUCTION

IAS16 sets out the requirements for the recognition and measurement of property, plant and equipment (PPE) and prescribes the disclosure requirements.

Characteristics of Property, Plant and Equipment (PPE)

Property, plant and equipment are tangible items that are held for use in the production or supply of goods or services or for rentals to others, or for administrative purposes and are expected to be used for more than one period:

a. They are non-current assets

b. They have useful life of more than one year

c. They are used for production of goods or services or for rental

d. Benefits from its use flow to the organization

e. The entity has control over the use of the asset.

5.9.2 RECOGNITION OF PROPERTY, PLANT AND EQUIPMENT

Two criteria are used to determine the recognition of Property, plant and Equipment

(a) It is probable that the future economic benefit associated with the item will flow to the entity.

(b) The cost of the item can be measured reliably.

(i) If the value of an item is insignificant individually, an entity can aggregate the value of such similar items so that they can be material and quality for recognition (e.g. moulds and dies).

However, each unit of the items must be expensed if they cannot be aggregated with similar items

(ii) The amount of major overhaul or inspection components of an asset can be recognised as an item of PPE if the original cost can be separately identified and separately depreciated (overhaul and replacements for ships and aircraft)

5.9.3 MEASUREMENT AND RECOGNITION

An item of PPE should be recognised initially at its cost.

<u>Element of Cost</u>

a. Purchase price, including import duties and any other none refundable purchase taxes, less trade discounts and rebates granted by the supplier.

b. Cost that are directly attributable to bringing the asset to the location and condition for its intended use.

Examples are:

i) Cost of transportation of the asset to the site

ii) Cost of preparing the site

iii) Installation and assembly cost

iv) Remuneration paid to employees who set up the asset

v) Borrowing costs that can be capitalized (IAS23)

c. Cost that are not directly attributable like advertising costs, promotion costs and training costs should be expensed in the period they are incurred.

d. The same principle for measuring costs apply to both acquired and constructed assets. If the entity construct similar item for sale, the profit element should be removed.

5.9.4 MEASURING OF COST

a) The cost of an asset is measured at cash price at the date of acquisition

b) If payment for an item of property planning and equipments is deferred beyond normal credit items (e.g finance lease and hire purchase), the difference between the cash price and the total price is recognized as a finance cost.

c) If an asset is acquired in exchange for another asset, the asset acquired is measured at its fair value.

d) If the fair value of the asset acquired cannot be determined, the item is measured at the carrying amount of the asset given up.

ILLUSTRATION 5.4

SKY POWER PLC. Purchased a sky oriented machine to be used at a project site

The following cost were incurred:	N'000
Purchase price of the machine	4,000
Delivery cost	400
Installation cost	500
Trade discount given	200
Cost of site preparation	800
Architect's fees	60

Administration expenses	600
Test run cost	300

The test run was to ensure that the asset was installed and working correctly without causing any sky pollution items of inventories were produced during the test run. This has a value of N40,000. The Standards organization of Nigeria (SON) have granted the company a license to operate the asset on the condition that the company will remove the asset at end of the project and return the site to its former condition . The company has recognised a liability of N1,000,000 in respect of expected clearance cost.

Require:

Calculate the cost of machine in accordance with the provisions of IAS 16 on property plant and equipment.

SOLUTION TO ILLUSTRATION 5.4

COST OF SKY POWER MACHINE

	₦'000
Purchase price (4,000-200)	3,800
Delivery cost	400
Installation cost	500
Cost of site preparation	800
Architect's fees	60
Decommissioning cost	1,000
Test run cost (300- 40)	260
Cost of machine	6,820

5.9.5 MEASUREMENT AFTER RECOGNITION

After recognition an item of property, plant and equipment should be measured using their cost model or revaluation model. Any model selected must be applied consistently.

5.9.6 COST MODEL

The cost model requires an asset after initial recognition, to be carried at cost less accumulated depreciation and impairment losses.

Depreciation is the systematic allocation of the depreciable amount of an asset over its expected useful life. An entity is required to apply depreciation to an item PPE on systematic basis over its expected useful life.
Depreciable value is the cost of the asset less its residual value.

Expected useful life is the period used, not the assets economic life which could be appreciably longer.
The residual value of the asset shall be deducted when considering depreciation.
Residual value is the estimated disposal costs at the end of its useful life. The depreciation charged for each period shall be recognized in the income statement.

Depreciation method: An entity is permitted a choice of depreciation method. It can use the straight line method or the reducing balance method or units of production method. The depreciation shall be reviewed annually and shall be changed to reflect the change in expected pattern of consumption in future. The change shall be accounted for as change in accounting estimates.

5.9.7 REVALUATION MODEL

a. An item of property plant and machinery whose fair value can be measured reliably, may be carried at a revalued amount.
b. The revaluation amount would then be subject to depreciation and impaired losses for the remaining useful life of the asset which would now represent the fair value of the asset.
c. When an asset is revalued, the entire class of the PPE to which the asset belongs must be revalued.
d. The increase in the carrying amount of property, plant and equipment is credited to comprehensive income statement and transferred to statement of changes in equity under revaluation surplus. If the increase in carrying amount reverses a previous decrease, then, the increase in carrying amount is recognized in income statement to the extent it offset the previous decrease.

5.9.8 DERECOGNITION OF PROPERTY, PLANT AND EQUIPMENT

a. When an asset is disposed or it cannot provide any more future economic benefits, it is derecognised

b Profit or loss on the disposal of the property, plant and equipment in the statement of profit or loss but is treated as income or loss.

c. When an item property plant and equipment are held for sales, the carrying amount is transferred to inventory. The proceed from the sale of such property, plant and equipment should be recognized in revenue.

ILLUSTRATION 5.5

(a) An item of property plant and equipment which cost N750m is expected to have a useful life of five years and an expected residual value of N5m. using straight line method of depreciation. What is the annual depreciation charge? And what will be the carrying amount of the assets after four years?

(b) A non-current asset cost N100m it is depreciated using a reducing balance method at rate of 20percent each year. What is the annual depreciation charged in years 1 to 4.

(c) An office equipment which originally cost N75m with accumulated depreciation of N51m was sold for N18m and the cost of disposal was N5m

What is the gain or loss on disposal of the office equipment?

SOLUTION TO ILLUSTRATION 5.5

(a) Depreciation charged for the year = $\dfrac{\text{cost of asset less residual value}}{\text{Expected useful life(years)}}$

$$= \frac{\text{₦750m less ₦5m}}{\text{5years}}$$

Annual depreciation = ₦149m

Carrying amount at end of year 4.

Cost of asset	₦750m
Less	
Accumulated Depreciation (₦149mx 4)	(₦596m)
Carrying Amount	₦154m

(b)

YEAR	COST/CARRYING AMOUNT(N'000)	ANNUAL DEPRECIATION AT 20% (N'000)	CARRYING AMOUNT (N'000)
1	100,000	20,000	80,000
2	80,000	16,000	64,000
3	64,000	12,800	51,200
4	51, 200	10,240	40,960

(C) GAIN OR LOSS ON DISPOSAL OF OFFICE EQUIPMENT

	N'm	N'm
Sales proceed on disposal		18
Less: disposal costs		(5)
		13
Less:		
Asset cost	75	
Accum depreciation	(51)	
Carrying amount at date of disposal		(24)
Loss on disposal		11

5.9.9 DISCLOSURE REQUIREMENTS OF IAS 16

IAS 16 requires the following disclosures in the note to the financial statements for each class of property plant and equipment.

a. Measurement bases (cost or revaluation model)
b. Depreciation methods
c. Useful lives or depreciation rates used
d. Gross carrying amount and accumulated depreciation at the beginning and end of the period
e. Assets classified as held for sale
f. Additions during the year
g. Increase or decrease arising from revaluation and from impaired losses and reversal thereof.
h. Assets pledged as security for liabilities
i. Assets in the course of construction. For asset that are revalued the following need to be disclosed:
    - . The effective date for valuation
    - Whether an independent valuer was involved
    - Methods and significant assumption used in assessing the fair value
    - For each class of asset revalued, the carrying amount that would have been recognized if the class had not been revalued.
        - The revaluation surplus, stating the change for the period and any restriction in distribution to shareholders.

J. A reconciliation between the opening and closing values for gross carrying amount and accumulated depreciation, showing:
    - Additions during the year
    - Disposal during the year
    - Depreciation charged for the year
    - Assets classified as held for sale in accordance with IFRS5.

- Acquisition of assets through business combinations

- Impairment losses
- Effect of revaluation.

The following table below is an example of a simple statement of non- current assets which are normally presented in the notes to the financial statements of entities.

	Buildings	**Machine**	**Plant and equipt**	**Total**
Cost :	Nm	N'm	N'm	N'm
At start of the year	X	X	X	XX
Additions	X	X	X	XX
Disposal	(X)	(X)	(X)	(XX)
At end of the year	XX	XX	XX	XX
Accumulated depreciation:				
At start of the year	X	X	X	XX
Charged for the year	X	X	X	XX
At year end	X	X	X	XX
Carrying amount:				
At start of the year	XX	XX	XX	XX
At end of the previous year	XX	XX	XX	XX

5.10 IFRS FOR SMEs

The IASB also develop s and publishes a separate standards intended to apply the General purpose financial statements of and other financial reporting entities that in many countries are referred to by variety of terms , including **small and medium entities (SMEs**), private entities, non- publicly accountable entities etc. this standard is referred to as **international financial reporting standards for small and medium-sized entities (IFRS for SMEs).**

5.10.1 DESCRIPTION OF SMALL AND MEDIUM - SIZED ENTITIES

Small and medium – sized entities are entities that:

- Do not have public accountability
- Publish general purposes financial statements for external users .Examples of the external users include the owner of the business and potential creditors and credit rating agencies.
- The objectives of the financial statement of a small and medium sized entity is to provide information about the financial position, performance and cash flows of the entity that is useful for economic decision making by board range of users who are in the position to demand reports tailored to meet their particular information needs.

5.10.2 COMPLETE SET OF FINANCIAL STATEMENT FOR SMEs.

A complete set of financial statement of an SMEs shall include all of the following:

- A statement of financial position as at the reporting date
- (I) a single statement of comprehensive income for the reporting period displaying all items of income and expenses recognized during the period including those items recognized in determining profit or loss and items of other comprehensive income. Or

  (II)a separate statement of profit or loss and a separate statement of comprehensive income. The separate statement of comprehensive income will begin with profit or loss and displayed the items of other comprehensive income

  - A statement of changes in equity for the period
  - A statement of cash flows for the period
  - Notes, comprising a summary of significant accounting policies and other explanatory information.

If the only changes to equity during the period for which the financial statement are presented arises from profit or loss payment of dividend, correction of prior period errors, and changes in accounting policies the entity equity may **present a single statement of income and retained earnings in place of comprehensive income and statement of changes in equity.**

Also if the entity has no item of comprehensive income in the period in which a financial statement is presented it may present only a statement of profit or loss which ends with profit for the year.

5.11 CHAPTER SUMMARY

The adoption of International Financial Reporting Standards (FIRS) is now universal; hence most Countries around the world are now adopting it in the preparation and presentation of Financial Statements.

The presentation and disclosure requirements in the Financial Statements in accordance with International Accounting Standards (IAS) 1,2,7,8,16 were fully discussed. Also there was brief discussion of IFRS for SMEs.

5.12 MULTIPLE CHOICE QUESTION AND SHORT ANSWER QUESTION

1. Which of the following is not a component of financial statements under IASI?
   (A) A statement of financial position
   (B) A statement of comprehensive income
   (C) A statement of change in equity
   (D) A statement of Affairs
   (E) A statement of Cash flows

2. Which of the following disclosure is NOT required under IASI?
   (A) A description of the entity's operation and its‟ principal activities
   (B) The level of rounding used in presenting the financial statements
   (C) Name of the reporting entity
   (D) Name of major shareholders of the entity
   (E) The measurement basis used in preparing financial statement

3. Which of the following NOT a qualitative characteristic of financial statement according to IASB framework?

(A) Understability

(B) Relevance

(C) Reliability

(D) Comparability

(E) Materiality

4. Which of the following should NOT be included in cost of inventory?

   (A) Normal amount of wasted material

   (B) Administrative overhead

   (C) Purchase price

   (D) Import duties

   (E) Variable production overhead

5. Which of the following should NOT be included in the cost of an item of plant?

   (A) Cost of delivery and handling cost

   (B) Cost of site preparation

   (C Cost of plant per suppliers invoice

   (D) Estimated discounting cost to be incurred after 5 days

   (E) Interest charges paid to supplier of plant for deferred credit.

6. Inventories are required to be valued at lower of ……………… and ……………..

7. Which of the qualitative characteristics is closely related to materiality?

8. Subsequent to its acquisition, two models are specified for measurement of an item of property plant and equipment state them.

9. Assets held for sale in the ordinary course of business are………………….

10. Depreciable amount is the cost of an asset less its…………………..

5.13 SOLUTIONS TO MULTIPLE CHOICE QUESTION AND SHORT ANSWER QUESTION

1. D
2. D
3. E
4. B
5. E
6. Cost, net realizable value
7. Relevance
8. Cost model, revaluation model
9. Inventories
10. Residual value

CHAPTER SIX

PARTNERSHIP ACCOUNTS

6.0 Introduction

This section covers 20% of the syllabus and there is usually a question on this topic in every diet of the examination at this level. The areas of coverage on partnership accounts as stated in the syllabus include the following:

A. Features of Partnership to include:

i. Definition
ii. Formation
iii. Types of partners
iv. Partnership agreement and
v. Accounts peculiar to partnership

B. Changes in partnership structure to include:

i. Accounting for Goodwill
ii. Revaluation of Assets
iii. Admission of new partners
iv. Death or retirement of a partner (Dissolution of partnership)
v. Amalgamation of a partnership (with a sole proprietor or another partnership)
vi. Conversion of partnership to Limited Liability Company

6.1 Learning Objectives

At the end of this chapter, candidates should be able to:

i. Define Partnership And State Types Of Partners In A Partnership
ii. Explain How A Partnership Is Formed
iii. State The Contents Of A Partnership Agreement And Rules Applicable In Case There Is No Agreement
iv. Identify Accounts That Are Peculiar To The Partnership Business And
v. Prepare Partnership Accounts under normal situations

6.2 Definition of Partnership

A partnership is an association that brings the talents and resources of two or more people together to carry on a business in common with a view of profit. The business could be carried on by all or any of them for the benefit of all of them. The minimum number to form a partnership is two people with a maximum limit of twenty persons except for firms of professionals such as solicitors, accountants and chartered engineers and surveyors, which are exempted from the maximum rule.

6.3 Types of Partners in a Partnership

In a partnership, there are different types of partners based on different types of classification. Participation in management and the extent of liability borne are the two major criteria used to classify the partners. The different types are enumerated and discussed below one after the other with their different characteristics.

General Partner or Active Partner: this partner has full power of participating in the conduct of the partnership business and is liable to the full extent of his estate for the partnership debt hence have unlimited liability.

Limited Partner: this partner is liable for the debts of the partnership only up to the amount he has agreed to contribute to the business and he cannot take part in the management of the business.

Sleeping or Dormant Partner: he does not take active part in the management of the partnership business; he contributes money and share in the partnership profit. By inference, this partner usually has limited liability.

Nominal Partner: this partner has no capital contribution in the partnership business but share in the profit. This is usually based on agreement as such partner must have allowed his name to be used by the business as a result of his good image, which the partnership would want to be associated with, to enhance their business privileges.

One or more partners in a partnership may limit their liability, but at least one partner must have unlimited liability. Every partner in a partnership is an agent of the firm and the other partners for the purpose of the business of the partnership.

6.4 Formation of Partnership

In order to form a partnership, a copy of the partnership agreement and a prescribed form signed by all the partners should be delivered to the regulatory authority in charge of business and company registration in the country where the partnership business is to be domiciled. For instance, in Ghana, the Registrar General is the relevant authority while in Nigeria; the documents will be delivered to the Corporate Affairs Commission for registration. The form would contain the following:

i. The name of the partnership

ii. The general nature of business

iii. The principal place of business and any other places where the business is carried on The address and post office box number

iv. The names and any other former names, residential addresses and business is carried on; and

v. The date of commencement of the partnership

The firm would be registered upon satisfaction that the contents of the documents are in order and after payment of the prescribed fee.

6.5 Partnership Agreement

It is possible to form a partnership at will with or without the existence of any agreement, whether oral or written. However, it is expedient that, the partners before doing business together should come to an understanding on how issues are to be handled in the course of the partnership. The basic document that sets out the conditions under which the partners would carry on the business of partnership is the Partnership Agreement otherwise known as Partnership Deed. Usually the issues set forth in the agreement would include the following:

a. **Capital:** The agreement would indicate whether each partner should contribute a fixed amount of capital or not and how much each partner should contribute.

b. **Profit Sharing:** How profits and losses should be shared among the partners will be spelt out; whether they are capital or revenue profits or losses.

c. **Interest on capital and drawings:** Whether interest on capital or drawings should be allowed or charged before arriving at divisible profits, and if so at what rate.

d. **Interest on loan by partners:** The rate of interest payable on any loan advanced by any of the partners.

e. Whether current accounts are to bear interest, and if so at what rate;

f. Whether partners' drawings are to be limited in amount so that the current account does not turn into debit balance or not;

g. Whether partners are entitled to remuneration for their services before arriving at divisible profits and if so what amounts and which of the partners;

h. How the books of account would be kept and where they should be kept.

i. The method for the valuation of assets i.e. goodwill in case of an incoming or outgoing partner;

j. The method and procedures for settlement of disputes;

It should be noted that partnership is by mutual agreement and issues that have been clearly spelt out in the deed cannot be set aside. However, the partners can all agree to either change or modify any of the clauses in the agreement at any time.

6.6 Rules Applicable in the Absence of Partnership Agreement

Where there is no partnership agreement, or the existing one is silent over a number of vital issues, then the following rules shall apply:

a) Partners shall share profits and losses equally and shall contribute equally to capital.

b) The firm shall indemnify every partner in respect of payments made and liabilities incurred by him/her in the ordinary and proper conduct of the business of the firm;

c) Any advance or payment in excess of agreed share of capital will attract an interest at the rate of 5%;

d) Every partner may take part in the management of the firm;

e) No partner shall be entitled to remuneration for acting in the firm's business;

f) No person may be introduced as a partner without his consent and the consent of all the existing partners.

g) Partners shall not be entitled to payment of interest on capital before ascertainment of profits of the firm;

h) The partnership books and accounts shall be kept at the place of business of the firm or at the principal place of business and every partner, may when he/she deems fit, have access to and inspect and copy any of them; and.

i) Differences arising from ordinary matters in connection with the partnership business may be decided by majority of the partners.

However, no change in the nature of the partnership business may be made without the consent of all existing partners.

6.7 Accounts That Are Peculiar To the Partnership Business

The capital of a partnership business would normally be contributed by more than one person. Therefore, in addition to keeping the record of the partnership business transactions, record of each partner's contribution to the business must be kept. This is usually done through a current account and/or a capital account depending on whether the capital account has been decided by the partners to be fixed or fluctuating.

In most cases, partners would want their original or initial contributions to remain intact, at least in the books. In such a case, there is the need to keep a "Current Account" on behalf of the partners to take care of other dealings between a partner and the firm. The Current Account, if it is kept, is a very important account which records all transactions between the partners and the firm, except the initial contributions. Thus, interest on capital, interest on loans, salaries and share of residual profits must pass through the Current Accounts. Drawings by partners, whether cash or in kind, should either be directly debited to either the Drawings Account or the Current Account.

Drawings should not be debited against the Profit or Loss Account because it is neither an expense nor a charge against profit. It is debited to the current account.

Where a partner makes an advance to the firm, the amount so advanced should be credited to a loan Account. Normally such advance would attract an interest of 5% or the partnership agreement might stipulate the rate agreed on by all the partners. Interest on loans would be deducted from profit before arriving at distributable profit. Where the partners agree that there should be interest on capital accounts, the interest on capital should never be charged to Income Statement, it must be charged against the statement of distribution of income.

The Statement of Distribution of Income would be credited with the interest on drawings, and debited with interest on capital, share of profit or loss, and salaries of partners if any.

Therefore in a partnership business, the following accounts could be found for each of the partners:

i Fixed Capital Account
ii. Current Account
iii. Fluctuating Or Floating Capital Account (combined i and ii)
iv. Loan Account
v. Salary Account
vi. Drawings Account
vii. Interest Account

In addition to the above, a partnership business will prepare a Statement of Distribution of Income to show how partnership profit is to be shared among the partners. This is the additional statement prepared by a partnership business which distinguishes it from a sole proprietor's business.

6.8 Guaranteed Share of Profit

Occasionally, there are agreements that a partner will not receive a share of profit that is less than a specified amount annually from the partnership business. If there is a year when the share of profit due to such partner is less than the stated amount, then the deficiency will be borne by the other partners in their profit and loss sharing ratio or the ratio in which they contribute to capital if that was the initial agreement.

6.9 Recording of Partnership Transactions

The relevant accounting entries for recording transactions in a Partnership are as follows:

Drawing of stocks for personal use:
Debit: Partner's Current Account
Credit: Trading Account

Payment of expenses of the Firm from personal resources:
Debit: Profit & Loss Account
Credit: Current Account

Interest on loan advanced by a partner:
Debit Profit & Loss Account
Credit Partner's Current Account

Interest on drawings:
Debit Partner's Current Account
Credit Statement of distribution of income

Interest on Capital Account:
Debit Statement of distribution of income
Credit Partners Current Account

Partner's Salary:
Debit Statement of distribution of income
Credit Partner's Current Account

Share of Profit:
Debit Statement of distribution of income
Credit Partner's Current Account

Share of Loss:
Debit Partner's Current Account
Credit Statement of distribution of income

Drawings by a partner:
Debit Partner's Current Account
Credit Partner's Drawings Account

6.10 Worked Examples

Let us illustrate some of the points raised with the following examples

Illustration 6.10.1

Mamah and kwesi have been in partnership for the past ten years. The accounts of the partnership are made up to 31 December. Interest on drawings is charged at the rate of 15% and interest allowed on Capital is at 10%. Kwesi received a salary of ⊄ 76 million per annum. The balance of profit is shared as follows: Mamah 3/5 and Kwesi 2/5. At 31/12/2005 the following balances appeared in the firm's books:

Capital Accounts:	⊄ m
Mamah	190
Kwesi	114
Current Accounts:	
Mamah	95 Cr
Kwesi	57 Cr

The net profit for the year ended 31 December 2005 was ⊄ 285 million and at that date, the balances on the Partner's Drawings Accounts were: Mamah ⊄114 million and Kwesi ⊄ 95 million.

Prepare the following:

(a) The Statement of Distribution of income of the Partnership for the year to 31 December 2005.

(b) The Partner's Current Accounts as at 31 December 2005.

Solution 6.10.1

Statements of Distribution of Income for the Year Ended 31 December 2005

		⊄m			⊄m
Current Accounts:			Net Profit B/d		285.0
Interest on Capital	Mamah	19.0	Current Accounts:		
	Kwesi	11.4	Interest on Drawings	Mamah	17.1
				Kwesi	14.3
Salary	Kwesi	76.0			
Share of Profit					
	Mamah (3/5)	126.0			
	Kwesi (2/5)	84.0			
		316.4			316.4

Table 6.1

Partners' Current Accounts

	Mamah ⊄m	Kwesi ⊄m		Mamah ⊄m	Kwesi ⊄m
31/12/2005 Interest on Drawings	17.1	14.3	1/7/2005 Bal. B/d	95.0	57.0
31/12/2005	114.0	95.0	31/12/2005 Interest on Capital	19.0	11.4
Bal. c/d	108.9	119.1	Salary	-	76.0
	240	228.4	Share of Profit	126.0	84.0
				240.0	228.4

Illustration 6.10.2

Zumi, Brah and Zotu started a partnership on the 14th of January, 2000 sharing profits and losses in the ratio 2:2:1. The partners agreed that partners' capital accounts and drawings were to attract interest. The trial balance of the partnership as at 30 September 2006 after the preparation of the Profit & Loss Account for the period was as follows:

Current Accounts:	₦	₦
Zumi		24,000
Brah	6,000	
Zotu		13,500
Capital Accounts:		
Zumi		150,000
Brah		135,000
Zotu		120,000
Loan By Zotu		30,000
Bank & Cash	31,500	
Creditors		27,000
Profit & Loss Account		51,000
Debtors	40,500	
Stocks at 30/9/06	52,500	
Vehicle	97,500	
Furniture & Fittings	22,500	
Buildings	300,000	
	550,500	550,500

The following have not been taken into consideration before preparing the trial balance.

(a) Goods taken for personal use by Zumi ₦7, 000; and Brah ₦3, 500.

(b) General expenses paid by Brah personally was ₦2, 250

(c) Zotu received ₦4, 500 as salary from the partnership

(d) Cash drawings made were as follows:

Zumi N9, 000 Brah ₦6,000 and Zotu ₦4,500

(e) Interest on drawings: Zumi ₦1, 000; Brah ₦550: Zotu N450

(f) Interest on loan Zotu ₦3,000

(g) Interest on Capital account is charged at the rate of 5%

You are Required to Prepare:

(a) The Profit & Loss and the Statement of distribution of incomes

(b) The Partners Current Accounts

(c) The Balance Sheet as at 30/09/06

olution 6.10.2

(a) **Income Statement Zumi, Brah, Zotu & Co. for the year ended 30 September 2006**

		₦	₦
Balance per Trial Balance			51,000
Current A/cs: Goods taken			
	Zumi	7,000	
	Brah	3,500	
			10,500
			61,500
Current A/cs: Brah	(General expenses)	2,250	
Zotu	(interest on loan)	3,000	(5,250)
Net Profit			56,250

Statement of Distribution of Income Account for the year ended 30 September 2006

		₦	₦
Net Profit		56,250	56,250
Current A/cs:	Interest on drawings:		
	Zumi	1,000	
	Brah	550	
	Zotu	450	2,000
			58,250

Current Accounts:	Salary to Zotu	4,500
	Interest on Capital	
	Zumi	7,500
	Brah	6,750
	Zotu	6,000
		24,750

Current Accounts:	Share of Profit:		
	mi (2/5)	13,400	
	Brah (2/5)	13,400	
	Zotu (1/5)	6,700	
			58,250

Partners Current Account

	Zumi	Brah	Zotu		Zumi	Brah	Zotu
	₦	₦	₦		₦	₦	₦
Bal B/d	-	6,000	-	Bal B/d	24,000	-	13,000
Goods taken	7,000	3,500	-	Interest on loan	-	-	3,000
				Salary			4,500
Interest on Drawings	1,000	550	450	General expenses	-	2,250	-
Drawings	9,000	6,000	4,500	Interest on Capital	7,500	6,750	6,000
C/d	22,900	6,350	28,750	Share of Profit	13,400	13,400	6,700
	44,900	22,400	33,700		44,900	22,400	33,700

6.11 Accounting for Goodwill in Partnership

Goodwill is an intangible asset usually not listed in an entity's financial statement like other tangible assets. It is the excess value of a business over the net realisable value of its separately ascertainable assets. Goodwill may be as a result of the following attributes found in a firm:

i. Monopolistic advantage

ii. Strategic location of the firm

iii. A long established list of experienced employees

iv. Reputable customers' patronage built sustained customers demand and taste satisfaction.

v. High reputation for credit ratings

vi. Good employer and employee relationship

vii. High quality products and services

viii. Competent Management Team

ix. Organized and effective advertising and marketing strategy

Goodwill could be purchased, un-purchased or negative. Un-purchased goodwill is inherent in the firm, generated within the business in the course of normal business activities. Purchased goodwill is derived from valuation during the acquisition of a business when the purchase consideration is more that the net book value of the assets acquired. If such purchase consideration is lower than the net book value of the assets then negative goodwill is the difference.

In a partnership, a number of events take place that will give rise to the recognition and valuation of goodwill in the partnership business whether such is to be kept in the books or not. As long as there is a change in the structure or composition of the partnership, then goodwill must be recognised and could be treated in different ways. These events include: Admission of a new partner, retirement or death of a partner, amalgamation and conversion of partnership business.

6.11.1 Recording of Goodwill in Partnership Accounts

Goodwill could be calculated based on:

i. Purchase of profits or average profits of some years

ii. Weighted average method or

iii. Super-profit method.

At this stage the bookkeeping aspects of goodwill is what is required, hence valuation issues are deferred to another stage of the examination.

There are a number of ways in which goodwill recognised and valued could be treated in the books of accounts. These include the following:

i. **Raising a goodwill account:** This method is adopted if goodwill is to be kept in the books of the firm. The amount of goodwill agreed upon is shared among the old partners are credited in their old profit and loss sharing ratio.

Debit Goodwill Account

Credit Capital Accounts of partners in the old firm in the existing profit sharing ratio

ii. **Payment for goodwill:** In this case the goodwill account is not to be maintained in the books; the new partner pays for his own share of the goodwill in addition to the capital contribution. The cash book will be debited with the payment while the old partners will be credited in the old profit and loss sharing ratio.

iii. **Direct payment to old members for goodwill:** No record of this in the partnership books as the new member paid directly to the old partners in old profit and loss ratio.

iv. **Withdrawal of cash by old partners:** Instead of crediting old partners and debiting goodwill, the old partners will withdraw cash equivalent to their share of goodwill. Goodwill account is debited while cash account is credited.

v. **Adjustment of capital account of partners:** If the new partner is not to pay cash for goodwill and goodwill account is not to be maintained in the books of the partnership despite its existence, then it might be necessary to adjust the capital account of partners. The new partner's share of goodwill will be credited to the old members in their profit and loss sharing ratio and debited to the new partner's capital account.

Debit Goodwill Account

Credit Capital Accounts of partners in the old firm in the old profit sharing ratios.

Debit Capital Accounts of partners in the new firm in the new profit sharing ratio

Credit Goodwill Account to close the account

6.12 Revaluation of Assets

Apart from recognition and valuation of goodwill, revaluation of assets also usually accompanies change in structure or composition of a partnership business in the interest of fairness and to maintain equity between the partners.

6.12.1 Bookkeeping in Respect of Revaluation

If an asset is re-valued, three situations can arise. The asset may increase in value; decrease in value or the value placed on it may be the same as the book value. If the value does not change, there will not be any bookkeeping entries to be made. If there is an increase in value, that is a capital profit, you need to debit the Asset account with the difference between the previous value and the new value and credit the Revaluation Account.

On the other hand, if there is a decrease in value, there is a capital loss on revaluation, debit the Capital Account of partners and credit Revaluation Account.

Illustration 6.12.1

Mensah and Babatunde have been partners for some time. On 26th March 2006, they decided to admit Shola. So they requested for a revaluation of the assets of the partnership.

The Statement of Financial position of Mensah and Babatunde as at 31st March 2006, was as follows:

Non-Current Assets	**Cost**	**Depreciation**	**Net Book Value**
	¢000	¢000	¢000
Freehold Property	7,600	2,850	4,750
Plant & Machinery	4,275	2,375	1,900
Motor Vehicles	3,610	2,185	1,425
	15,485	7,410	8,075
Current Assets:			
Inventories		1,330	
Receivables		1,140	
Bank and Cash		7,125	
		9,595	
Less Acct. Payable		4,485	5,110
			13,185
Capital Accounts			
Mensah			4,800
Babatunde			4,800

Current Accounts:

Mensah	1,585
Babatunde	2,000
	13,185

The new valuations were as follows:

	¢000
Freehold Property	9,500
Plant and Machinery	1,425
Motor Vehicles	1,140

It was also agreed that provision for doubtful debts should be made to 2½ of receivables. Creditors agreed to receive ¢3,000,000 for full settlement of their interest.

Required:

(a) Pass the necessary journal entries to give effect to the revaluation of the assets.
(b) Show the Partners Capital Accounts
(c) Show the Revaluation Account

Solution 6.12.1

Note:

Let us note that in the accounts proper, fixed assets are usually shown at cost or revalued amounts. Hence, the net assets shown in the balance sheet would not have any T accounts. Therefore, it would be necessary to close the provision on Revaluation Account. We would then be left with the assets accounts.

Compare the balances on the assets accounts with the revalued figures. If the revalued amounts are higher, it means the assets have increased in value. The only way to record increases in the assets accounts is to debit the assets accounts with the difference. In the same way, to record a decrease in an asset account, you need to credit the asset account. To complete the double entry you need to pass the other entry through the Revaluation Account.

On receivables, a 2½% of provision has to be made. So let us debit the Revaluation account with ¢28,500 and credit Provision for Doubtful Debt Account with the same amount.

(a) Debit: Provision for depreciation:

1. Freehold Property 2,850

Plant and Machinery 2,375

Motor Vehicles 2,185

Credit: Revaluation Account 7,410

To close the provisions on depreciation accounts

2. Debit: Freehold Property 1,900

Credit: Revaluation Account 1,900

To record increase in the balance on freehold property

3. Revaluation Account 5,348.5

Plant and Machinery 2,850

Motor Vehicles 2,470

Provision for doubtful debt 28.5

Being adjustment needed to reflect the revalued amounts

4. Payables Account 1,485

Revaluation Account 1,485

To record the decrease in the payable balance

5. Debit: Revaluation Account 5,446.5

Credit: Partners‟ Capital Account 5,446.5

To close off the Revaluation Account

(b) **Revaluation Account**

	¢000		¢000
Plant and Machinery	2,850	Provision on Depreciation	7,410
Motor Vehicles	2,470	Freehold Property	1,900
Provision for doubtful debts	28.5	Creditors Account	1.485
Partners' Capital Accounts			
Mensah	2,723.25		
Babatunde	2,723.25		
	10,795		10,795

Capital Accounts

	Mensah	Babatunde	Mensah		Babatunde
	¢000	¢000	¢000	¢000	
Bal c/d	7,523.25	7,523.25	Balance b/d	4,800.00	4,800.00
Revaluation	2,723.25	7,523.25			
	7,523.25	2,723.25		7,523.25	7,523.25
b/d	7,523.25	7,523.25			

6.13 Chapter Summary

A partnership is an association between two or more people carrying on a business in common with a view of profit. The business could be carried on by all or any of them for the benefit of all of them; any member could take active part in the management of partnership. The number of members ranges from two to twenty except for firms of professionals that could have up to fifty members. The partners could have their liability limited or unlimited but there must be at least a general partner whose liability will be unlimited. We also have sleeping or dormant partners who contribute capital and share in the profit but do not take active part in the management of the company. Nominal partners do not contribute capital but share in the profit of the partnership perhaps because he allowed his name to be used in the business.

Partnership business is one of the simplest business enterprises to form. The firm would be registered upon satisfaction that the contents of the partnership agreement and prescribed form are in order and with the payment of the prescribed fee. It is possible to form a partnership at will with or without the existence of any agreement, whether oral or written. Partnership is by mutual agreement and issues that have been clearly spelt out in the deed cannot be set aside. However, the partners can all agree to either change or modify any of the clauses in the agreement at any time. In case of dispute and circumstances not provided for in the partnership deed or when there is no written agreement at all, there are provisions in the Partnership Act on how to resolve issues relating to the business.

In addition to keeping the record of the partnership business transactions, a partnership keeps record of each partner's contribution to the business through a current account and/or a capital account depending on whether the capital account has been decided by the partners to be fixed or fluctuating. Therefore, it is usual to find the following books being kept in respect of each partner: Fixed Capital Account, Current Account, Fluctuating Or Floating Capital Account, Loan Account, Salary Account, Drawings Account and Interest Account. A Statement of Distribution of Income (known as Profit and Loss Appropriation Account) will also be prepared by the partnership business after determination of trading profit.

A partner may be given a guaranteed share of profit whereby if at any period the share of profit due to the partner is lower than the agreed amount, the other partners will share the deficiency in the profit and loss sharing ratio. Normal double entry principles are followed in the partnership rules with adherence to basic accounting principles and concepts except when there are changes in the structure of partnership.

CHAPTER SEVEN

PARTNERSHIP ACCOUNTS 2

CHAPTER CONTENTS

a. Changes in the structure of Partnership;

b. Goodwill;

c. Revaluation of assets and liabilities;

d. Admission of a new Partner;

e. Retirement and death of a Partner;

f. Amalgamation of Partnership;

g. Dissolution of Partnership; and

h. Conversion of Partnership to a Limited Liability company

7.0 Objectives

After studying this chapter, students should be able to understand:

a. The various types of circumstances that would change the structure of partnership;

b. The adjustments that are made to the partner's accounts on admission of a New partner(s);

c. Accounting for revaluation of assets, and dissolution of partnership;

d. The various treatments of goodwill in partner's accounts; and

e. The Accounting entries necessary to close the existing partnerships and forma new one.

7.1 Changes in the Structure of Partnership

The structure of a partnership can change as a result of admission of more partners, retirement of a partner or death of a partner. In any of the three events, the partnership structure would have changed. Before we take the three events one by one, it is necessary to consider two important issues that usually affect changes in structure of partnership, these are goodwill and revaluation.

Irrespective of the very reason for admitting a new partner, it is required that all the existing partners should agree on the ratio of sharing both profits and losses and the amount of capital the incoming partner should contribute.

7.2 Goodwill

"Goodwill is that which enables business to earn super-normal profit, because of the reputation or special advantages which the business engages with the rest of the world". It is also defined as "the difference between the value of the business as a whole and the aggregate of a fair value of its separable net assets".

The goodwill a firm has may be due to the following:

a. Superior management skills of its top management
b. The possession of efficient and dedicated employees;
c. Advantageous or strategic location of the firm;
d. The nature of the firm's services or products;
e. Possession of favourable contract, trade marks, patents and others;
f. High quality of goods or services; and
g. Effective and efficient advertising campaign.

Goodwill is an intangible asset. Where it is internally generated. It is normally not recorded in the books. If it is unrecorded it means that the partners interests in the business have been understated.

7.3 Accounting for Goodwill

There are many different ways of calculating internally generated goodwill. At this stage you would learn the bookkeeping aspects and leave the valuation out.

There are two cases

a. Goodwill to remain in the books**:**

Debit Goodwill Account

Credit Capital Accounts of partners in the old firm in the existing profit sharing rates

b. If the goodwill is not to be in the books:

Debit Goodwill Account

Credit Capital Accounts of partners in the old firm in the old profit sharing ratios.

Debit Capital Accounts of partners in the new firm in the new profit sharing ratio

Credit Goodwill Account

To close the account

Illustration 7.1

Panyin and Kakrah are partners in a firm and share profits and losses equally. Their capital accounts have the following balances. Panyin ¢25,000,000; Kakrah ¢15,000,000. On 1/9/2006 they admitted Olu as a partner and agreed on profit sharing ratio as $^{2}/_{5}$%, $^{2}/_{5}$%, and $^{1}/_{5}$% for Panyin, Kakrah and Olu respectively.

Goodwill has been valued at ¢18,000,000 but has not been recorded in the books of the partnership. Olu paid into the firm's bank account an amount of ¢35,000,000 as his capital

Show the bookkeeping entries to record the above transactions:

(a) If goodwill is to remain in the books

(b) If goodwill is not to remain in the books

SOLUTION TO ILLUSTRATION 7.1

	Panyin	**Kakrah**	**Olu**		**Panyin**	**Kakrah**	**Olu**
	ÿm	**Ÿm**	**ÿm**		**ÿm**	**ÿm**	**ÿm**
				1/9/2006 Bal. b/d	25	15	-
1/9/2006	34	24	35	1/9/2006 Bank	-	-	35
				1/9/2006 Goodwill	9	9	9
	34	24	25		34	24	35
				Bal	34	24	35
				b/d			

Goodwill
Account

1/1/2006 Partners" Capital Account ¢m ¢m

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(b) If Goodwill is not to remain in the books

In this case, in effect the goodwill account is to be closed against the partners" accounts

in the new profit sharing ratio. The full accounts would be as follows:

Capital
Accounts

	Panyin	**Kakrah**	**Olu**		**Panyin**	**Kakrah**	**Olu**
	ÿm	**ÿm**	**ÿm**		**ÿm**	**ÿm**	**ÿm**
1/9/2006 Goodwill	7.2	7.2	3.6	1/1/2006 Bal b/d	25	15	
Bal. c/d	26.8	16.8	31.4	1/9/2006 Bank	-	-	35
				1/9/2006 Goodwill	9	9	-
	34	24	35	34	24	35	
				Bal. b/d	26.8	16.8	31.4

Goodwill Accounts

	¢m		**¢m**
1/9/2006 Partners Capital Accounts	18	1/9/2006 Partners Capital Account	18

7.4 Revaluation of Assets and Liabilities

Since partnership by its very definition implies the carrying on of business by more than one person for the purpose of making profit, it is desirable and necessary that the true interest of each partner in the firm, as far as possible is shown.

To be able to do this, the accounts of the partners must be adjusted periodically to reflect the financial position of the firm. Some of the assets of the firm may have either appreciated or deteriorated in value. Note that the partners" capitals must be equal to the net worth of their business. The net worth must also be equal to the net assets.

The "true" net assets would depend on a realistic valuation of the assets and liabilities. Hence, it is necessary to review the values of these assets and liabilities of the firm whenever there is a change in the partnership.

7.5 Bookkeeping in Respect of Revaluation

If an asset is revalued, three situations can arise. The asset may increase in value, decrease in value or the value placed on it may be the same as the book value. If the value does not change, there will not be any bookkeeping entries to be made. If there is an increase in value, you need to debit the Asset account with the difference between the previous value and the new value and credit the Revaluation Account.

On the other hand, if there is a decrease in value, the Revaluation Account in respect of the asset. This is done by debiting the Provision Account and crediting the Revaluation Account and credit the partners Capital Accounts. If there is a capital loss on revaluation, debit the Capital Account and credit Revaluation Account.

Let us illustrate the above points with the following question:

Illustration 7.2

Mensah and Babatunde have been partners for some time. On 26th March 2006, they decided to admit Shola. So they invited a valuer to revalue the assets of the partnership.

The Statement of Financial position of Mensah and Babatunde as at 31st March 2006, was as follows:

Non-Current Assets	Cost	Depreciation	Net Book Value
	¢000	¢000	¢000
Freehold Property	7,600	2,850	4,750
Plant & Machinery	4,275	2,375	1,900
Motor Vehicles	3,610	2,185	1,425
	15,485	7,410	8,075
Current Assets:			
Inventories		1,330	
Receivables		1,140	
Bank and Cash		7,125	
		9,595	
Less Acct. Payable		4,485	5,110
			13,185
Capital Accounts			
Mensah			4,800
Babatunde			4,800
Current Account:			
Mensah			1,585
Babatunde			2,000
			13,185

The new valuations were as follows:

¢000

Freehold Property	9,500
Plant and Machinery	1,425
Motor Vehicles	1,140

It was also agreed that provision for doubtful debts should be made to 2½ of receivables. Creditors agreed to receive ¢3,000,000 for full settlement of their interest.

Required:

(a) Pass the necessary journal entries to give effect to the revaluation of the assets.

(b) Show the Partners Capital Accounts

(c) Show the Revaluation Accounts

Solution 7.2

Note:

Let us note that in the accounts proper, fixed assets are usually shown at cost or revalued amounts. Hence, the net assets shown in the balance sheet would not have any T accounts. Therefore, it would be necessary to close the provision on Revaluation Account. We would then be left with the assets accounts.

Compare the balances on the assets accounts with the revalued figures. If the revalued amounts are higher, it means the assets have increased in value. The only way to record increases in the assets accounts is to debit the accounts with the difference. In the same way, to record a decrease in an asset account, you need to credit the asset account. To complete the double entry you need to pass the other entry through the Revaluation Account.

On receivables, a 2½% of provision has to be made. So let us debit the Revaluation account with ¢28,500 and credit Provision for Doubtful Debt Account with the same amount.

(a) Debit: Provision for depreciation:

	¢000	¢000
1. Freehold Property	2,850	
Plant and Machinery	2,375	

Motor Vehicles	2,185	
Credit: Revaluation Account		7,410
To close the provisions on depreciation accounts		
2. Debit: Freehold Property	1,900	
Credit: Revaluation Account		1,900

To record increase in the balance on freehold property

3. Revaluation Account	5,348.5
Plant and Machinery	2,850
Motor Vehicles	2,470
Provision for doubtful debt	28.5

Being adjustment needed to reflect the revalued amounts

4. Payables Account	1,485
Revaluation Account	1,485
To record the decrease in the payable balance	
5. Debit: Revaluation Account	5446.5
Credit: Partners‟ Capital Account	5446.5

To close off the Revaluation Account

(b) **Revaluation Account**

	¢000		¢000
Plant and Machinery	2,850	Provision on Depreciation	7,410
Motor Vehicles	2,470	Freehold Property	1,900
Provision for doubtful debts	28.5	Creditors Account	1.485
Partners Capital Accounts			
Mensah	2,723.25		
Babatunde	2,723.25		
	10,795		10,795

Capital Accounts

	Mensah	Babatunde	Mensah		Babatunde
	¢000	¢000	¢000	¢000	
Bal c/d	7,523.25	7,523.25	Balance b/d	4,800.00	4,800.00
Revaluation	2,723.25	7,523.25			
	7,523.25	2,723.25		7,523.25	7,523.25
b/d	7,523.25	7,523.25			

7.6 ADMISSION OF A NEW PARTNER

A new partner may be invited to join a partnership for various reasons. It may be that the firm has expanded its operations so much that the existing partners feel they need an additional person with some skills. It may also be that more capital is required to take advantage of opportunities to expand the business. At times a new partner may be admitted to replace an outgoing partner, whether due to death or retirement.

For whatever reason for admitting a new partner, it is necessary to take account of the following:

a. Change in terms of the partnership agreement with particular reference to capital contribution and profit and loss sharing ratios.
b. Revaluation of the assets of the firm in order to reflect the true values of the assets; and
c. Put a value on the goodwill the firm has required.

It is only fair to adjust the books to ensure that the balances on the partners‟ capital represent a fair value of each partner`s interest in the partnership. This will mean that if there are undisclosed assets and liabilities, they should be reflected in the books. This may take the form of recognizing the existence of goodwill or revaluing the assets of the partnership. So long as you remember how to account for goodwill, revaluation of assets and liabilities, there would be very little difficulty in accounting for admission of additional partners.

Let us illustrate the necessary accounting treatment with an example:

Illustration 7.3

Gyamfi and Lawal were in partnership sharing profits and losses equally. As a result of expansion of business, they decided to admit Ekiti who contributed N65,000 as his capital. The partners agreed that the ratio of sharing profits and losses should be Gyamfi $^2/_5$, Lawal $^2/_5$ and Ekiti $^2/_5$. The balance sheet of the partnership was as follows:

Statement of Financial Position As At The Date Of Admission

	₦000		**₦000**
Capital Accounts:			
Gyamfi	75,000	Non-current assets	
Lawal	75,000	Plant and Machinery	120,000
		Motor Vehicle	65,000

Current Accounts:

Gyamfi	20,000	Current Assets:	
Lawal	30,000	Inventory	45,000
		Receivables	58,000
		Cash	4,000

Current Liabilities:

Payables	52,000		
Overdrafts	40,000		
	292,000		292,000

The following information were to be taken into account:

1. On the admission of Ekiti the following revaluations were made: Plant and machinery ₦250,000,000, Motor Vehicle ₦80,000,000, Inventory ₦40,000,000 Receivable ₦45,000,000
2. Goodwill had been estimated at ₦45,000,000 but it should not be kept in the books.
3. Suppliers had given the partnership a discount of ₦6,000,000

You are required to prepare the following accounts: (a)
Revaluation Account
(b) Partners Capital Accounts
(c) Statement of financial position immediately after the admission of Ekiti.

Solution 7.3

Goodwill was not shown on the Statement of Financial Positon. The only reason for its estimation was to ensure that the old partners are compensated. Hence, the Capital Accounts of the old partners should be adjusted. In the same way, the net effect of the revaluation of the assets and liabilities should be for the benefits or to the detriment of the existing partners.

In writing off the goodwill, the new partner would be affected.

Revaluation Account

	N000		N000
Inventory	5,000	Plant & Machinery	130,000
Receivables	13,000	Motor Vehicle	15,000
		Goodwill	45,000
Capital Accounts:		Suppliers (Payable)	6,000
Gyamfi	89,000		
Lawal	89,000		
	196,000		**196,000**
Goodwill Account	45,000		
		Gyamfi	18,000
		Lawal	18,000
			9,000
	45,000	**Ekiti**	**45,000**

Partners Capital Accounts

	Gyamfi	Lawal	Ekiti		Gyamfi	Lawal	Ekiti
	₦000	₦000	₦000		₦000	₦000	₦000
Revaluation Account	18,000	18,000	9,000	Balance b/d	75,000	75,000	-
Bal. c/d	146,000	146,000	56,000	Bank	-	-	65,000
				Revaluation A/c	89,000	89,000	-
	164,000	164,000	65,000		164,000	164,000	65,000
				b/d	146,000	146,000	56,000

Gyarafi, Lawal & Ekiti

Statement of Financial position (After the revaluation)

		N`000		N`000
Capital Accounts:			Non-current assets	
	Gyamfi	146,000	Plant & Machinery	250,000
	Lawal	146,000	Motor Vehicle	80,000
	Ekiti	56,000		330,000
		348,000	Current Assets:	
			Inventories	40,000
Current Accounts:			Receivables	45,000
	Gyamfi	20,000	Bank and Cash	69,000
	Lawal	30,000		154,000
	Ekiti	50,000		
Current Liabilities				
	Payables	46,000		
	Overdraft	40,000		
		484,000		**484,000**

7.7 RETIREMENT AND DEATH OF A PARTNER

A partner may retire from a partnership for many reasons. Indeed, when a partner dies, he has effectively retired from the partnership. For purposes of accounting, the reasons for retirement would not be important. Usually, the partnership deed, if it is properly drawn, would provide the necessary guidelines as to how the affairs between the partners should be settled. In the absence of specific guidance from the partnership agreement, the normal rules are as follows:

a. Prepare a Profit and Loss Account to the date of retirement/death. Note that retirement/death might not coincide with the end or beginning of the accounting period. Hence the results of the operation to the date of retirement/death must be shared i.e. credited to the partners Capital Accounts in their profit sharing ratios. If the result is a loss, the partners Capital Accounts must be debited accordingly;

b. Transfer the balance on the current account of the retiring partner to the Capital Account;

c. Credit/debit the outgoing partner with his share of the difference between the net revalued amount of the assets and the book value; and

d. Credit the outgoing partner with his share of goodwill of the firm, if any.

e. The credit balance on the retiring partner's account becomes a liability to the firm which should be settled. The partnership deed would give an indication of how the settlement of the retiring partner should be dealt with.

Illustration 7.4

Yekini, Olu and Essien formed a partnership in 1990 and agreed to share profits or losses in the ratio 4:3:3. Olu decided to retire on 31/12/2005 due to both ill health and misunderstanding between the partners. The Statement of financial position as at 31/12/2005 was as shown below:

Statement of financial position as at 31/12/05

	¢m	¢m
Non-current Assets:		
Freehold Land and Buildings	540	
Machinery	180	
Office Equipment	45	
Motor Vehicles	105	
		870
Current Assets:		
Inventory	100	
Receivable	125	
Bank	23	
		248
Current Liabilities:		
Payables	158	
Bank Overdraft	30	

	188
	60
	930
Capital Accounts:	
Yekini	420
Olu	300
Essien	210
	930

The partners noted that the account did not reflect the following:

a. Interest on the following drawings should have been charged at 5%.

	¢m
Yekini	60
Olu	60
Essien	60

b. Interest on partners Capital Account at 6% had not been credited. Partners account for the purpose of the interest calculation was to be taken as follows: Yekini ¢210m; Olu ¢105m.

c. Olu received ¢24 million payable by cheque immediately.

d. Goodwill was valued at ¢300 million and was to be kept in the books.

e. Other assets and Liabilities were revalued as follows:
Freehold Land and Buildings ¢600 million. Machinery ¢ 240 million; Office Equipment ¢35 million and Motor Vehicles ¢156 million.

f. Discount to be received from creditors amounted to ₦27 million.

g. 20% of the debtors was irrecoverable, whilst 15% of stock was obsolete

h. The balance due to Olu was to be kept in the firm as a loan.

Required:

Prepare the Revaluation Account, the Partners Capital Accounts and the Adjusted Balance Sheet on 31/12/2005.

Solution 7.4

Note the import of notes b, e, and f carefully

Revaluation Account

	¢m		¢m
Office Equipment	10	Freehold Land and Building	60
Receivables	25	Machinery	60
Inventory	15	Motor Vehicles	51
Bal. c/d	448	Goodwill	300
		Payables	27
	498		498
Capital Accounts:			
Yekuni (4/10)	179.2		
Olu (3/10)	134.4	Bal. b/d	448
Essien(3/10)	134.4		
	448.0		448.0

Partners‟ Capital Accounts

	Yekini	Olu	Essien		Yekini	Olu	Essien
	ÿm	ÿm	ÿm		ÿm	ÿm	ÿm
Interest on Drawings	3.0	3.0	3.0	Balance b/d	420.0	300.0	210.0
Bank		24		Revaluation A/c	179.2	134.4	134.4
P &L Appr. A/c	7.56	5.67	5.67	Interest on Capital			
Bal. c/d	601.24	410.73	342.03		12.6	9.0	6.3
	611.8	443.4	350.7		611.8	410.73	350.7
				B/d	601.24	410.73	342.03

Yekini, Essien & Co

Statement of financial position as at 31/12/2005300

	¢m	¢m	¢m
Non-current Assets			
Goodwill		300	
Freehold, Land and Buildings		600	
Machinery		240	
Motor Vehicles		156	
Office Equipment		100	
Current Assets:			
Inventory	85		
Receivable	100		
		185	
Current Liabilities:			
Payable	131		
Bank Overdraft	31	162	
			23
			1,354
Non-current Liabilities (Loan)			(410.73)
			943.27
Capital Accounts:			
Yekini	601.24		
Essien	342.03		943.27

Workings:

Statement of Income Distribution

Interest on Capital:	¢m	Interest on Drawing		¢m
Yekini	12.6	Yekini		3
Olu	9.0	Olu		3
Essien	6.3	Essien		3
				9
		Share of Balance		
		Yekini	7.56	
		Olu	5.67	
		Essien	5.67	18.9
	27.9			27.9

7.8 AMALGAMATION OF PARTNERSHIPS

Two separate partnerships may decide to merge into one firm. The reasons may include the following:

The partners of each firm believe that coming together would bring economies of scale or they might have worked together in the past, or the businesses are similar, or they are complimentary. It may often due to the existence of variety of skills, expertise and experience concentrated in one firm.

So far as accounting for the amalgamation goes, the main point to note is that the accounts of the two firms would need to be adjusted to ensure that the capital accounts are fairly stated in their individual books before the amalgamation.

In order to fairly state the balances of each partner's account, the assets may be revalued and goodwill may need to be recognized.

Let us illustrate some of the points

Illustration 7.5

Eghan and Adepate are partners in the firm of Egapate & Co. sharing profits and losses equally. Shola and Boafo are partners in the firm of ShoBoafo & Co and share profits and losses in the ratio 3/5 amd 2/5 respectively.

The partners of each firm agree to amalgamate under the new name EgaSho & Co.
The profits and losses in the new firm will be shared as follows:

Eghan	25%
Adepate	30%
Shola	25%
Boafo	20%

Statement of Financial position are:

	Egapate	ShoBoafo
Non-current	¢m	¢m
Assets	120	160
Inventory	8	24
Cash	10	5
	138	189
Capital Accounts:		
Eghan	100	
Adepate	38	
Shola		99
Boafo		90
	138	189

For the purpose of the amalgamation, the assets were revalued as follows:

	Egapate	SholaBoafo
	¢m	¢m
Non-Current Assets	180	200
Inventory	12	16
Goodwill	80	320

The new partnership does not want to show goodwill in its balance sheet. The capitals of the partners in the new firms are to be:

	¢m
Eghan	100
Adepate	150
Shola	300
Boafo	250

Required:

a. The Capital Accounts of the partners.

b. The Opening Statement of financial Position of Egasho & Co.

Solution 7.5

Before the amalgamation, it is necessary to adjust each partners account to reflect his true interest in the business. Since goodwill will not be shown in the books of the new partnership, the total goodwill (80 + 320) should be written off against the four partners in their new profit and loss sharing ratio. The question did not ask for a revaluation account but it will be advisable to prepare one.

Revaluation Account of Egapate & Co.

Capital Accounts:	¢m		¢m
Eghan	72	Non-Current Assets	60
Adepate	72	Inventory	4
		Goodwill	80
	144		144

Revaluation Account of Shoboafo & Co.

	¢m		¢m
Inventory	8		
Capital Accounts:			
Shola	211.2		
		Non-Current Assets	40
Boafo	140.8	Goodwill	320
	360		360

	Eghan	Adepate	Shola	Boafo		Eghan	Adepate	Shola	Boafo
	ÿm	ÿm	ÿm	ÿm		ÿm	ÿm	ÿm	ÿm
Goodwill	100	120	100	80	Balances b/f	100	38	99	90
Bal c/d	100	150	300	250	Revaluation	72	72	211.2	140.8
					Bank	28	160	89.8	99.2
	200	270	400	330		200	270	400	330
					b/d	100	150	300	250

Statement of financial position Egasho & Co.

	¢m
Non-Current Assets	380
Inventories	28
Cash	392
	800
Capital Accounts:	
Eghan	100
Adepate	150
Shola	300
Boafo	250
	800

7.9 Dissolution of Partnership

Partners of a firm may decide to dissolve the firm for various reasons. The reasons may include the following:

- The death of a partner
- The bankruptcy of a partner
- The lunacy of a partner

Whatever the cause of the dissolution, the following steps are necessary:

- Transfer all non cash assets to the Realization Account by debiting the Realization Account with the book value of the assets and crediting the Assets Accounts with the same.
- Debit the Realization Account with all relevant expenses and credit Cash or Bank Account.
- Debit Bank or Cash with proceeds assets and credit Realization Account.
- Assets taken over by any partners must be debited to the partners Capital Account and Realization Account credited with the agreed price.

- Pay off liabilities by crediting Bank or Cash and debiting the Liability Account. Any discount allowed by creditors must be debited to the Creditor's Accounts and credited to the Realization Account.
- Close the Realization Account to the Partner's Capital Accounts.
- Pay off the Partner's current accounts to their capital accounts, by debiting the Current Accounts and crediting Partner's Capital Accounts.
- Close off the Partner"s Capital Accounts by paying the amount due to them by receiving the amount due from them.

Let us illustrate the above points

Illustration 7.6

John David and Ajomale have been partners for some time, making up their account to 30th September every year. The following was their balance sheet as at 30th September 2006.

Non-current Asset	¢m	¢m	¢m
Leasehold Properties		550	
Motor Vehicles		220	
Furniture and fittings		150	
		920	
Current Assets:			
Inventories	420		
Receivables	350	770	
		1690	
Current Liabilities			
Trade payables	390		
Bank Overdraft	91	481	
	289		
		1,209	

Loan from Amogu		305
		904
Capitals:		
John	225	
David	200	
Ajomale	275	700
Current Accounts:		
John	75	
David	50	
Ajomale	49	174
		904

The partners share profits and losses in the ratio 2:2:1. On 30 September 2006, they agreed to dissolve the partnership. John took over one of the vehicles which had a book value of ¢80m at a valuation of ¢150m. Mr. Ajomale took over half of stock for ¢250m. The leasehold properties, the remaining vehicle, fixtures and fittings realized ¢720m. Receivable realized ¢320m. After paying the trade payables in full, the partners received the monies due them on capital account or paid what was due to the firm from them.

Required:

1. Show the Realization Account
2. The Bank Account
3. The partner's Capital Accounts

Solution to Illustration 7.6

Realization Account

	¢m		¢m
Sundry Assets:			
Leasehold Properties	550	Capital Accounts:	
Motor Vehicle	220	John	150
Furniture and Fittings	150	Ajomale	250
Account Receivables	350		
Stocks	420		
		Bank:	
		Sundry Assets	720
		Account Receivables	320
		Capital Accounts:	
		John	100
		David	100
		Ajomale	50
	1,690		1,690

Partners Capital Accounts

	John	David	Ajomale		John	David	Ajomale
	ÿm	ÿm	Ÿm		ÿm	ÿm	ÿm
Assets taken over	150	-	250	Balance b/d	255	200	275
Realization	100	100	50	Current A/c	75	50	49
Bank	80	150	24				
	330	150	324		330	250	324

Bank Account

	¢m		¢m
Sundry Assets	720	Balance B/d	91
Account Receivables	320	Loan Account	305
		Account Payable	390
		Partners Accounts:	
		John	80
		David	150
		Ajomale	24
	1,040		1,040

7.10 Conversion of a Partnership to a Limited Company

When a partnership is converted to a Company, the partnership is dissolved. The former partners may become shareholders in the company or not. The price put on the firm is known as the purchase price or the purchase consideration. The purchase consideration can be settled by cash, by issue of shares to the partners or by issue of debentures. It could also be partly by cash and shares or partly by shares and partly by debentures. It could also be partly by cash and shares or partly by shares and partly by debentures or by a combination of the three. In order to retain their comparative positions in the shareholding in the new company, the shares could be divided in the partners" profit sharing ratio and the balances in their capital accounts are settled through either cash being paid by or received from the dissolution.

It is obvious that since the partnership would cease forthwith, the Realization Account and the Capital Accounts of partners would be used. Indeed, the accounting treatment of the sale of the partnership would be akin to the entries passed when considering the dissolution of partnership.

Note that the settlement of the purchase would cease forthwith, the Realization Account and the Capital Accounts of partners would be used. Indeed, the accounting treatment of the sale of the partnership would be akin to the entries passed when considering the dissolution of partnership.

Note that the settlement of the purchase consideration would necessitate the following:

1. Treat the purchaser as a Receivable: That is, debit the Purchaser and credit the Realization Account.
2. Payment by cash. Debit Bank Account and Credit the Purchaser
3. Payment by issue of shares. Debit Ordinary Shares in Purchaser Name and Credit the Purchaser.
4. Payment by issue of debentures. Debit Debenture in Purchaser's Name and Credit Purchaser.
5. Closure of Partners Capital Account.

Debit Partners" Capital Accounts and Credit Bank, Ordinary Shares, Debentures in Purchaser's Account with appropriate amounts.

You should remember that in this instance the purchaser is a limited liability company. Let us illustrate the bookkeeping aspects with a question.

Illustration 7.7

Olu, Mosho and Aryee have been in partnership for several years sharing profits and losses in the ratio 5:3:2 respectively. On 1/1/2006 they decided to convert their business into a limited liability company Olumosho Ltd, on the same date. The statement of financial position at the close of business on 31/12/2005 was as shown below:

Statement of Financial Position as at 31/12/2005

		Olu	Mosho	Aryee
Total				
	¢000	¢000	¢000	¢000
Capital Account	36,000	24,000	18,000	78,000
Current Account	1,560	1,920	840	4,320
Loan	2,000	2,000	2,000	2,000
	39,560	27,920	20,840	88,320

Freehold buildings	36,000
Vehicles (Cost less Depreciation)	14,400
Equipment (Cost Less Depreciation)	7,500
Inventories	18,375
Receivables(Less provision for doubtful debt)	14,445
Bank	6,600
	97,320
Less Payables	9,000
	88,320

Apart from the cash and one of the vehicles, all assets and liabilities were taken over by the company. Mr. Aryee took over one of the vehicles at a valuation of ¢6,000,000. The purchase consideration was calculated as follows:

	¢000
Freehold buildings	69,000
Vehicle	7,200
Equipment	4,800
Inventories	12,000
Receivable	13,800
Goodwill	24,000
	130,800
Trade payables	9,000
	121,800

The company was to issue fully paid shares of ¢1,000 each to meet the purchase consideration.

Required:

Close the books of the partnership on the assumption that realization expenses was ¢5,000,000.

Solution to Illustration 7.7

Realization Account

		¢000		¢000
Expenses		5,000	Capital (Car taken over by Aryee)	6,000
Freehold buildings		36,000		
Vehicles		14,400	Olumosho – Ltd	
Equipment		7,500	Purchase Consideration	121,800
Inventories		18,375	Trade payables	9,000
Receivables		14,445		
Bal c/d		41,080		
		136,800		136,800
			Bal b/d	41,080
Capital Accounts				
Olu	20,540			
Mosho	12,324			
Aryee	8,216	41,080		
		41,080		41,080

	¢000			¢000
Realization	121,800	Shares in Olumosho Ltd:		
			Olu	60,900
			Mosho	36,540
			Aryee	24,360
	121,800			121,800
	211,800			

Shares in new Company

Olu	60,900
Mosho	36,540
Aryee	24,360

Partners‟ Capital Accounts

	Olu	Mosho	Aryee		Olu	Mosho	Aryee
	ym	ym	ym		ym	ym	ym
Realization – Car	-	-	6,000	Balance b/d	36,000	24,000	18,000
Shares Olumosho	60,900	36,540	24,360	Current A/c	1,560	1,920	840
Cash	-	1,704	-	Realization	20,540	12,324	8,216
	60,900	38,244	30,360	cash	60,900	38,244	30,360
				Bank a/c	2,800	3,304	3,304

Bank Account

	¢000		¢000
Bal. b/f	6,600	Realisation Expenses	5,000
Olu‟s Capital A/c	2,800	Partners Loan A/cs	6,000
Aryee‟s Capial A/c	3,304	Mosho‟s Capital A/c	1,704
	12,704		12,704

7.11 Chapter Summary

Surpluses and deficits on revaluation will be transferred to a revaluation account. The balance on this account must be shared between the partners in their profit sharing ratio.

Goodwill is an intangible asset; it is the value placed upon the ability of an organization to earn supernormal profits. Any value placed on unrecorded goodwill can be adjusted for by contra entries on the partners‟ capital accounts.

If there is a change in partnership pathway through an accounting period, the profit up to the date of the change will be shared between the old partners in accordance with the old agreement.

Note that a realization account will record the book values of assets disposed of and the proceeds realized. The profit or loss on disposal will be shared between the partners in their profit sharing ratio. The partners" capital accounts will be debited with the value placed upon assets they receive from the firm and with the final cash settlement.

7.12 Multiple Choice and Short Answer Questions

Use the following information to answer questions 1 and 2.

Shola and Bada are in partnership and share profits in the ratio 2:3 on 1 September 2010, a new partner; Carol joins the business introducing N24 million capital.

The following also take place at this date

A. Goodwill is valued at N80 million

B. The profit share ratio is to be 3:6:1

C. Property is re-valued upwards by N70 million

Shola had a balance of N90m credit prior to adjusting the accounts. Goodwill is not retained in the business.

1. Calculate the total amount of goodwill and revaluation surplus credit into Bada"s Capital Account.

   A. N32m

   B. N42m

   C. N48m

   D. N60m

   E. N90m

2. What is the balance in Shola's Capital account after all adjustment?

   A. ₦112m

   B. ₦118m

   C. ₦126m

   D. ₦136m

   E. ₦150m

Use the following information to answer questions 3 and 4

Joe, Okon and Koko were in partnership, sharing profits in the ratio 1: 1: 2 respectively. The capital balance after the partnership was dissolved and all accounts closed were:

Joe ₦40 million Credit

Okon ₦60 million Credit

Koko ₦50 million Debit

3. State how Koko‟s debit balance should be accounted for if he is not insolvent.
4. How much would Joe contribute to the deficiency of Koko, assuming that Koko is insolvent?
5. When a partnership is converted to a Company, the purchase consideration could be in form of (i) Cash and (ii)……………………
6. What is the accounting entry for asset taken over by a partner, when a partnership is dissolved?
7. When a partner retires, the balance in his capital account after all adjustments has been completed is transferred to………………account.

7.13 SOLUTIONS

1. B
2. C
3. Koko deficit would be settled from the surplus in his private estate
4. N20 million (40/100 x N50m) The rule in Garner V Murray
5. Ordinary Share Capital account
6. Debit the partner's Capital account

   Credit the Realisation account
7. Bank Account

Tutorial

Question 1

Bada

Share of goodwill $^3/_5 \times {}^{80}/_1$	= 48
Share of revaluation surplus $= {}^3/_5 \times {}^{70}/_1$	42
	90
Goodwill written back $^6/_{10} \times 80$	48
	42

Shola

Capital b/f	90
Share of Goodwill 2/5 x 80	32
Share of surplus 2/5 x 70	28
Goodwill written back = 3/10 x 80	(24)

CHAPTER EIGHT

INTRODUCTION TO COMPANY ACCOUNTS

CHAPTER CONTENT

a. Introduction

b. Types of companies

c. Public and Private Companies

d. Differences between Companies and Partnerships

e. Procedures required for formation of Companies

f. Capital Structure of a Company

g. Debentures; and

h. Accounting for issuing of shares.

8.0 OBJECTIVES

At the end of this chapter, it is expected that readers should:

a. Know the various types of companies;

b. Know the different types of shares issued by companies;

c. Understand how Limited Liability Companies differ from Sole Trader and Partnerships;

d. Be able to differentiate between shares and debentures; and

e. Understand how to account for issue, forfeiture, and re-issue of shares.

8.1 INTRODUCTION

A company is a legal entity created by the association of two or more persons in accordance with the provisions of company law. The relevant law for the registration and operation of companies in Nigeria is the Companies and Allied Matters Act (CAMA), CAP C20 LFN 2004.

8.2 TYPES OF COMPANIES

There are three (3) main types of companies which may be constituted and incorporated under Companies and Allied Matters Act (CAMA CAP C20 LFN 2004.

a. Company limited by shares

b. Company limited by guarantee

c. Unlimited company

8.2.1 Company Limited By Shares

This is a company having the liability of its members limited by the MEMORANDUM OF ASSOCIATION to the amount (if any) unpaid on the shares held by them. Once capital is fully paid up, there is no further liability on the shareholders.

Majority of the companies registered by the Corporate Affairs Commission are limited by shares.

8.2.2 Company Limited By Guarantee

This is a company having the liability of its members limited by the memorandum to such an amount as members may respectively undertake to contribute to the assets of the company in existence.

8.2.3 Unlimited Company

This is a company not having any limit on the liability of its members, i.e. every shareholder is liable to the debt of the company in the event of liquidation as in ordinary partnership

8.3 PUBLIC AND PRIVATE COMPANIES

There are two classes of companies in Nigeria namely:

a. Private Company

b. Public Company

However, in Nigeria, private companies far out-numbered the public companies.

8.3.1 Private Company

Section 22 of the CAMA CAP C20 LFN; 2004 defines a private company as a company which possesses the following qualities:-

a. The company shall by its articles restrict the transfer of its shares;

b. Number of shareholders is limited to 5 excluding persons who are bonafide in the employment of the company;

c. The company is prohibited from making any invitation to the public to subscribe for its shares or debentures; and

d. The minimum membership is two(2).

8.3.2 Public Company

Section 24 of the CAMA CAP C20 LFN; 2004 defines a public company as any company other than a private company. Therefore a public company fulfils the following conditions:

a. Its memorandum states that it is a public company and has been registered as such; and
b. Minimum member-ship is seven and there is no maximum

8.3.3 Name of Company

Section 29 of CAMA CAP C20 LFN; 2004 The name of a private company limited by shares shall end with the word "**Limited" ("LTD").**

The name of a public company limited by shares shall end with the words **"Public Limited Company" ("PLC").**

The name of companies limited by guarantee shall end with the words **("Limited by Guarantee")** in brackets (**"LTD/GTD").**

The name of an unlimited company shall end with the word **"Unlimited" ("ULTD").**

8.4 DIFFENRENCES BETWEEN COMPANIES AND PARTNERSHIP

S/NO	COMPANIES	PARTNERSHIP
a.	Companies are separate legal entities	Partnership are not
b.	Liabilities of members are limited to the amount contributed	Liabilities of partners are unlimited.
c.	Minimum number of members for private companies is two (2) and for public companies is seven (7) the maximum number for private is (50) and no limit for public companies.	Minimum number for partnership is two(2) and maximum is 20 except for professional firms.
d.	Only shareholders who are Directors of the Company can form part of the management team of the company	All partners may be involved in the management of the partnership business.
e.	Activities of the company are regulated by Memorandum and Articles of Association.	Activities of the partnership are regulated by partnership agreement or partnership deed.
f.	Statutory audit of financial statements required for companies	Statutory audit not required for partnership business.
g.	Capital of company is fixed by Memo & Articles and can only be increased by passing a resolution	Capital of the partnership is fixed by partners.
h.	Companies can sue or be sued in companies name.	Partnership firm cannot sue or be sued. The name of the affected partner must be mentioned in any law suit involving the firm
i.	Companies have perpetual succession that is they do not cease to exist upon the death of any of the shareholders	Partnership firm is dissolved upon the death of any of the partners.

8.5 PROCEDURE REQUIRED FOR FORMATION OF COMPANIES

(a) Promoters embark on scheme of capitalization with the following in mind:

i. Assets to be purchased

ii. Cost of formation; and

iii. Working capital requirement

(b) Promoters may need to approach financier (Issuing House) with the aim of underwriting the issue in the case of a public company. This may not be necessary for private companies.

(c) A Solicitor may prepare all contracts relating to the purchase of Assets and underwriting of share issues; and

(d) A Solicitor will prepare some documents to be filed with the registrar of companies at the Corporate Affairs Commission (CAC) which includes:-

i. Memorandum and Articles of Association

ii. Declaration of compliance with requirement/provision of Companies and Allied Matters Acts etc.

e. All the above documents are then lodged with Corporate Affairs Commission for the purpose of registration, after which the Commission will issue.

Certificate Of Incorporation to confirm the registration.

8.5.1 Content Of Memorandum Of Association Of A Company

Section 27 of CAMA , CAP C20LFN; 2004 stipulates the content of the Memorandum of Association some of which include the following;

a) The name of the company ending with the word limited or guaranteed, as the case may be;

b) Location of the registered office of the company;

c) The main object(s) of the company or the nature of its business(es);

d) The number/amount of the authorized share capital; and

e) Names of subscribers to memorandum of association

8.5.2 Content of Articles of Association

Sections 33 and 34 of CAMA as well as Table a of Schedule 1 stipulate the content of Articles of Association of a Company.

This consists of the regulations governing the management of the company and its operations. Some of its contents include:

a. Registration that relates to the issue of the company shares;
b. Power/responsibility of directors;
c. Duties of shareholders;
d. Power/duties of company secretary;
e. Appointment/removal of auditors;
f. Borrowing power of directors; and
g. Winding up procedures,

8.5.3 OTHER INFORMATION RELATING TO FORMATION OF COMPANIES

(a) Preliminary Expenses:- These are costs incurred in the process of formation of a company e.g. legal costs, registration fees and other incidental operational costs.

These are usually called preliminary expenses and they are regarded as Capital Expenditure which are usually written off into statement of income over a period of time.

(b) Prospectus:- These are documents issued by public companies inviting members of the public to subscribe for shares and debentures of the company.

A Prospectus is usually signed by Directors of the company or promoters and it usually contains the following information.

(i) Number of shares to be issued by the company;
(ii) Financial summary of past activities of the company;

(iii) Profit forecast and reporting accountants" report;

(iv) Legal information relating to issue of shares.

8.6 Capital Structure Of Companies

Companies are financed by:

a. People who take equity or risk in the company. Such people are referred to as Shareholders or Members.

b. People or institutions who lend money to the company. Such individuals are referred to as payables debenture holders.

It is customary to classify these funds into several categories depending on the terms of the issue as highlighted below:

8.6.1 Ordinary Share Capital

These funds are provided for an indefinite period by the investors. This class of investment fund is also called Equity.

Ordinary shares possess the following features:

a. Holders of ordinary shares normally control the company through their power to vote at meetings to elect directors, appoint auditors and amend the Memorandum and Articles of Association;

b. Holders of ordinary shares are entitled to dividend, the amount of which depends on volume of profit earned and the availability of cash;

c. However, in the event of winding up of the company the fund invested by ordinary shareholders will not be refunded until all creditors and other categories of investors have been fully paid; and

d. Ordinary shares are sometimes classified into two categories, i.e. those having voting rights and those not having voting rights. The two classes are sometimes designated A and B ordinary shares.

8.6.2 Preference Share Capital

This class of capital is provided by persons who are partly owners and partly lenders to the company.

This class of shares possess features of owners of the business and features of lenders, some of which are highlighted below:

a. Preference shareholders are entitled to prior payment of dividend instead of interest.

b. Preference shareholders are entitled to prior payment of dividend before the ordinary shareholders.

c. However, preference shareholder have no voting rights at Annual General Meeting hence they cannot control the company like ordinary shareholders.

d. There are various types of preference share capital, some of which include the following:

(i) Participating Preference Shares:- These are preference shares that are given the right to share out of surplus income of the company.

(ii) Cumulative Preference Shares:- These are preference shares that are given the right to make claims in future for dividend not paid due to insufficient profit.

(iii) Redeemable Preference Shares:- These are preference shares that are redeemable in future

(iv) Convertible Preference Shares:- These are preference shares in which the holder has the option of converting to equity or ordinary shares in future.

8.6.3 Basis of Issuing Share Capital

(a) Authorised Share Capital

This is the amount approved by the Memorandum and Articles of Association of a company which the Company can legally raise by issue of shares (usually in the form of ordinary or preference shares).

(b) Issued Share Capital

This is the part of the authorized shares that have been issued and allotted whether or not they have been fully paid for. Issued share capital cannot exceed the authorized capital.

(c) Called- Up Share Capital

This is the cumulative portion of the nominal value of shares called up to date. This is usually includes the amount which was due on application, allotment and any subsequent calls that have been made.

(d) Paid- Up Share Capital

This is the portion of called up share capital which has actually been received from the subscribers.

8.6.4 Other Important Terminologies In Share Issues

(a) Share Premium

This is the excess amount over which the share capital of a company is issued above the nominal value.

For example: If a company with Nominal Value of N1.00 issues its shares at N1.20 the excess amount of 20k per share is the Share premium. This excess amount is normally credited to Share Premium Account. The account is considered to be a capital reserve account. It cannot be used to declare dividend, but can be used for other purposes e.g. such as writing off share issue expenses.

(b) **Bonus Issue**

This is also referred to as Capitalization issue or Scrip Issue. It is simply capitalization of reserve. These are shares issued to existing shareholders on a pro-rata basis without the shareholders making any payment for shares received.

For example: If a company issues a 1 for 2 Bonus, it means that for every two shares held by a shareholder, the shareholder will receive 1 Bonus share. Hence if a shareholder has a total ordinary shareholdings of 100,000 when a Bonus of 1 for

2 is issued it means he would receive additional 50,000 ordinary shares without paying for them to bring his total holdings to (100,000 + 50,000) = 150,000 ordinary shares.

(c) Right Issues

These are shares issued to existing shareholders at a price which is usually lower than the market price of the shares: The shareholders therefore have the following options,

(i) To take up the rights;

(ii) To sell/take up part of the rights;

(iii) Not to do anything at all.

Rights are also issued on pro rata basis to existing shareholders. For example; rights issue of 1 for 2 means that for every two shares held by existing shareholders one share would be issued to them.

Therefore, a shareholder that has 50,000 ordinary shares would be entitled to 25,000 ordinary shares as rights.

(d) **Share Discount**

These are shares issued to subscribers at a value which is lower than the nominal value of shares. Although this is not normally allowed in practice and if it is to be done certain legal procedure has to be followed.

For example: If the nominal value of a company's shares is 50k and the shares are issued at 40k per share, then the discount of the share is 10k per share.

8.7 DEBENTURES

Debentures holders are creditors to the company and they are entitled to fixed interest and not dividend because.

a. The interest is a prior charge and must be paid whether or not the business earns profit.

b. Their capital must be repaid to them in priority over other forms of capital (e.g. ordinary and preference share capital) in the event of the company winding up; and

c. There are various types of debentures some of which include:

   i. Convertible Debenture;.
   ii. Non-Convertible Debenture;
   iii. Redeemable Debenture; and
   iv. Non-Redeemable Debenture.

Usually debentures are secured with Fixed Assets or Current Assets. Hence there is usually a charge over those assets.

The charge over Fixed Assets is called Fixed Charge. While the charge over current assets is referred as Floating Charge.

8.8 ACCOUNTING FOR ISSUE OF SHARES

Book Keeping Entries For Issue Of Shares

In practice, shares are rarely issued for payment to be made by instalment. Shares are also usually not forfeited. However, these can sometimes occur hence we are giving the detailed book keeping entries to include all possible situation.

8.9 Basic Journal Entries On Issue Of Shares

There are two basic journal entries that are required when shares are issued.

a. The first step is to record the value and the amount received along with the application for shares.

b. The second Step: The second step after allotment is to transfer the nominal value of the allotment to share capital account.

c. Other Steps: Other steps will however be necessary under the following conditions:-

   i. Where shares are paid for on instalment basis.
   ii Where issues are over subscribed to the extent that excess money has to be refunded to unsuccessful applicants.
   iii. Where shares are not taken up and have to be forfeited and subsequently re- issued.

The procedure highlighted above can be illustrated as follows:

Illustration 8.1

60,000 ordinary shares at ₦1 each were issued by Arugungu & Co. Ltd. The whole issue was fully subscribed for at the Market price of N1.20k which was paid on application. After this, the shares were subsequently allotted.

Required:

Show the Journal & Ledger entries and the summary of ledger entries (i.e. the Balance Sheet Extract).

Suggested Solution

(a) Table 8.1 JOURNAL ENTRIES

		DR	**CR**
(i)	Cash/Bank	72,000	
	Application and Allotment A/c		72,000
	Being cash received from application for		
	60,000 shares at ₦1.20		
(ii)	Application & Allotment A/c	72,000	
	Share Capital Account		60,000
	Share premium account		12,000
	Being amount due at ₦1.20 on issue of 60,000		
	Shares at ₦1 share		

(b) Ledger Entries

(i) Application And Allotment Account

	₦		₦
Share Capital A/c	72,000	Cash/Bank	72,000

(ii) Ordinary Share Capital Account

	₦		₦
Bal. c/d	60,000	Application and Allotment	60,000
		Bal. b/d	60,000

(iii) Share Premium Account

	₦		₦
Bal. c/d	12,000	Application and Allotment	12,000
		Bal. b/d	12,000

(iv) Bank And Cash Account

	₦		₦
Application and Allotment	72,000	Bal. c/d	72,000
Bal. b/d	72,000		

(C) Summary Of Ledger Entries (Balance Sheet Extract)

ASSETS	₦
Cash & Bank	72,000
CAPITAL	₦
Ordinary Share Capital	60,000
Share Premium Account	12,000
	72,000

Illustration 8.2

XYZ Ltd issued 40,000 ordinary shares of 50k each at 70k per share, payable by installment on application 1 April, 2005 10k; on allotment 3 May 2005 30k and on first and final call on 1 Sept. 2005 30k.

70,000 shares were applied for. Application for 20,000 were allotted in full. Application for 40,000 shares was granted half allotment while applications for 10,000 shares were refused.

Members holding 200 shares did not pay the call. These shares were forfeited on 11 November, 2005 and sold again at 80k per share on 5 December, 2005. The company‟s financial year end is 30 June every year.

Required:

Show the Journal entries required to record the above transaction with detailed explanation in form of Tutorial notes.

Suggested Solution To Illustration 8.2

JOURNAL ENTRIES

		DR	CR
		₦	₦
(i)	Bank/Cash Account	7,000	
	Application Account		7,000
	(Being cash received from application For 70,000 shares at 10k per share)		
(ii)	Application A/c	4,000	
	Share Capital A/c		4,000
	(Being amount due at 10k/share on Issue of 40,000 shares of 50k each)		
(iii)	Application A/c	1,000	
	Cash/Bank		1,000
	(Being return of cash to unsuccessful Applicants)		
(iv)	Application A/c	2,000	
	Allotment Account		2,000
	(Being utilization of over payment by		

	Some applicants to pay for sums due)		
	As allotment		
(v)	Allotment account	12,000	
	Share capital		4,000
	Share premium A/c		8,000
	(Shares at 30k per share)		
(vi)	Cash/Bank	10,000	
	Allotment A/c		10,000
	Being cash due on allotment		
(vii)	Call A/c	12,000	
	Share capital		12,000
	(Being amount due in first call)		
(viii)	Cash/Bank A/c	11,940	
	Call A/c		11,940
	(Being cash received on first call)		
(ix)	Share capital A/c	100	
	Forfeited shares A/c		100
	(Being forfeiture of 200/shares)		
(x)	Cash/Bank A/c	160	
	Share Capital		100
	Call A/c		60
	(Being amount received on the issue of 200 forfeited Shares at 80k per share)		
(xi)	Forfeited Share A/c	100	
	Share Premium A/c		100
	(Being Premium on the issue of forfeited Shares transferred to Share Premium A/c)		

NOTES:

Shows the actual amount received from those that applied i.e. 70,000

Application at 10k per share = N7,000

Sets up application Account as a Debtors A/c which is the amount due from shareholders on application i.e. 40,000 x 10k = N4,000

Shows the cash returned to unsuccessful applicants i.e. 10,000 shares at 10k per share = N1,000

Applicants for 40,000 shares received only 20,000 shares. Extra amount paid by them i.e. (20,000 x 10k) = N2,000 was used for the amount due in allotment.

This journal sets up the total amount due in allotment i.e. 40,000 shares at 30k/share = N12,000. Note that part of it has been paid on A/c in journal (iv) above.

This shows the balance of share capital on allotment i.e. Total

amount due is	₦12,000
Amount paid via journal (iv)	₦(2,000)
Balance was paid	10,000

This shows the amount received on re-issue of the forfeited share A/c.

This shows the amount transferred from forfeited share A/c to share premium A/c as a result of share re-issued.

8.10 CHAPTER SUMMARY

This chapter has dealt with major features of incorporated companies and those features that distinguish them from unincorporated ones.

The procedure of registration of such companies has been reviewed with particular emphasis on legal and accounting documents required for such registration.

Memorandum and Articles of Association as important registration documents were also considered. Also differences between public and private companies was considered in detail.

A distinct feature of companies is that they tend to issue various types of securities to raise capital. Those considered in this chapter include ordinary shares, preference shares and debentures.

The procedure normally followed by companies when issuing shares was also considered in this chapter and the relevant accounting entries required for recording the transactions were discussed.

We consider the fact that securities may be issued at par, premium or even at a discount.

8.11 MULTIPLE CHOICE QUESTIONS

(1) A company with ordinary shares of 80k each issued shares at a price of 60k per share. This means that:-

A. The share was issued at a premium of 20k per share.

B. The share was issued at market price of 140k per share.

C. The share was issued at a discount of 20k per share.

D. The share was issued at par.

E. The share was issued at bonus.

(2) The abbreviation PLC is used by

A. Private company only

B. Public & private company

C. Public company only

D. All companies incorporated share

E. Company Limited by Guarantee

(3) When the ordinary shares of a company are over subscribed, this means that

A. Nominal value of the share is more than market price.

B. Number of ordinary shares applied for is more than the number of shares to be issued by the company.

C. The share premium of the company`s share is very high

D. Ordinary and preference share holders applied for the shares

E. The shareholders were issued at a bonus

(4) When cash is received on application by a company issuing shares, the double

entries required in the record of the company are:

A.	DR share capital	CR application
B.	DR cash	CR share capital A/C
C.	DR cash	CR application A/C
D.	DR cash	CR cash
E.	DR cash	CR allotment A/C

(5) Which of the following is NOT an example of preliminary expenses?

A. Legal cost of incorporating a company

B. Registration fee paid at Corporate Affairs Commission share capital

C. Stamp duty paid on the issue of share capital

D. Repairs and maintenance of plant and machinery

E. Sitting allowance paid to promoters of company.

8.12 SHORT ANSWER QUESTIONS

(6) What is redeemable debenture?

(7) The issue of shares to existing shareholders at a price which is lower than the market price is called....................

(8) The document issued by the Corporate Affairs Commission (CAC) evidencing the Registration of a Company is referred to as.....................................

(9) The nominal value paid by the shareholders and the maximum amount he has agreed to pay in future is described as.........................

(10) The type of shares that carry voting rights in a company is...........................

SOLUTION TO REVIEW QUESTION

MULTIPLE CHOICE QUESTIONS

(1) C

(2) C

(3) B

(4) C

(5) D

SHORT ANSWER QUESTIONS

(6) These are Debentures that are repayable at a future date.

(7) Rights Issue

(8) Certificate of Incorporation.

(9) Called-up share capital

(10) Ordinary shares

8.13 EXAMINATION TYPE QUESTIONS

QUESTION 1

Babatunde Ltd. Issued 100,000 ordinary shares of N1.00 each at N1.40 per share payable as follows:

(i) 35kobo on application

(ii) 65kobo on allotment (including premium)

(iii) 40kobo on first call

All monies were received on due dates except for N10,000 shares not paid on first call. The holders of 10,000 shares failed to pay up and after some reminders the shares were forfeited.

The shares were re-issued at 75kobo per share and all the monies were received.

(a) You are required to draw up journal entries to record the above transaction.

(b) The share premium account may be used in certain circumstances, state any four of such circumstances (ICAN Foundation May 2006)

QUESTION 2

(a) Compare the principal features of a Limited Liability Company with those of a partnership business.

(b) What are the functions and relevance of Memorandum of Association and Articles of Association with regard to company formation?

(b) Distinguish between public and private companies.

8.14 SOLUTION TO EXAMINATION TYPE QUESTIONS

SUGGESTED SOLUTION TO QUESTION 1

(b) BABATUNDE JOURNAL ENTRIES

		DR ₦	CR ₦
(i)	**Bank Account**	35,000	
	Application & allotment accounts		35,000
	Being application money received for 100,000 ordinary shares		
(ii)	Application & allotment accounts	35,000	
	Ordinary share capital		35,000
	Being application money transferred to ordinary share capital account		
(iii)	Application & allotment account	65,000	
	Ordinary share capital account		25,000
	Share premium account		40,000
	Being allotment of 100,000 shares		
(iv)	Bank Account	65,000	
	Application & allotment account		65,000
	Being amount received on allotment of 100,000 shares		
(v)	First call account	40,000	
	Ordinary shares capital		40,000
	Being amount called-up on 100,000 shares		
(vi)	Bank Account	36,000	
	Call in arrears account	4,000	
	First call account		40,000

	Being amount received on first call and amount of default		
(vii)	Forfeited shares account Call in arrears account Being forfeiture of 10,000 shares for non-payment of 1^{st} call	4,000	 4,000
(viii)	Share capital account Forfeited shares account Being account called on 10,000 shares before forfeiture	10,000	 10,000
(ix)	Forfeited shares account Share capital account Being re-issue of shares earlier forfeited	10,000	 10,000

(b) Share premium account may be applied for the following:

(i) Paying up un-issued shares to be issued as fully paid bonus shares.

(ii) Writing off preliminary expenses

(iii) Writing off expenses or commission paid or discount allowed on issue of shares or debentures.

(iv) Providing any premium payable on redemption of redeemable preference shares or debentures partnership

SUGGESTED SOLUTION TO QUESTION 2

(a)

	Limited Liability Company	**Partnership**
(i)	Separate legal entity	Assets of partners are not separate from partnership business

(ii)	Activities of the company are regulated by Memorandum & Articles of Association	Partnership activities are regulated partnership deed or partnership agreement
(iii)	Statutory Audit of the company is compelled by CAMA 1990	Statutory Audit of partnership business is not compulsory
(iv)	Company can be sued as a separate legal entity	

(b) Functions and Relevance of Memorandum and Articles of Association:-

Memorandum of Association

This document highlights the following:-

i. The mode of appointment of Auditors, Directors, Company Secretary etc.
ii. The name of the company ending with the word limited or guaranteed, as the case may be.
iii. Location of the registered office of the company.
iv. The main object of the company or the nature of its business(es)
v. The number/amount of the authorized share capital
vi. Names of subscribers to memorandum of association.

Articles of Association

This document highlights the following:

i. Registration that relates to the issue of the company shares.
ii. Power/responsibility of directors
iii. Duties of shareholders
iv. Power/Duties of company secretary
v. Appointment/removal of auditors
vi. Borrowing power of directors'
vii. Winding up procedure

d) (i) **A Public Company:-** Is a company in which its memorandum, indicates that the company is a public company and the company's minimum membership is seven with no maximum limit, the name of such companies ends with PLC.

(ii) **Private Company:-** This is a company in which its memo and articles restrict share transfer having a minimum membership of two individuals and with a maximum number of fifty individuals. The name of such companies normally ends with "Ltd".

CHAPTER NINE

FINAL ACCOUNTS OF COMPANIES

CHAPTER CONTENTS

a. Introduction

b. Preparation of Manufacturing Accounts

c. Other information required for preparation of financial statements

d. Other important information in income statement

9.0 OBJECTIVES

Upon completion of this chapter it is expected that readers should be able to:

a. Draw up manufacturing account of a limited liability company

b. Draw up statement of profit or loss for a Limited Liability Company

c. Draw up statement of financial statement of a Limited Liability Company

9.1 INTRODUCTION

The preparation of the final accounts of a limited liability company is usually done in compliance with the provisions and requirements of the Companies & Allied Matters Act CAP C20 LFN and International Financial Reporting Standards.

Unlike Sole Trader accounts, the accounts can be prepared either for internal use i.e. for the use of the management or for publication that is for the use of shareholders. When Final Accounts of Limited Liability Companies are prepared for internal use, the presentation can either be in Horizontal (T-format) or Vertical format (Column form).

Preparation of account for publication must comply strictly to the laid down laws and relevant International Financial Reporting Standards (IFRS).

However, we shall limit our discussion to preparation of final accounts for internal use only.

Limited Liability Companies can engage in several forms of business hence we shall approach the preparation of the final accounts from the point of view of manufacturing business concern or a trading concern. This would necessitate preparing both MANUFACTURING ACCOUNTS as well as STATEMENT OF PROFIT OR LOSS and STATEMENT OF FINANCIAL POSITION.

9.2 PREPARATION OF MANUFACTURING ACCOUNT

When a business engages in manufacturing, a special need arises to ascertain the cost of goods manufactured as a basis for fixing selling price. This need is fulfilled by the preparation of MANUFACTURING ACCOUNT.

9.2.1 OBJECTIVE OF MANUFACTURING ACCOUNT

The aim of manufacturing account is primarily to disclose the total cost of manufacture, this amount being equivalent of or substitute for figure of purchases. Also, the manufacturing account enables companies to determine relative efficiency of its production function.

9.2.2 DIVISION OF COSTS

In a manufacturing company, cost can be classified into the following categories.

(i) Direct Costs

(ii) Indirect Costs

DIRECT COSTS:- These are costs that vary directly with the level of production i.e. they are costs that can be traced to having been incurred in manufacturing an item. They are also referred to as prime cost.

INDIRECT COSTS:- These are costs that cannot be easily traced to the item being manufactured i.e. they are costs which do not vary directly with the cost of production. They are also referred to as overheads.

The relevant classification of these costs in a manufacturing concern accounts are as follows:

9.2.3 PRIME COST

Prime cost is the addition of the following costs

(a) Direct Material Cost

(b) Direct Labour Cost

(c) Direct Expenses

9.2.4 PRODUCTION COST

Production cost is PRIME COST PLUS FACTORY OVERHEADS.

FACTORY OVERHEADS:- Are costs incurred in the factory where production is being done which cannot be easily traced to items being manufactured.

Examples of factory overhead include the following:

a. Depreciation of plant and machinery
b. Rent and Rate of factory
c. Cost of operating fork-lift
d. Wages of crane drivers
e. Wages of factory cleaners

9.2.5 TOTAL COST

To determine the total cost the administrative expenses as well as selling and distribution expenses would have to be added to the total production cost as determined above.

9.2.6 FORMAT OF MANUFACTURING ACCOUNT

The essence of preparing a manufacturing account is to determine the TOTAL PRODUCTION COST as explained above. The amount obtained will then be transferred to the STATEMENT OF PROFIT OR LOSS.

A typical format of a manufacturing account is shown below:

MANUFACTURING ACCOUNT

FOR THE YEAR ENDED 31 DECEMBER 200X

RAW MATERIALS:-	₦		₦
Opening inventories	X		
Purchases	X		
Carriage Inward	X		
Less:	XX		
Closing inventories	(X)		
Cost of Raw materials consumed			XX
DIRECT WAGES:-			
Manufacturing wages	X		
DIRECT EXPENSES:-			
Royalties	X		XX
PRIME COST			XX
FACTORY OVERHEADS:			
Rent of factory	X		
Depreciation on Equipment	X		
Supervisors Salaries	X		XX
Cost of production			XX
ADJUSTMENT FOR WORK-IN-PROGRESS:		X	
Add: Opening work in progress (WIP)		(X)	X
Factory cost of goods completed transferred to statement of Profit or loss			XXX

Details of the costs shown in the manufacturing account format above are as follows:-

(i) **RAW MATERIALS:-** These are physical items which are used in producing the finished product. For example in a cocoa factory, the following would be classified as raw materials: cocoa bean, jute bags etc.

(ii) **DIRECT LABOUR:-** This is the remuneration paid to factory workers for works directly related to production. Note that this will not include supervisory or clerical labour.

(iii) **DIRECT EXPENSES:-** This is the cost incurred specifically for a particular product. An example is royalties paid per unit of copyright design.

(iv) **PRIME COST:-** This is an important costing terminology which consists of cost of direct materials, direct labour and direct expense as earlier highlighted.

(v) **DIRECT COST:-** These are costs which can be directly identified with particular jobs or products.

(vi) **FACTORY OVERHEADS: -** These are costs which are incurred in operating the works in the factory but which cannot be identified directly with a particular job or product.

(vii) **INDIRECT LABOUR:-** This includes remuneration paid to supervisors, clerks, maintenance staff etc.

(viii) **INDIRECT MATERIAL:-** This includes lubricating oil, spare parts for machinery, cleaning materials, maintenance materials etc.

(ix) **WORK-IN-PROGRESS (WIP):-** These are products that have not completed the manufacturing cycle hence they are semi-finished products..

ILLUSTRATION 9.1

The following information were obtained from the books of GO-GO Manufacturing Company Ltd. For the year ended 31 December, 2016.

	₦
Raw materials 1/1/2016	175,000
Work in progress 1/1/2016	120,400
Finished goods 1/1/2016	207,200
Purchase of raw material	954,800
Carriage inward on raw materials	47,740
Rent of factory building	67,200
Rent of office building	75,600
Bad debt	13,440
Office general expenses	181,020
Factory equipment depreciation	227,920
Office & distribution, equipment depreciation	208,320
Revenue/Sales (Net)	3,010,000
Light & Power (General)	44,800
Light & Power (Factory)	78,540
Salaries & Wages of salesmen	315,980
Salaries of factory supervisors	122,360
Factory general expenses	117,040
Factory wages	257,460
Insurance of factory equipment	39,760
The closing inventories of the company at the end of the year are as follows:	
Raw materials	202,720
Work in progress (WIP)	143,500
Finished goods	257,460
Work-in-progress is normally valued at prime cost plus related portion of factory overheads	

Required:

Prepare the Manufacturing Account for the year ended 31 December, 2016.

SUGGESTED SOLUTION TO ILLUSTRATION 9.1

MANUFACTURING ACCOUNT

FOR THE YEAR ENDED 31 DECEMBER, 2016

Raw materials	₦	₦
Opening inventory	175,000	
Purchase of raw material	954,800	
Carriage on raw material	47,740	
	1,177,540	
Less Closing inventory	(202,720)	
Cost of raw materials consumed		974,820
DIRECT WAGES		
Factory wages		257,460
PRIME COST		1,232,280
Add: FACTORY OVERHEADS		
Rent on factory buildings	67,200	
Supervisors salaries	122,360	
Insurance of equipment	39,760	
Light & power (factory)	78,540	
Factory general expenses	117,040	
Depreciation of factory equipment	227,920	
		652,820
FACTORY COST OF PRODUCTION		1,885,100
Add:		
Opening work in progress		120,400
Less:		
Closing work in progress		(143,500)
Factory cost of goods produced transferred to cost of sales		1,862,000

TUTORIAL NOTE

You will observe that in preparing the manufacturing account only relevant figures were obtained from the list of information provided. The remaining figures would be required in preparing statement of profit or loss.

Also students/readers should take note of the manner in which the PRIME COST and FACTORY COST OF PRODUCTION were derived.

9.2.7 ADJUSTMENT IN MANUFACTURING ACCOUNTS

(i) APPORTIONMENT OF EXPENSES

Sometimes some examination questions require the apportionment of overheads between manufacturing and other functions such as selling and distribution or administration. The ratio or proportion of apportionment would be stated. Based on this, the portion that relates to manufacturing would be charged to manufacturing account while the balance would be treated in the appropriate account (statement of profit or loss).

ILLUSTRTION 9.2

XYZ Co. Ltd paid ₦25,000 as insurance expenses during the year. However, it was discovered that ₦5,000 insurance expenses was still outstanding for the year while out of the payment made ₦7,500 related to period after the year end.

Insurance apportionment is considered to be 2/5 for factory and 3/5 for office. Determine the insurance expenses that would be treated in the manufacturing account.

SOLUTION TO ILLUSTRATION 9.2

	₦
Insurance paid in the year	25,000
Less:	
Amount paid in advance	(7,500)
Add:	
Amount outstanding	5,000
Total Insurance Exp. For the year	22,500
Amount chargeable to manufacturing account	22,500 x 2/5 = ₦9,000

9.2.8 ASCERTAINMENT OF PROFIT OR LOSS ON MANUFACTURED GOODS

Sometimes cost of manufactured goods transferred to cost of sales is adjusted to reflect PROFIT OR LOSS arising from manufacture. The profit (or loss) on manufacture is ascertained on the basis of opportunity cost principle, i.e. is by reference to what the company would have paid for identical goods if it were purchased instead of manufacturing them.

If such imputed total purchase value exceeds the cost of manufacture then a GROSS PROFIT on manufacture would result. A LOSS on manufacture will occur if the cost of manufacture exceeds the imputed purchase value.

ILLUSTRATION 9.3

Based on information provided in illustration 9.1 and assuming that the company estimated that had it not manufactured the goods, the total cost of purchase would have been N2,100,000, calculate the profit or loss on manufacture.

SUGGESTED SOLUTION TO ILLUSTRATION 9.3

		₦
	Purchase value of goods manufactured	
	and transferred to cost of sales	2,100,000
Less:	Cost of goods manufactured transferred	
	to cost of sales (per illustration 9.1)	1,862,000
	Profit on manufactured goods transferred to	
	Statement of profit or loss	238,000

9.3 OTHER INFORMATION REQUIRED FOR PREPARATION OF FINANCIAL STATEMENTS OF COMPANIES

The following financial statements are required by IAS 1:

1. Statement of profit or loss
2. Statement of comprehensive income
3. Statement of financial position
4. Statement if changes un equity
5. A statement of cash flows

9.3.1 STRUCTURE AND CONTENT OF FINANCIAL STATEMENT

IDENTIFICATION OF FINANCIAL STATEMENTS

Financial statements should be clearly identified from the other information in the same published account. The name of the entity, the period covered and so on must be displayed.

The following items must be presented on the face of the statement of financial position; assets, equity and liabilities.

Current and Non-Current Assets and Liabilities

Current and non-current assets and liabilities should be classified separately on the face of the statement of financial position.

Current and Non-current Assets

A current asset is one that is likely to be realised within the normal operating cycle or within 12 months, held for trading purposes, or it's cash or cash equivalent. All other assets are non-current assets. Inventory and receivables are examples of current assets.

Current and Non-current liabilities

A current liability is one that is likely to be settled within the normal operating cycle of 12 months of the financial statement date, held for trading purposes or there is no unconditional right to defer settlement for at least 12 months after the statement of financial position date. All other liabilities are non-current. Examples of current liabilities are trade and other payables and company income tax estimate for the current year.

Statement of Profit or Loss

All items of income and expenses should be included in the income statement of profit or loss for the period.

All expenses are classified under one of the following headings:

1. Cost of sales
2. Distribution costs
3. Administration costs
4. Finance costs

Format

Statement of profit or loss

	₦`000	₦`000
Revenue		X
Costs of sales	(X)	(X)
Gross profit		X
Administration Expenses	(X)	
Distribution Expenses	(X)	(X)
Profit from operations		X
Financial cost	(X)	(X)
Profit before Tax		X
Income Tax Expenses	(X)	(X)
Net Profit for the period		X

Profit or Loss for the period

An entity shall recognise all items of income and expense in a period in statement of profit or loss.

9.3.2 Classification of Expenses

Expenses can be classified using either the nature or the function of expense method. The function of expense method is already demonstrated in the format above where expenses are classified as distribution expenses, administration expenses and cost of sales.

An example of a classification using the nature of expense method is presented below:

4. FORMAT NATURE OF EXPENSE

	₦	₦
Revenue		X
Other income		X
Changes in inventory of finished goods and WIP	(X)	
Raw materials and consumable used	(X)	
Employees benefit expenses	(X)	

Depreciation and amortisation expenses	(X)	
Other expenses	(X)	
		(X)
Profit from operations		X
Net interests cost		(X)
Profit before tax		X
Tax expenses		(X)
Profit for the period		X

Explanations

- Net interest cost is the difference between interest paid less interest received.
- Changes in inventory of finished good and work-in-progress.

This represents the difference between the closing amount and the opening amount of inventories. When the closing inventory is higher than the opening, the difference is added but when the closing is less than the opening inventory the difference is deducted.

Raw Materials and Consumable Used:- This is the addition of opening inventory of raw material and purchases of raw materials less closing inventory.

SOLUTION TO ILLUSTRATION 9.1

GO-GO Manufacturing Company Limited

Statement of Profit or Loss for the year ended 31 December 2016

	₦	₦
Revenue		3,010,000
Cost of sales (w^1)		(1,811,740)
Gross Profit		1,198,260
Administration expenses (W^2)	523,180	
Distribution expenses (W^2)	315,980	
		(839,160)
Profit before tax		359,100
Income tax expense		-
Profit for the year		359,100

Workings

Costs of Sales

	₦
Opening inventory	207,200
Cost of goods manufactured	1,862,000
	2,069,200
Less: closing inventory of finished goods	(257,460)
Cost of sales	1,811,740

Expenses

	Distribution	Administration
	₦	₦
Rent of office space		75,600
Light and power office		44,800
Office expenses		181,020
Depreciation of office equipment		208,320
Bad debt		13,440
Salaries & Wages of salesmen	315,980	
	315,980	523,180

9.3.3 Statements of Comprehensive Income¸

Statement of comprehensive income. The gain or loss in revaluation of property shall be added to the profit for the year. The following items if material are also required to be reported at the face of the statement of comprehensive income.

a. Disposal of items of property, plant and equipment (PPE)

b. Disposal of investment

c. Write down of inventory or PPE.

9.3.4 Statement of Financial Position

The statement of financial position shall include non-current assets, current assets, current liabilities, non-current liabilities and equity. Any of the following approaches can be adopted to present the statement.

a. Non-current assets plus current assets on one side and equity plus liabilities on the other.

b Total assets less current liabilities on one side and equity plus non-current liabilities on the other side.

c. Total assets less total liabilities on one side and equity on the other side.

9.3.5 Presentation of Dividends

a. Only dividend income is shown in the statement of profit or loss and other comprehensive income.

b. Dividends paid or payable in respect of preference shares are shown in the statement of profit or loss and other comprehensive income as part of finance cost and the payable also shown as a current liability.

c. The statement of changes in equity includes ordinary dividends paid. The final dividend cannot be accounted for until approved at the AGM, it will be included in the notes to the accounts.

Format of statement of financial position as at 31 December 2016

	₦`000	₦`000
<u>Non-current Assets</u>:		

Property, Plant and Equipment		X
Investment		X
Intangible		X
		X
Current assets:		
Inventories	X	
Trade and other receivables	X	
Prepayments	X	
Cash	X	X
Total assets		X
EQUITY		
Ordinary share capital		X
Preference share capital		X
Share premium		X
Accumulated profits		X
		X
Non-current liabilities		
Long term loans/Borrowings	X	
Loan notes	X	X
Current Liabilities		
Trade and other payables	X Bank overdrafts	X
Current income tax expense	X	
Tax payables	X	
	X	
Total equity and liabilities		X

Statement of changes in equity

An entity is required to present a statement of equity that will show

1. Total comprehensive income
2. The reconciliation between the carrying amount of equity at the beginning and end of the period.
3. Changes resulting from each item of equity and comprehensive income shall be disclosed separately.

Format statements of changes in equity

	Share capital	Share Premium	Revaluation Reserves	Accumulated Profits/Earnings	Total
	N`000	N`000	N`000	N`000	N`000
Balance b/f	X	X	X	X	X
Equity shares issued	X	X			X
Revaluation surplus			X		X
Net profit				X	X
Dividends paid				(X)	(X)
Balance c/f	X	X	X	X	X

ILLUSTRATION 9.4

Ake Ltd has 120 million ordinary share capital of ₦1 each and 60 million 5% preference shares of N1 each.

The profits for the year ended 31 December, 2016 is ₦43,868,000. The company estimated the tax expense for the year to be ₦8,200,000. The management of the company declares a dividend of 10% per share before the year end and paid the preference dividend at the fixed rate on July 1, 2016, the company had paid interim dividend of ₦2,000,000 to the ordinary shareholders. Assume that accumulated profit on 1 January 2016 is nil.

Calculate the amounts to be shown in the statement of changes in equity and statement of financial position.

Solution to Illustration 9.4

	₦`000
Interim dividend	2,000,000
Preference dividend 5% x 60m	3,000,000

Statement of change in equity

	₦`000
Ordinary share capital	120,000
Preference share capital	60,000
Preference dividend	(3,000)
Interim dividend paid	(2,000)
	175,000
Net profit for the year	35,668
Statement of change in equity	210,668

Statement of financial position

	₦`000
Ordinary share capital	120,000
Preference share capital	60,000
Accumulated profits	35,668
	210,668

9.4 OTHER IMPORTANT INFORMATION IN STATEMENT OF PROFIT OR LOSS OF LIMITED LIABILITY COMPANIES

(a) DIRECTORS REMUNERATION

Directors are regarded as employees of the company as such their remuneration is an expense and its is usually treated the same way as salaries and wages would be treated in the profit and loss accounts.

(b) LOAN NOTE INTEREST

Interest on debentures is an expense and would be treated in the same way as loan interest i.e. it should be charged to profit and loss account as an expense.

ILLUSTRATION 9.5

The following trial balance was extracted from the ledger of PANSEKE LIMITED as at 31st March 2016.

	DR	CR
	₦`000	₦`000
10% Pref. Share Capital		10,000
Ordinary Share Capital		20,000
Share premium		6,000
9% loan notes		12,000
General reserve		9,280
Profit or Loss account 1st April, 2015		3,060
Plant & Machinery at cost	44,000	
Motor Vehicle at cost	13,000	
Accumulated Depreciation – Plant & Machinery		4,800
Accumulated Depreciation – M/V		3,600
Furniture & Fittings	4,800	
Accumulated Depreciation – (Furniture & Fittings)		1,120
Inventories 1st April 2015	5,360	
Account Receivables	48,400	
Bills receivables	5,668	
Account payables		36,420
Cash in hand and at Bank	17,240	
Revenue (Net)		149,760
Purchases (Net)	92,320	
Carriage Inward	3,240	
Salaries & Wages	11,320	
Rent & Rates	4,320	
Insurance	1,740	

Office Expenses	3,660	
Bad Debt	212	
Light & Power	344	
Interest Income		100
Motor Running Expenses	516	
	256,140	256,140

The following additional information is provided:

(i) Provision is to be made for depreciation on the non-current assets at the following rates.

Plant & Machinery	15%
Motor Vehicle	20%
Furniture & Fittings	10%

(ii) The following payments were made in advance in respect of:

Rent	₦1,120,000
Insurance	₦292,000

(iii) One year interest is due on loan notes

(iv) Provision to be made on doubtful debts is ₦1,120,000

(v) Provision to be made for audit fees of ₦2,400,000

(vi) Directors fees of ₦3,000,000 were due as at the year end

(vii) Closing inventories 31/3/2016 ₦9,720,000

(ix) The Directors have recommended transfer of ₦4,000,000 to general reserve

(x) Current year income tax charge ₦6,420.00

(xi) The year`s preference dividend is to be provided for while 20% on nominal capital is to be recommended as dividend on ordinary shares.

(xii) Authorised Share Capital are as follows:

10,000,000 10% pref. Shares at ₦1 each	10,000,000
30,000,000 ordinary shares at ₦1 each	30,000,000

You are Required to prepare:

(i) The statement of profit or loss

(ii) The statement of changes in Equity

(iii) The statement of financial position

(i) **PANSEKE LIMITED**

Statement of Profit or Loss for the year ended 31 March, 2016

	₦'000	₦'000
Revenue (Net)		149,760
Less cost of sales:		
Opening Inventories	5,360	
Add purchases (Net)	92,320	
Carriage inwards	3,240	
	100,920	
Less closing inventories	9,720	91,200
Gross profit		58,560
Interest income		100
		58,660
Less expenses:		
Salaries and wages	11,320	
Rent and rates (₦4,320 – ₦1,120)	3,200	
Insurance (₦1,740 – ₦292)	1,448	
Office expenses	3,660	
Bad debt	212	
Allowance for doubtful debt	1,120	
Light and power	344	
Motor running expenses	516	
Audit fees	2,400	
Directors fees	3,000	
Finance cost – interest on loan notes	1,080	
-Preference share dividend	1,000	
Depreciation – plant and machinery	6,600	
Motor vehicle	2,600	
Furniture and fittings	480	38,980
Profit before tax		19,680
Income tax expense		(6,420)
Profit for the year		13,260

ii) **PANSEKE LIMITED**

Statement of changes in Equity for the year ended 31 March 2016

	Ordinary share capital	Share premium	General reserve	Retained carrings	Total
	₦ '000	₦ '000	₦ '000	₦ '000	₦ '000
Balance b/f	20,000	6,000	9,280	3,060	38,340
Profit for the year	-	-	-	13,260	13,260
Transfer	-	-	4,000	(4,000)	-
Balance c/f	20,000	6,000	13,280	12,320	51,600

iii)

PANSEKE LIMITED

Statement of Financial position as at 31 March 2016

Non-current Assets:	**₦'000**	**₦'000**	**₦'000**
Plant and machinery	44,000	(11,400)	32,600
Motor vehicle	13,000	(6,200)	6,800
Furniture and fittings	4,800	(1,600)	3,200
	61,800	19,200	42,600
Current Assets:			
Inventories		9,720	
Accounts receivables	48,400		
Allowance for doubtful debts	(1,120)	47,280	
Bills receivables		5,668	
Prepayment (N1,120 + N292)		1,412	
Cash and bank		17,240	81,320
			123,920
Equity and liabilities:	Authorised		
Ordinary shares of N1 each	30,000		20,000
Share premium			6,000
General reserve			13,280
Retained earings			12,320
			51,600
Long term liabilities			₦
10% Preference shares		10,000	
9% Loan notes		12,000	
			22,000
Current Liabilities:			
Account payables		36,420	
Accrued expenses – Audit fees		2,400	
Directors fee		3,000	

	Interest on loan notes	1,080	
	Preference dividend	1,000	
Current tax expense		6,420	50,320
			123,920

CONTENT OF COMPANY STATEMENT OF FINANCIAL POSITION

(i) **INTANGIBLE ASSETS:-** These are assets that cannot be seen physically. They include Goodwill, Patent and Trade Marks.

(ii) **TANGIBLE ASSETS:-** These are definite assets which can be seen and touched. They include Land and Buildings, Motor Vehicles and Furniture.

(iii) **NON-CURRENT ASSETS:-** These are durable assets which have a life of more than one year. They have both tangible and intangible components. They are also referred to as Property, Plant and Equipment (PPE).
Examples of non-current Assets are Land & Building, Motor Vehicle, Furniture & Fittings.

(iv) **INVESTMENTS:-** These are the aggregate amounts of the Company`s Trade Investment. There are two types of Investments.
(a) Quoted Investment
(b) Unquoted Investment

(v) **CURRENT ASSETS:-** These are circulating assets, i.e. assets that are convertible to cash or near cash within one year and they are readily available to discharge the liabilities of the company. Examples of Current Assets are Inventory, Trade Receivables, Prepayment, Cash and Bank Balance.

(vi) **CURRENT LIABILITIES:-** As the name implies these are liabilities due for settlement within one year. They are obligations of the company which must be discharged within one year. Examples of current liabilities are Trade payables, Accruals, Bank Overdraft, Provision for Taxation.

(vii) **NON-CURRENT LIABILITIES:-** This is a source of funding of company. They are sometimes referred to as DEBT CAPITAL. Usually they are Long Term Liabilities with life span of 5 to 10 years. They include Long Term Loan, Loan notes, preference shares capital, etc.

(viii) **SHARE CAPITAL:-** This is the owners" contribution of capital to the business. Thus, it is also a source of funding to the company. The issue of Equity or ordinary shares provided the received share capital for entities.

(ix) **RESERVES:-** These are retained earnings or undistributed profit of the business which are retained in the business for further expansion. Reserves are of two major types, Capital Reserve which is not distributable as dividend and revenue which can be distributed as dividend.

(x) **SHAREHOLDERS` FUND:-** This is also referred to as equity and it is simply the owners` fund which is made up of Ordinary Share Capital and Reserves of a Company.

9.5 Chapter Summary

When a company is engaged in manufacturing activities, it will always be necessary for the organisation to prepare a MANUFACTURING ACCOUNT in order to ascertain the cost of the goods manufactured as distinct from its normal selling activities. In view of this, it would be necessary to properly ascertain the cost of raw materials consumed, work in progress, prime cost, and manufacturing overheads with a view to determining the cost of goods manufactured.

Sometimes certain margins are added to the cost of manufacture in order to arrive at a probable market value of goods manufactured before the cost is transferred to the cost of sales.

a. Statement of profit or loss are prepared in order to ascertain the gross profit and the net profit for the period.

b. The Net Profit for operation are transferred to statement of changes in equity and the statement of financial position. Hence, the following issues are treated in statement of changes in equity.

i. Share capital

ii. Profit for the period

iii. Dividend paid (interim)

iv. Preference dividend paid

v. Share premium

vi. Revaluation reserves

Companies are also required to prepare statement of financial position which shows true and fair view and which discloses the Assets, Liabilities and Capital of the Company.

The Financial Statement of Limited Companies can be prepared for publication or the financial statement for internal use while preparation for publication is covered in more details at a higher level.

9.6 MULTIPLE CHOICE QUESTIONS

(1) Prime cost of goods manufactured by companies is defined as the following;

(A) Direct cost of materials plus opening work in progress.

(B) Opening inventory and factory overhead

(C) Direct cost of materials plus cost of direct labour plus direct factory

(D) Cost of factory overhead, plus wages

(E) Opening inventory of material plus purchase of raw materials less closing inventory of raw material.

(2) Companies engaged in manufacturing only are expected to prepare the following final accounts,

(i) Manufacturing Account

(ii) Statement of profit or loss and other comprehensive income

(iii) Statement of changes in equity

(iv) Statement of financial position

(A) I only

(B) II and III only

(C) I, III and IV

(D) I, II, III and IV

(E) II, III and IV.

(3) An increase in closing inventory will have one of the following effects.

(A) Cost of sales will increase and Gross Profit will also increase

(B) Sales will reduce and Gross Profit will increase

(C) Purchase will reduce and cost of sale will increase

(D) Cost of sales will reduce and Gross Profit will increase

(E) Cost of goods available for sale will increase and purchase will increase

(4) XYZ Ltd. With accounting year end of 31 Dec., 2016 paid Rent and Rates amounting to N720,000 which covers three years up to 31 Dec., 2018. As at 31 Dec., 2016 ₦100,000 was outstanding in respect of rent for year 2015. Determine the Rent and Rates that would be charged in the company`s statement of profit or loss for the year ended 31 Dec., 2016.

(A) ₦240,000

(B) ₦340,000

(C) ₦820,000

(D) ₦620,000

(E) ₦720,000

(5) Which of the following is not an Asset.

(A) Goodwill

(B) Prepayment

(C) Inventory

(D) Accrual

(E) Bills receivable

9.7 SHORT ANSWER QUESTIONS

(6) Define prepayment and accruals

(7) Give THREE examples of an intangible asset

(8) The technical term for the difference between current assets and current liabilities is called...................

(9) Mention THREE (3) items normally treated in statement of changes in Equity

(10) What is equity?

(11) TAKALUMI Limited, a manufacturing company has the following information in its records for the 2015:

	NOTES	DR	CR
		₦	₦
Raw materials as at 1/1/2015		350,000	
Work in progress as at 1/1/2015		240,800	
Finished goods as at 1/1/2015		414,400	
Purchase of raw materials		1.909,600	
Carriage inward on raw material		95,480	
Rent	2	285,600	
Irrecoverable debt		24,000	
Office general expenses		362,040	
Factory equipment depreciation		435,840	
Turnover/Revenue			6,040,000
Light and power	3	240,680	
Factory wages		514,920	
Factory general expenses		234,080	
Salaries and wages	4	906,680	
Insurance	5	80,000	
Receivables and payable		720,000	960,000
Bank		185,000	
		7,000,000	7,000,000

Following the information as given:

1) Closing inventories of the company as at 31 December 2015 are as follows:

	₦
Raw materials	405,440
Work in progress	287,000
Finished goods	514,920

2) Rent is apportioned at $^1/_3$ for factory and $^2/_3$ for office.

3) Light and power is apportioned $^2/_5$ for factory and $^3/_5$ for office.

4) Salaries of factor supervisors represent $^1/_5$ of the total salaries while balance was for salesman.

5) It was discovered that ₦10,000 insurance expenses will still outstanding for the year while out of the payment made in the year, ₦15,000 relates to 2016. Insurance apportionment is considered to be $^2/5$ for factory and $^3/_5$ for office.

You are required to prepare the manufacturing accounts of Takalamui Limited for the year ended 31 December 2015.

ATSWA adapted.

SOLUTION

TAKALUMI Limited
Manufacturing Account for the year ended 31 December 2015

	₦	₦
Opening inventory- raw materials		350,000
Purchase of raw materials	1,909,600	
Carriage inward on raw materials	95,480	2.005,080
		2,355,080
Less closing inventory – raw materials		405,440
Cost of raw materials consumed		1,949,640
Factory wages		514,920
Factory general expenses		234,080
Prime cost		2,698,640
Factory overhead:		
Rent (1/3 x N285,600)	95,200	
Equipment depreciation	435,840	
Light and power (2/5 x N240,680)	96,272	
Supervisor's salary (1/5 x N906,680)	181,336	
Insurance (2/5 x N75,000)	30,000	838,648
		3,537,288
Add opening inventory – W.I.P	240,800	
Less closing inventory – W.I.P	(287,000)	(46,200)
Production cost of goods manufacturer		3,491,088

Workings:	₦
Insurance – Per total balance	80,000
Add accrued	10,000
Less prepaid	(15,000)
	75,000

9.8 SOLUTION TO REVISION QUESTIONS

1. C
2. D
3. D
4. B
5. D
6. **Prepayment:** - Is a payment made in advance for services or benefit that has not been received or enjoyed.

Accrual:- These are benefits or services received during the accounting year but which are either not billed or not paid for in the year.

7. Example of Intangible Assets are Goodwill, Patent and Copyright.

8. Working Capital or Net Current Asset.

9. (i) Share capital and reserves at the start of the year

   (ii) Interim dividend paid and preference dividend

   (iii) Profits for the period

   (iv) New shares issued

10. **Equity:-** Is shareholders` fund, i.e. Ordinary Share Capital plus Reserve. It is also referred to as Networth.

CHAPTER TEN

STATEMENT OF CASH FLOWS

CHAPTER CONTENT

a. Introduction

b. Limitations of Statement of Cash flows

c. Differences between statement of cash flows and profits

d. Classification of cash flow-IAS 7

e. Preparation of Statement of cash flow

f. Methods

g. Investing Activities

h. Financing Activities

10.0 OBJECTIVES:

Upon completion of this chapter, the reader should be able to:

a. Know the importance of the statement of cash flows as an integral part of the financial reporting.

b. Know the relationship between the statement of cash flows and the statement of profit or loss and other comprehensive income

c. Know the differences between cash flows from operating activities, investing activities and financing activities

d. Prepare cash flows from operating activities using the direct and indirect methods

e. Prepare extracts of statement of cash flows from given information

f. Reconcile the cash flows from operating activities, investing activities and financing activities with cash and cash equivalents.

10.1 Introduction

The statement of cash flows is an integral part of the financial reporting. The statement of cash flows presents the inflows and outflows of cash and cash equivalents by category over a period of time.

The statement of cash flows provides users with a basis to:

a) Assess the ability of the enterprise to meet its debt obligations
b) Assess the entity's ability to generate and utilize cash
c) Assess the ability of the enterprise to finance its current operations using its own cash or external sources of cash
d) Reconcile profit or loss and cash flows
e) Estimate future cash flows.

10.2 Limitations of the Statement of Cash Flows

a) The statement may not be able to provide the required information for the future because it uses historical data.
b) Some non-cash transactions that are not disclosed on the face of the statement are of interest to users because they will impact on future cash flows.

10.3 Differences Between Statement of Cash Flows and Profits

A. The accrual accounting concepts are used to accrue at the profit whereas the statement of cash flows is based on the cash available during the period and the uses of this cash.
B. It is a better measure of the ability of the entity to meet its debt obligation than profits

10.4 CLASSIFICATION OF CASH FLOWS- IAS7

The Statement of cash flows is prepare using standard headings as explained below:

a. Operating Activities: These are principal revenue – producing activities of the entity and other activities that are not investing or financing activities

b. Investing Activities: These are activities of the entity that relates to acquisition and disposal of non-current assets, long-term investments and investment properties

c. Financing Activities: These are activities that results in changes in the size and composition of the equity and borrowing of an entity. Examples are proceeds from the issue of shares, redemption of loan notes etc.

d. Cash and Cash Equivalents

   i. Cash comprises cash on hand and demand deposits with banks

   ii. Cash equivalents are short-term highly liquid investments that are readily convertible into known amounts of cash and that are subject to an insignificant amount of risk of changes in value .Examples are demand deposits, bank overdraft and other easily reliable short term securities.

   iii. Net increase or decrease in cash and cash equivalents is the overall increase or decrease in cash and cash equivalents during the period. The balance of cash and cash equivalents at the end of the year is obtained by adding the cash and cash equivalent at the beginning of the period to the net increase or decrease in cash equivalent.

10.5 Preparation of a Statement of Cash Flows

Operating activities: It is one of the important components that assist in forecasting future operation cash flows of the entity.

Common examples are:

A. Cash inflows

i. Cash receipts from customers from sales of goods or rendering of service

ii. Royalties fees, commission and other revenue received in cash

iii. Income tax refunds received, unless they can be specially identified with investing or financing activities

c. Cash outflows

i. Cash payments made to suppliers of goods and services

ii. Cash payments made to and on behalf of employees"

iii. Income tax paid, unless the payments can be specifically identified with financing or investing activities

10.6 Methods

There are two methods of preparing cash flows from operating activities. **The direct method** and **the indirect method**. In practice, the vast majority of entities use the indirect method.

10.6.1 Direct Method

The direct method presents the items that affected cash flows and the amount of those cash flows.

Illustration 10.1

Direct method

Cash flows from operating activities 2010

	₦"000
Cash received from customers	X
Cash paid to suppliers	(X)
Cash paid to employees	(X)
Cash generated from operations	X
Interest paid	(X)
Income tax paid	(X)
Net cash from operating activities	X

Illustration 10.2

Chuks Ltd is preparing it statement of cash flows using the direct method and has provided this information.

	₦"m
Credit sale	20,000
Trade and other receivable at year end	3,000

Trade and other receivable at beginning of the year	5,000
Purchase on credit	8,000
Trade payable at year end	3,800
Trade payable at beginning of year	4,000
Operating expenses incurred	6,000
Accrued expenses, beginning of the year	1,000
Accrued expenses, end of the year	800
Depreciation of property, plant and equipment	1,200
Tax paid	3,200

Required:

Prepare the cash flows from operating activities using the direct method.

Solution

Cash flows from operating activities

	₦'m
Cash received from customers (w1)	22,000
Cash paid to suppliers (w2)	(8,200)
Cash paid towards operating expenses (w3)	(5,000)
Tax paid	(3,200)
Net cash flows from operating activities	6,000

Working

Receivable Account

	Nm		Nm
Bal b/f	5,000	Bank received	22,000
Credit Sales	20,000	Bal c/f	3,000
	25,000		25,000
Bal b/d	3,000		

Suppliers Account

	Nm		Nm
Bank-paid	8,200	Bal b/f	4,000
Bal c/f	3,800	purchase	8,000
	12,000	Balance b/d	12,000
		Balance b/d	3,800

Operation Expenses Account

	Nm		Nm
Bank-paid	5,000	Bal b/f	1,000
Depr. On PPE	1,200	Income statement	6,000
Bal c/f	800		
	7,000		7,000
		Balance b/d	800

10.6.2 Indirect Method

Under this method the profits or loss is adjusted for the effects of transactions of non-cash nature. It derives net cash flows from operating activities from the net operating results for the year as reported in the statement of profit or loss.

Example 3

Indirect Method

Cash flows from operating activities

		2010
	₦,000	₦"000
Profit before taxation		X
Adjustment for:		
-Depreciation	X	
-Income from investment	X	

-Interest expense	(X)	X
Movement in working capital:		
Decrease in inventories	X	
Increase in receivable	(X)	
Increase in payables	X	X
Interest paid	(X)	
Tax paid	(X)	(X)
Net cash flows from operating activities		X

Illustration 10.3

Ajileye Ltd has provided the following information

	₦'m
Profit before tax	800
Depreciation on PPE	400
Loss on sale of building	200
Interest paid	200
Interest expenses	300
Income tax paid	100
Account receivable year end	1,700
Account receivable beginning to the year	1,000
Account payable year end	1,000
Account payable beginning of the year	400
Inventory year end	800
Inventory beginning of the year	1,000

Required: prepare the statement of cash flow from operating activities using the indirect method.

Solution to illustration 10.3

AJILEYE Ltd

Statement of cash flows- indirect method

Cash flows from operating activities:	N"m	N"m
Profit before taxation		800
Adjustment for:		
Depreciation on PPE	400	
Loss on sale of building	200	
Interest expense	300	900
Movement in working capital:		
Increase in account receivable	(700)	
Increase in account payables	600	
Decrease in inventory	200	100
Cash from operation		1,800
Interest paid	200	
Tax paid	100	(300)
Net cash flows from operating activities		1,500

10.7 Investing Activities

The cash flows from investing activities represent the extent to which expenditure had been made for resources intended to generate future income and cash flow.

Examples

a. Cash inflows

i. A proceed from sale of property, plant and equipment

ii. Proceed from sale of investments

iii. Collection of cash advances

vi. Dividend received

v. Interest received

b. Cash outflows

i. Purchase of property, plant and equipment b.

ii. Purchase of investment

iii. Cash advances made to third parties

10.8 Financing Activities

Cashflows from financing activities included funds provided by and paid to owners and third parties.

Examples

a. Cash inflows

i. Cash received on issue of shares

ii. Cash received from issuing debt instruments

iii. Proceeds from bank borrowings

b. Cash outflows

i. Payment of dividends to shareholders

ii. Repayment of principal portion of debt, including lease obligations

iii. Repayment of bank borrowings

Illustration 10.4

The statement of financial position of Alade Ltd as at 31 December 2015 and 2016 are given below:

	2016	2015
	₦"000	₦"000
Non-current assets		
Land and buildings	7,170	6,940
Plant and equipments	5,404	6,214
	12,574	13,154
Intangible assets		
Patents	1,704	1,570
Current assets		
Inventory	11,434	11,470

Receivables and prepayments	9,870	9,394
Cash and bank balances	930	230
	36,512	35,818
Current liabilities		
Trade and other payable	(5,590)	(5,344)
Current taxation	(1,790)	(1,970)
Bank overdraft	(544)	(1,410)
	28,588	27,094
Deferred taxation	(3,110)	(3,090)
	25,478	24,004
Capital and reserves		
Ordinary share capital	8,800	8,800
Share premium	1,034	1,034
Accumulated profits	15,644	14,170
	25,478	24,004

Notes

a) Depreciation has been charged for the year ended 31 December 2016 as follows

	₦"000
Land and building	174
Plant & machinery	1,200
patents	46

b) Plants sold during the year realized ₦80, 000. The cost of the plant when it was acquired was ₦304, 000, accumulated depreciation at date of disposal amounted to ₦264, 000.

c) The tax charge was ₦2,080,000

d) Dividend paid in the year amount to ₦1,854,000

e) The profit for the year before tax was ₦5,428,000

Required :

Prepare the statement of cash flows using the indirect method for the year ended 31 December, 2016.

Solution to illustration 10.4

SOLUTION

ALADE LTD

Statement of cash flows for the year ended 31 December 2016

	₦"000	₦"000
Cash flow from operation activities:		
Profit before tax		5,428
Adjustment for:		
Depreciation	1,374	
Amortization of patents	46	
Profit on disposal of plant	(40)	1,380
Change in working capital		
Decrease in inventory	36	
Increase in receivables	(476)	
Increase in payables	246	(194)
Cash flow from operating activities		6,614
Tax paid		(2,260)
Net cash from operating activities		4,354
Cash flow from investing activities:		
Purchase of land and buildings	(404)	
Purchase of plant & machinery	(430)	
Purchase of patents	(180)	
Proceed from disposal of plant & machinery	80	
Net cash used in investing activities		(934)
Cash flow financial activities:		
Dividend paid	(1,854)	
Net cash flow used in financing activities		(1,854)

Net increase in cash & cash equivalents	1,566
Cash & cash equivalent at Jan. 1(230-1410)	(1,180)
Cash & cash equivalent at Dec.31	386

	₦"000
Cash and cash equivalent comprises:	
Cash and Bank Balance	930
Bank overdraft	(544)
	386

Workings

Land and Building Account

	₦"000		₦"000
Opening balance	6,940	Depreciation charged	174
Bank purchase	404	Bal c/d	7,170
	7,344		7,344

Plant disposal

	₦"000		₦"000
Plant account cost	304	Plant account depreciation	264
Income statement	40	Bank sale proceed	80
	344		344

Taxation Account

	₦"000		₦"000
Bank (Paid)	2,260	Opening balance b/d	1,970
Closing balance c/d	1,790	Statement of profit or loss	2,080
	4,050		4,050

10.9 Chapter summary

Introduction to preparation of cashflow statement in accordance with the disclosure requirements under IAS7, this include discussion of Direct and indirect method of preparing cash flow statement. Limitation of Cash flow and differences between statement of flow and profit. We also treated classification of cash flow.

10.10 MCQ AND SHORT ANSWER QUESTIONS

1. Which of the following is cash and cash equivalents?
    a. Investment in equity shares
    b. Loan
    c. Bank overdraft
    d. Ordinary share capital
    e. Irredeemable preference shares

2. Which of the following would not be reported in statement of cash flows?
    a. Issuance of share to acquire property
    b. Purchases of plant and machinery
    c. Proceed from sale of non-current asset
    d. Payment of dividends
    e. Proceed from issue of debenture

3. Dividends received by a company from another entity should be treated in its statement of cash flow as
    a. Operating activities
    b. Investing activities
    c. Financing activities
    d. Cash and cash equivalent
    e. Non-cash transaction

4. How should capital gain tax paid on the profit of sale of property be treated in the statement of cash flow?
    a. Reported as deduction under operating activities

b. Reported as financing activity
c. Reported as investing activity
d. Deducted from the profit on disposal
e. Deducted from sales proceed

5. Which of the following will be included in statement of cash flow from operating activities using the direct method?

   i. Cash sales
   ii. Depreciation charged
   iii. Loss on sale of property
   iv. Payment to suppliers

   a. I and II
   b. II and III
   c. III and IV
   d. I and IV
   e. II and IV

6. Give Two examples of non-cash transactions relating to financing activity.
7. Interest received should be reported in statement of cash flows as which activities

10.11 SOLUTION TO MCQ & SAQ

1. C
2. A
3. A
4. E
5. D
6. i. Conversion of debentures to equity
   ii. Issue of share capital to acquire property, plant and equipment.
7. Operating activities.

CHAPTER ELEVEN
INTERPRETATION OF FINANCIAL STATEMENT

11.0 Introduction

It is imperative to interpret and evaluate information in financial statements for them to become more useful to investors, shareholders, managers and other interested parties. Not only this, some of the information needed are not displayed on the pages of the financial statements, but have to be derived or calculated from the accounts. Hence, users of financial statement undertake series of analysis on the annual reports of companies to be able to get necessary information needed for their economic decisions. It is therefore essential for professional accountants to be equipped with and understand various tools of financial statement analysis to meet the need of numerous users. The following subheadings are used in this chapter:

a. Users Of Financial Statements And Their Information Needs
b. Financial Analysis
c. Tools Of Financial Analysis
d. Summary Of Basic Accounting Ratios
C. Calculation of Basic Ratios and Their Interpretations
D. Limitations of Ratio Analysis

11.1 Objectives

At the end of this chapter, readers should be able to:

a) Distinguish Vertical And Horizontal Financial Analysis
b) Identify Different Tools Of Financial Analysis
c) Calculate Basic Financial Ratios.
d) Analyse Results Over Time Or Between Entities.
e) Interpret Such Results
f) Produce Reports Based On The Interpretation
g) Understand Basic Limitations Inherent In Such Analysis.

11.2 Users of Financial Statements and Their Information Needs

Financial statements are produced not for their own sake but for different uses to which they can be put by various groups interested in different aspects of the report. These users and their information needs are considered below:

Employees (existing and potential, including management): They are interested in the overall profitability, financial soundness, growth and efficiency of the company.

Investors (existing and potential, including shareholders, takeover bidders, predator companies): These are interested in profitability, earnings potential, dividend policy, yields on investment, financial stability and risk exposure of the firm where they have committed or are intending to commit their fund.

Creditors (existing and potential, including debenture holders, loan providers, bankers, trade creditors, lessors): These are concerned about the company's solvency and ability to pay debt and interest as at when they fall due, asset backing for liability, their position vis-à-vis other stakeholders, etc.

Analysts and Advisors (including credit rating agencies, stockbrokers, investment advisors, insurance brokers, etc.): These are professionals interested in the overall performance of the firm relative to the industry or the whole market.

Government and Its Agencies (including VAT Service, CEPS, IRS and Local Government, Central bank, etc.): This group of users are interested in the profitability and growth prospects of companies within the economy, their ability to meet their tax liability, their ability to generate employment and fulfil their statutory obligation and corporate responsibilities, etc.

Business Contacts (including suppliers, bankers, insurance companies, consumers): This group of people are interested in different things. Suppliers are interested in the continued existence of their client company and its growth. Consumers are interested in quality of goods and/or service delivery, reasonableness of pricing and trade terms, etc. Bankers are interested in the cash flow and performance efficiency of the client. Insurance companies are also interested in the continued operation of the client, risk management policies and safety measures.

The General Public: would like to see corporate bodies living up to their social responsibilities

11.3 Financial Analysis

The process of reviewing and evaluating the financial statements of companies, thereby gaining an understanding of the financial health of the company and enabling more effective decision making is what is referred to as **Financial Statements Analysis** or simply **Financial Analysis**.

Financial Analysis is usually performed by professionals who prepare reports using ratios that make use of information taken from financial statements and other sources. Financial analysis is required for many financial managerial decisions such as:

- How to manage the finances to achieve the strategic goals of the institution
- How to increase profitability
- How to reach self-sufficiency/breakeven point
- How to increase efficiency especially reducing the cost per client
- How to manage the costs of human resources as part of overall human resource management
- How to deal with the effect of inflation
- How to manage liquidity
- How to manage the fixed assets, i.e. what should the asset structure be? How to finance them, are they insured and are they safe, what should be the depreciation policy?
- What is the best financing structure, i.e., how much debt?
- What is the optimum level of each different operational expense including the cost of funds?

11.3.1 Tools of Financial Analysis

Analysing the financial statement could be done in several ways; through horizontal, vertical or intercompany and ratio analysis.

Horizontal Analysis

Horizontal analysis is the comparison of financial information over a series of reporting periods; it is a form of inter-temporal analysis i.e. a comparison between accounting periods. Horizontal analysis compares two or more years of financial data in both monetary and percentage terms, which is the most straight forward method of analysing financial statements. The current year figures and information are compared with the previous year (s) to note and rationalize any significant changes. A variation of horizontal analysis is **Trend Analysis** where percentage changes are calculated for several successive years thus having a long run view of the analysis. In trend analysis a firm's present performance figure is compared with its past and expected future performance figure to determine whether the company's financial condition is improving or deteriorating over time.

Vertical Analysis

Vertical Analysis also known as common size financial statement is the proportional analysis of a financial statement, where each line item on a financial statement is listed as a percentage of another item. Typically, this means that every line item on an income statement is stated as a percentage of gross sales, while every line item on a statement of financial position is stated as a percentage of total assets. It is the review of the proportion of accounts to each other within a single period.

Intercompany Analysis

This relates to comparison of performance figure of two or more similar companies. In intercompany analysis, the performance figures of a firm are compared with those of similar firms or with industry averages or norms to determine how the company is faring relative to its competitors. Ideally the `benchmarked companies` should be operating under similar business and economic conditions and applying similar accounting policies. If these are lacking, then adjustments should be made to ensure fair and comparable bases.

Ratio Analysis

Ratio analysis provides relative measures of the firm's conditions and performance. It identifies meaningful statistical relationships between different components of the financial statements. Ratios are useful in evaluating a company's financial position and operations and in comparing financial data for several years or for many companies.

11.4 Comparisons and Basis of Comparisons in Financial Analysis

Our discussion of tools of financial analysis enumerated above reveals that comparisons are being made; either inter-temporal and/or intra or intercompany. A single performance indicator or ratio is not sufficient on its own but becomes more meaningful if a benchmark or yardstick is available against which to set the indicator. This call for benchmarking and possible yardsticks to use as a basis for comparisons includes the following:

- Company's own budgeted or targeted performance
- Company's own previous year(s) performance (trend analysis or intra-company analysis)
- Performance figures of similar entities
- Industrial average performance figures
- National economic targets

11.5 Ratio Analysis as a Tool of Financial Analysis

Ratio analysis is the most common form of financial analysis. There are different categories and types of ratios with each of them focusing and evaluating different areas of performance. Therefore, it is important to restrict the calculation by being selective. The ratios chosen should be the key ones relevant to the requirements of the situation. The main point is that there is no single group of ratios suitable for all purposes; specific ratios are required for specific purposes and the analysis must be developed accordingly.

11.5.1 Categories of Ratios

Different users of financial statements are interested in different ratios since their information needs and areas of interest in the company differ. Ratios can be grouped into categories such as:

a) Profitability,

b) Activity or Efficiency,

c) Liquidity (short-term financial stability),

d) Gearing (Long-term financial stability) and

e) Investment and Market Value Ratios.

a) Profitability Ratios

Profitability is the ratio that measures the ability to earn income and sustain growth in both short and long run. A company's degree of profitability is usually based on the income statement, which reports on the company's results of operations. These ratios measure the entity's potential to earn income /revenue in excess of its operating costs.

The absolute figure of profit earned is not in itself significant since the size of the business earnings and profit may vary enormously. It is significant to consider the size of the profit relative to the size of the business; size being expressed in terms of the quantity of capital employed. This is why these ratios are of two types; those showing profitability in relation to sales and those showing profitability in relation to investment. Measures of profitability include the following:

i. Gross Profit Margin

ii. Net Profit Margin

iii. Return on Equity (ROE)

iv. Return on Assets (ROA)

v. Return on Capital Employed

-

Gross Profit Margin

Gross profit ratio expresses the relationship between gross profit and net sales. Gross profit is the difference between sales and cost of sales. Normally, a higher ratio is considered good. Gross profit ratio is a reliable guide to the adequacy of the selling prices and efficiency of trading activities.

$$\frac{\textit{Gross}\ \text{Profit}}{\textit{Total}\ \text{Sale}} \text{ x } 100$$

This is the margin that the enterprise makes on its sales. Normally, this ratio is expected to remain reasonably constant. A change in this ratio over various accounting periods may be traced to a change in:

- Selling price – normally deliberate though sometimes unavoidable, for example, because of increased competition
- Sales mix (often deliberate)
- Purchase cost including carriage or discounts
- Production cost (material, labour, production overhead)
- Inventory (error in counting, valuing or cut off, inventory shortages)

Low margins usually suggest poor performance but may be due to expansion cost (e.g. launching a new product) or trying to increase market share. Above average margins are usually a sign of good management although unusually high margins may make the competition keen, whereby many will be willing to join the industry and enjoy the rich pickings.

Generally, industries with high volumes of sales and quick turnover rates like food retailing are able to support and sustain low margins while manufacturing industries with high operating overheads would normally have high margins.

Net Profit Margin

This ratio establishes the relationship between net profit and net sales. Net profit ratio indicates the overall efficiency of the business. The higher the net profit ratio, better the business.

$$\frac{\textit{Net}\ \text{Profit after tax}}{\textit{Total}\ \text{sales}} \text{ x } 100$$

Rate of Return on Equity (ROE)

This is the required rate of return on investment in shares. It varies from investor to investor, but should reflect the fact that investment in shares is having a higher level of risk than leaving the money in the bank.

$$\frac{\textit{Net}\text{ Profit after tax - Preferred Stock Dividend}}{\textit{Shareholders'}\text{ Equity}}$$

Return on Assets

This is an indication of how profitable a company is relative to its total **assets**. **It** gives an idea as to how efficient management is at using its **assets** to generate earnings.

$$\frac{\textit{Net}\text{ Profits after Tax}}{\textit{Total}\text{ Assets}} \text{ x } 100$$

Return on Capital Employed (ROCE)

Return on Capital Employed or Return on Investment judges the overall performance of the enterprise. It measures how efficiently the sources entrusted to the business are being used. The return on capital employed is a fair measure of the profitability of any concern. This ratio also helps in judging performance of different departments as well. In practice, this ratio can be calculated in various ways depending on how capital employed is defined and which of the earnings figure is used, whether earnings before interest and tax (EBIT) or profit after tax (PAT).

In its simple form, this ratio is $= \frac{\text{Earnings}}{\text{Capital Employed}} \text{ x } 100\%$

Other versions of ROCE are as follows:

$$\frac{\text{EBIT (Net Profit before interest on long term loan and taxation)}}{\text{Shareholders Fund + Long term loan}} \text{ x } 100$$

EBIT means Earnings Before Interest and Tax

$$\frac{\text{Profit after Interest and Tax – preference dividends}}{\text{Ordinary share capital + reserves}}$$

b) Activity or Efficiency Ratios

These ratios show how well management have been able to utilize the resources of the business to generate income. They include:

i. Sales to Assets Ratio

Sales to Assets Ratio = $\frac{\text{Sales}}{\text{Assets}}$

The denominator (Assets) can be defined as Non-current Assets, total assets or various categories of assets; the choice of the appropriate base depends on the user of the information and the purpose of the analysis. The perceived performance of the company is good with a high figure from this ratio; therefore the higher this ratio, the better the performance.

ii. Sales to Capital Employed

This ratio suffers similar challenges like the ROCE because of the different ways of measuring capital employed by the business. Its interpretation is not different from that of Sales to Asset ratio.

$$\frac{\text{Sales}}{\text{Capital Employed}}$$

iii. Inventory Turnover Ratio/Period

Inventory turnover ratio establishes the relationship between the cost of goods sold during a given period and the average amount of inventory carried during that period. Higher ratio indicates that more sales are being produced by a unit of investment in inventory. The objective of computing inventory turnover ratio is to ascertain whether investment in stock has been efficiently used or not. A low inventory turnover may reflect dull business, over investment in stock or accumulation of inventory.

$$\frac{\text{Average Inventory x 365 days/52 weeks/12 months}}{\text{Cost of Sales}}$$

Receivables Turnover Ratio/period

This ratio is computed to establish the relationship between net credit sales and average Receivables. This ratio indicates the number of times the receivables are turned over in a year in relation to sales. It shows how quickly receivables are converted into cash. It indicates the efficiency of the staff entrusted with collection of debts. A high ratio is better since it would indicate that debtors are being collected more quickly.

$$\text{Debt Collection Period} = \frac{\text{Average Receivables x 365 days/52 weeks/12 months}}{\text{Credit Sales}}$$

iv. **Payable Payment Period**

This ratio shows the relationship between net credit purchases and average Trade payables. The objective of computing this ratio is to determine the efficiency with which the creditors are managed and paid. A high ratio indicates that creditors are not paid in time while a low ratio gives an idea that the business is not taking full advantage of Trade payables period allowed by the creditors. A long payment period may be good. It represents a source of free finance. It may however indicate that the company is unable to pay more quickly because of liquidity problems. Note that if the payment period is long, then:

i. The company may develop a poor reputation as slow payer and may not be able to attract new suppliers.
ii. Existing suppliers may decide to discontinue supplies
iii. The company may be losing out worthwhile cash discounts.

$$\text{Trade payable Payment Period} = \frac{\text{Average Trade payables x 365 days/52 weeks/12 months}}{\text{Credit Purchases}}$$

It is usual to find the last three ratios 'iii' to' v' listed under liquidity or short-term financial stability ratios as well. This is because they are part of working capital components and determinants of cash operating cycle.

c) Liquidity or Short-term financial stability Ratio

Liquidity or short-term financial stability ratios measure the ability of a firm to maintain positive cash flow, while satisfying immediate obligations. The common ones are:

Current Ratio

$$\text{Current Ratio} = \frac{\textit{Current}\text{ Assets}}{\textit{Current}\text{ Liabilities}}$$

The current ratio measures the adequacy of current assets to meet short term liabilities. It reflects whether the entity is in a position to meet its liabilities as they fall due. Traditionally, a current ratio of 2 or higher was regarded as appropriate for most businesses to maintain credit worthiness. However in recent times, a figure of 1.5 may be regarded as the norm (In practice, what is an ideal ratio depends on the industry and the particular circumstance of the entity involved). A higher figure should be perceived with some suspicion as it may be due to high level of inventory and receivable or high cash levels which could be put to better use. The current ratio should be looked at in the light of what is normal for the business. For example, supermarkets tend to have low current ratio because there are no trade receivables and there is usually very tight cash control.

Quick Ratio or Acid Test Ratio

Quick ratio is also known as the acid test ratio because by eliminating inventories from current assets, it provides the acid test of whether the enterprise has sufficient resources (in terms of receivables and cash) to settle its current liabilities. The Norm is for the quick ratio to be between 1 and 0.7 (even though in practice what is an ideal ratio depends on the industry and the circumstance of the entity).

$$\text{Quick Ratio or Acid Test Ratio} = \frac{\textit{Current}\text{ Assets less Inventory}}{\textit{Current}\text{ Liabilities}}$$

Stock Turnover Period

$$\text{Stock Turnover Period} = \frac{\text{Average Inventory x 365 days/52 weeks/12 months}}{\text{Cost of Sales}}$$

Debt Collection Period

$$\text{Debt Collection Period} = \frac{\text{Average Trade Debtors x 365 days/52 weeks/12 months}}{\text{Credit Sales}}$$

Creditors Payment Period

$$\text{Creditors Payment Period} = \frac{\text{Average Trade creditors x 365 days/52 weeks/12 months}}{\text{Credit Purchases}}$$

Cash Operating Cycle/Working Capital Cycle

This indicates the length of times it takes a business to convert its Inventory into sales (stock turnover period), converts receivables into cash (receivable collection period) and mobilizes cash to pay its trade payables (payable payment period).

Inventory turnover period	xx
Receivable Collection Period	xx
	xx
Less payables payment period	xx
Cash operating cycle	xx

The longer the period, the worse it is for the business because the longer the period, the higher the working capital requirement. It is therefore essential that under normal circumstances, a company works towards reduction of the Inventor turnover period and the Trade receivable collection period and expansion of the Trade payables payment period.

The Concept of Overtrading

Overtrading arises when a company expands its sales revenue fairly rapidly without securing additional long term capital adequate for its needs. The symptoms of overtrading are:

i. Inventory increasing, possibly more than proportionately to revenue

ii. Receivables increasing, possibly more than proportionately to revenue

iii. Cash and liquid assets declining at a fairly alarming rate

iv. Payables increasing rapidly

The symptoms imply that the company has expanded without giving proper thought to the necessity to expand its capital base. It has consequently continued to rely on its suppliers and probably its bank overdraft to provide the additional finance required. It will reach a stage where suppliers will withhold further goods and bankers will refuse to honour further cheques until borrowings are reduced. The problem is that borrowings cannot be reduced until sales revenue is earned which in turn cannot be achieved until production is completed; which in turn is dependent upon materials being available and wages paid. Overall result is deadlock and rapid financial collapse.

d) Gearing or Long- term Financial Stability Ratios

These ratios assess the ability of the entity to fulfil its obligation to creditors and other third parties in the long-run. They measure the relationship between equity capital and debt capital of the company and also indicate financial risk and stability of the company. Ratios computed under this sub-heading include the following:

i. Total Debts to Shareholders Fund = $\dfrac{\textit{Total debts}}{\text{Shareholders' equity}}$

ii. **Long Term Debts to Shareholders Fund**

This ratio measures the relationship between equity fund and debt capital. Within this context, preference shares are considered as debt capital (probably because they normally attract fixed rate of dividends and also they are cumulative). It is also known as the gearing or leverage ratio.

Gearing is the relationship between fixed interest bearing long term loans plus fixed dividend bearing shares on one hand and equity share capital or equity fund on the other. The objective of companies is to obtain favourable or positive leverage. This means that the business raises fund at a relatively low fixed servicing cost (in terms of interest and dividends) and uses these funds to earn a much higher returns than their servicing cost. This strategy is known as trading on the equity and is evidenced by improvement in earnings per share.

Long Term Debt to Shareholders Fund = $\dfrac{\text{Long Term Loan + Preference Shares}}{\text{Shareholders Fund}}$

The Concept of Financial Balance

The capital leverage of a company brings into focus the concept of *'financial balance'* It is the balance between the various forms of available funds. A business must have a sufficient level of long term capital to finance its long term investments in non-current assets. Part of the investment in current assets will also be financed by relatively permanent capital with the balance being provided by credit from suppliers and other short- term borrowings.

Any expansion in activity will normally require a broadening of the long capital base, without which overtrading may develop.

Suitability of finance is also a key factor. A permanent expansion of a company's activities should not be financed by temporary, short term borrowings. On the other hand a short term increase in activity such as the ***December Christmas Sales'*** for a company retailing children's wear would ideally be financed by short-term borrowing e.g. bank overdraft.

A major addition to property plant & equipment fixed assets such as the construction of a new factory would not normally be financed on a long term basis.

iii. Proprietary Ratio

Proprietary ratio is also known as Equity Ratio or Net worth to total assets. It establishes relationship between proprietor's funds to total resources of the firm. It is the inverse of debt ratio and is not very widely used.

$$\text{Proprietary Ratio} = \frac{\text{Shareholders Fund}}{\text{Total Tangible Assets}}$$

iv. Fixed Interest Cover

Interest cover shows how many times interest payments are covered by operating profits, or the ability of a company to pay for the cost of its long term borrowing out of profit is measured by its interest cover. A low interest cover is a warning to ordinary shareholders that their dividend may be endangered if profits are not maintained.

$$\text{Fixed Interest Cover} = \frac{\text{Net Profit before Interest and Tax}}{\text{Fixed Interest paid or payable}}$$

v. **Fixed Dividend Cover**

This is the relationship between available profits and the ordinary dividends payable out of those profits, reflecting how sustainable the dividend level is likely to be in the future

$$\text{Fixed Dividend Cover} = \frac{\text{Net Profit before Interest and Tax}}{\text{Preference Dividend paid or payable}}$$

e) Investment or Market Value Ratios

These are ratios that measure potential and actual growth of a shareholder's investment

The Earnings Per Share (EPS)

The EPS is used primarily as a measure of profitability and so an increasing EPS is a good sign.

$$\text{Earnings per Share i.e. EPS} = \frac{\textit{Earnings}\text{ after Taxes}}{\textit{Total}\text{ Number Shares}}$$

The limitations of EPS are as follows:

i. In times of rising prices, EPS will increase as profits increase. Thus any improvement in EPS should be viewed in the context of the effect of the price level changes on the company's profits

ii. Earnings Per Share is dependent on an earnings figure, which is a subjective measure. Some elements of the earnings figure are particularly subjective such as depreciation charges.

iii. EPS is a historical figure based on historical accounts. This is a disadvantage where it is used for a forward looking figure such as the price earnings ratio

iv. EPS cannot be used as a basis of comparison between companies, as the number of share in issue in any particular company is not related to the amount of capital employed.

Dividend Per Share (DPS)

This indicates the amount payable as dividend per ordinary share. It is usually recommended by the directors and approved by the shareholders. When compared with EPS, it indicates the retention policy of the Company.

$$\text{Dividend per Share} = \frac{\textit{Dividend}}{\textit{Total}\ \text{Number of Shares}}$$

Earnings Yield

This measure relates EPS to the market price per share and it is a very important stock market performance indicator.

$$\text{Earnings yield} = \frac{\text{Earnings per share}}{\text{Market price per share}} \times 100$$

Price Earnings Ratio

This ratio is the reciprocal of earnings yield and it indicates the payback period of the investment made in the shares. It is the most widely referred to stock market ratio. It is also commonly referred to as *Earnings Multiple* and it represents the market`s consensus of the future prospects of that share. The higher the P/E ratio, the faster the growth the market is expecting in the company`s future EPS; and the lower the P/E ratio, the lower the expected future growth.

$$\text{Price/Earnings Ratio} = \frac{\textit{Share}\ \text{Price}}{\textit{Earning}\ \text{per Share}}$$

Dividend Yield

This is the percentage of the gross dividend to the market price. The dividends are grossed up to show the amount including tax where applicable.

$$\text{Dividend Yield} = \frac{\textit{Dividend}\ \text{Per Share}}{\textit{Share}\ \text{Price}} \times 100$$

Dividend Pay-Out Rate

This ratio indicates the percentage of the earnings for the year (available to equity shareholders) that is actually declared as dividend.

$$\text{Dividend Pay-Out Ratio} = \frac{\text{Dividend per share}}{\text{Earnings per share}} \times 100$$

11.5.2 Calculation of Basic Ratios and Their Interpretation

A number of worked examples showing how basic accounting ratios are calculated are given below.

Illustration 11.1

The capitals employed by two different companies operating in the same industry are as follows

	Glory Ltd	Praise Ltd
	¢	¢
Equity Shares (issued at ¢2)	600,000	1,800,000
Preferences Shares (issued at ¢2)	600,000	-
	1,200,000	1,800,000
Income Surplus	800,000	1,200,000
Shareholders` Fund	2,000,000	3,000,000
18% Debentures	2,000,000	1,000,000
Capital Employed	4,000,000	4,000,000

Required:

i) Calculate the gearing ratios of each company, stating in each case whether the gearing is high or low.

ii) Calculate the maximum dividend per share on equity dividend which each company could declare, without utilizing, or adding to, surplus if net profits before interest and tax for 2006 were Glory ¢1,000,000 and Praise ¢1,000,000. The preference shares attract a fixed dividend of 24 pesewas per share per annum. Assume corporation profit tax to be at the rate of 30%.

(iii) What conclusions can you draw from your calculation in (ii) above?

Solution 11.1

b) (i) Gearing = $\dfrac{\text{Long Term Loan + Preference Shares}}{\text{Equity Fund}}$

	Glory Ltd	Praise Ltd
	¢2,600,000	¢1,000,000
	= 1.85:1	= 0.33:1
	¢1,400,000	¢3,000,000
	Highly geared	Lowly geared
b) ii	Glory Ltd	Praise Ltd
Net Profit before Interest and Tax	¢1,000,000	¢1,000,000
Less Interest	360,000	180,000
Net Profit before tax	640,000	820,000
Less Tax	192,000	246,000
Net Profit after tax	448,000	574,000
Preference dividend (300,000 x 24p)	72,000	-
Profit available for equity shareholders	376,000	574,000

Maximum dividend per share without utilizing ¢376,000 ¢574,000

----------- = ¢1.253 ------------ = 63.8p

300,000 900,000

(iii) It can be seen that in Glory Ltd, the highly geared company, EPS is substantially better than in Praise Ltd which is lowly geared, although both companies have the same net profit before interest and tax. This is due to the fact that the return on capital employed earned was higher than the fixed interest rate and fixed dividend rate.

Illustration 11.2

The figures below relates to QRS Ltd For the year ended 31 December 2006

	Dalasi (D)
Gross profit	3,985,000
Net Profit	1,275,000
Turnover	13,715,000

As at 31 December 2006	D
Shareholders' Fund	6,675,000
Total Tangible Assets	10,040,000
Total Current Assets	160,000
Current Liabilities	125,000
Long term loans	3,240,000
Inventories	95,000

Required:

Using the above figures and what can be derived there from, calculate profitability and financial stability ratios discussed above.

Solution 11.2

Some ratios that can be used to measure profitability are

- Net Profit to Total asset % (Return On Assets or ROA)
- Net Profit to Non-current assets %
- Net Profit to capital Employed (ROCE)
- Gross Profit to Sales %
- Net Profit to sales %

Some ratios that can be used to measure financial stability are

- Shareholders‟ funds to total tangible assets (Proprietary ratio)
- Long term external finance to shareholders funds
- Total external finance to shareholders‟ funds

- Current ratio
- Quick ratio or acid test ratio

b)

Profitability

i)	Net profit on Total Assets %	= D1,275,000/D10,040 =12.7%
ii)	Net Profit to Noncurrent Assets %	=D1,275,000/(D10,040,000–D160,000) =12.9%
iii)	Net Profit to Capital Employed	=D1,275,000/(D6,675,000 +D3,240,000) = 12.86%
iv)	Gross Profit to sale%	=D3,985,000/D13,715,000 =29.1%
v)	Net Profit to Sales %	=D1,275,000/D13,715,000 =9.3%

Financial Stability

i)	Proprietary Ratio	=D6,675,000/D10,040,000 = 66.5%
ii)	Long Term External Finance to SF	=D3,240,00/D6,675,000 = 48.5%
iii)	Total External Finance to SF	= (D3,240,000+D125,000)D6,675,000 = 50.4%
iv)	Current Ratio	= D160,000/D125,000 :1 = 1.28:1
v)	Quick Asset Ratio	= (D160,000 – D95,000) /D125,000 = 0.52 :1

Illustration 11.3

The summarized final accounts for the year ended 31 December 2006 for two retailing companies in the same industry are as follows:

INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2006

	Adom Ltd		Grace Ltd
	L$		L$
Sales	400,000		400,000
Cost of sales	280,000	292,000	
Gross profit	120,000	108,000	

Expenses	94,800	84,960
Net Profit	25,200	23,040

Statement of Financial Positions as At 31 December 2006

		Adom Ltd (L$)	Grace Ltd (L$)
Non-Current Assets		260,000	160,000
Current Assets:			
Inventory	96,000	96,000	24,000
Receivables	34,000		8,500
Cash	10,000		39,500
		140,000	72,000
Current Liabilities		(40,000)	(4,000)
Net Current Liabilities		100,000	32,000
		360,000	192,000
Financed by			
Stated Capital		160,000	160,000
Income Surplus		200,000	32,000
		360,000	192,000
Notes:			
Opening Inventory were as follows		64,000	16,000

Required:

a) Calculate the following ratios for the respective companies:

- Current Ratio
- Acid Test Ratio
- Rate of Inventory Turnover

- Gross Profit to Turnover %
- Net Profit to Turnover %
- Net Profit to Capital Employed %

b) One of the companies had adopted the policy of selling goods as cheaply as possible to increase the volume of sales. The other company gives special attention to customer service and charges top prices for its goods.

Required

State with reasons, which of these companies, Adom Ltd or Grace Ltd, is better using ratios in part (a) of the question

Solution 11.3

		Adom Ltd	**Grace Ltd**
a)	Current Ratio	L$140,000	L$72,000
		------------- =3.5:1	------------- =1.8:1
		L$40,000	L$40,000
	Acid Test	L$44,000	L$48,000
		------------- = 1.1:1	-------------1.2:1
		L$40,000	L$40,000
	Rate of Inventory Turnover	L$280,000	L$292,000
		-------------- 3.5 times	-----------14.6times
		L$80,000	L$20,000
	Gross Profit %	L$120,000	L$108,000
		-------------- =30%	------------- = 27%
		L$400,000	L$400,000
	Net Profit %	L$25,200	L$23,040
		------------ = 6.3%	------------ = 5.8%

	L$400,000	L$400,000
Net Profit to Capital Employed	L$25,200	L$23,040
	------------ = 7.0%	------------ = 12%
	L$360,000	L$192,000

Adom Ltd carries a wider range of expensive Inventory, consequently inventory turnover is slower. More substantial investment in non-current assets, stemming from ownership of a prime prestigious site and luxurious premises has accounted for a relatively low return on capital employed.

Grace Ltd charges lower prices which encourage sales. The faster Inventory turnover is the result of the company operating on a Inventory figure of about one quarter of that of its competitor.

Illustration 11.4

The financial information provided below is for two companies, which operate in similar retail fields, using the same business and accounting policies.

STATEMENT OF FINANCIAL POSITION AT 30 JUNE 2006

	GODSON LTD	**ALLASON LTD**
Financed by:	¢	¢
Share Capital	7,000	9,400
Capital Surplus	1,300	700
Income Surplus	3,700	5,740
Shareholders" Interest	12,000	15,840
10% Debentures	1,100	1,280
	13,100	17,120

Represented by

Non-current	11,260	15,700
Current Assets		
Inventories	2,440	1,940
Trade Receivables	2,480	3,320
Cash	120	160
	5,040	5,420
Current Liabilities		
Bank Overdraft	420	400
Trade Payables	1,940	2,640
Expense Creditors	840	960
	3,200	4,000
Net Current Assets	1,840	1,420
	13,100	17,120

STATEMENT OF INCOME FOR THE YEAR ENDED 31 DECEMBER 2006

	GODSON LTD	ALLASON LTD
	¢	¢
Sales	14,940	11,400
Cost of sales	11,360	7,540
Gross Profit	3,580	3,860
Less: Expenses		
Selling and Distribution	1,280	1,200
Administration and General	620	580
Financial	180	160
	2,080	1,940
Net Profit before	1,500	1,920
Taxation	740	900

Net Profit after tax	760	1,020
Dividends	480	740
Retained Profit	280	280

You are required to:

a) Calculate for each company six ratios which you consider to be most appropriate for indicating the efficiency of operation and short term financial strength of the two firms showing the figures you have used and pointing out any weakness in the figures, and alternatives that might be taken had more information been available.

b) Using the financial information provided above and the ratios you have calculated, prepare a report which analyses and compares the efficiency of operations and short term financial strength of the two companies.

Solution 11.4

The question requires only six ratios to be calculated out of the many which can be calculated. The main feature of the question is that there should be a judicious selection of ratios. Different accountants would make different choices.

	Godson Ltd	**Allason Ltd**
Efficiency of Operation		
Sales/non-current Asset	¢14,940 ------------ =1.32 or 132% ¢11,260	¢11,400 -----------=0.72or 72% ¢15,700
Net Profit before Tax/Capital Employed	¢1,500 = 11.54 % ¢13,100	¢1,920 ¢17,120

Sale/Capital Employed	¢14,940 =1.4 or 114% ¢13,100	11,420 ----------=0.67 or 67% ¢17,120

Short Term Financial Strength

Working capital (Current) Ratio	¢5,040 :1 = 1.58 :1 ------------ ¢3,200	¢5,420 :1 = 1.36:1 ---------- ¢4,000
Debts collection period	¢2,480 ---------- x365days =61days ¢11,360	¢3,320 -----------x365 =106dyas ¢3,860

The main weakness in the figures is that the ratios have been calculated on the figures prepared under historic cost convention. Consequently, if one of the companies is much older than the other, it will have better efficiency ratios, all other things being equal, by reason of its total assets and capital employed being less than those of other company since a greater number of years‟ depreciation would have been accumulated.

If more information had been available, figure on current cost accounting basis could have been used. This would not only have taken inflation into account, but also would have the effect of making the two companies‟ figures time comparable.

b) **Report on Inter-Company Performance Comparison**

Efficiency of Operation

In absolute terms, Allason has achieved a greater net profit (¢1,920) on a lower turnover figure of ¢11,400) compared with ¢14,940m for Godson Ltd. This represents net profit to sales of 16.85% for Allason Ltd as against 10% for Godson Ltd.

This situation is mainly attributable to the Gross Profit Ratio of 33.86% and 23.96%

for Allason and Godson respectively. Bearing in mind that these are similar businesses, this disparity is remarkable. From the evidence which follows, there might be good reasons for saying that Godson Ltd is under-pricing its goods and that Allason Ltd is over-pricing them and that both companies might improve profits and profitability by remedying this situation.

Godson's lower Gross profit margin of 33.86% seems to be responsible for its faster Inventory turnover of 5.07 times compared with Allison's rate of Inventory turnover of 4 times. The lower turnover (¢11,400) and slower Inventory turnover (4 times) of Allason are reflected in its poor sales to capital employed ratio of 0.67 times or 67% compared with 1.14% for Godson Ltd. Overall profitability (ROCE) is consistent with the above findings.

Short-term Financial Strength

At both 1.56:1 and 1.36:1, the working capital positions of both companies seem weak. The Receivable collection and Payable settlement periods of Godson are evenly balanced (about 61/62 days) while those for Allason are about 106 days and 128 days respectively.

If those for Godson are on the high side, Allason's figures are incredibly high. Considering the similarity of the businesses, the disparities between the two companies is surprising. The liquidity problem could be overcome by issuing share capital or debentures.

11.6 Limitations of Ratio Analysis

Ratios are meaningless on their own unless they are interpreted to bring out their intended meaning and to tell the intended stories to aid management decisions. The following points should serve as a checklist

i. What does the ratio literally mean?
ii. What does a change in the ratio mean?
iii. What is the norm?
iv. What are the limitations of the ratio?

Computing financial ratios are merely one way of conducting financial analysis and financial ratios face several theoretical challenges among which are:

1. Financial statements themselves have limitations, e.g. they contain arbitrary estimates and figures which are based on personal decisions. Another limitation of financial statement is window dressing. To give a better picture of the company, accounting figures may be manipulated.

2. The application of accounting policies in the preparation of financial statements must be understood when attempting to interpret financial ratios. Inter firm comparison is possible provided these firms follow the same accounting policies regarding the method of depreciation, valuation of stock, etc. But this is very rare to see.

3. The effect of inflation: The problem of interpreting data in a period of changing prices is can only be catered for if prior year(s) figures are adjusted to constant values. The interpretation and comparison of ratios are rendered invalid by the changing value of money.

4. A few simple ratios do not provide an automatic means of evaluating a company. Business problems usually involve complex patterns which cannot be solved by the use of ratios.

5. Ratios must not be used as the sole test of efficiency. Concentration of ratios may inhibit the incentive to grow and expand, to the detriment of the long-term interests of the company.

6. The earning power of a business may well be affected by factors which are not reflected in the financial statements. Thus, these do not necessarily represent a complete picture of a business, but only a collection of those parts which can be translated into money terms e.g. the size of the order book and the existence of a highly trained workforce are normally ignored in financial statements.

7. Ratios say little about the firm's prospects in an absolute sense. Their insights about relative performance require a reference point from other time periods or similar firms.

8. One ratio holds little meaning. As indicators, ratios can be logically interpreted in at least two ways. One can partially overcome this problem by combining several related ratios to paint a more comprehensive picture of the firm's performance.

9. Seasonal factors may prevent year-end values from being representative. A ratio's values may be distorted as account balances change from the beginning to the end of an accounting period. Use average values for such accounts whenever possible.

10. Financial ratios are no more objective than the accounting methods employed. Changes in accounting policies or choices can yield drastically different ratio values.

11. They fail to account for exogenous factors like investor behaviour that are not based upon economic fundamentals of the firm or the general economy (fundamental analysis).

12. Many large companies actually operate a number of different divisions in quite different industries making it difficult to develop a meaningful set of industry averages for comparison purposes.

13. At times, even for those companies operating in one industry it is difficult to decide on a proper basis for comparison. Ratios of a company have meaning only when they are compared with some standards. Generally there is no standard ratio for the purpose of the comparison, because conditions of one concern differ significantly from another concern. For example, an ideal current ratio is 2: 1. But if a firm is able to procure additional funds easily and immediately, in that case current ratio of less than 2 may be considered good.

14. The differences in definitions of items in the statement of financial position and income statements make the interpretation of ratio difficult. In practice, differences exist as to the meaning of certain term e.g. capital employed. Terms used to calculate accounting ratios have no standard and precise

15. definition. For example, net profit ratio is calculated by different ways like net profit before tax or net profit after tax.

16. Ratios calculated at a point in time are less informative and effective as they suffer short-term changes and qualitative factors like skill of employees, quality of product/ service, competitions, industrial relations, etc. are ignored.

17. Life cycle of the business, such as type of firm, stage of development, objectives of owners are not considered. For example low profitability ratios may be accepted during early stages of growth.

18. Ratios indicate past performance only. Ratios are calculated on the basis of past figures. Thus, ratios indicate past performance and not expected future performance. Since past is quite different from what is likely to happen in future, it is difficult to use ratios for forecasting purposes. The financial analyst is more interested in what will happen in future. The management of a company has information about the company's future plans and, policies and is, therefore, able to predict future to a certain extent. But an outsider analyst has to rely only on the past ratios.

19. Unless ratios are calculated in a uniform manner, from uniform data, comparisons can be very misleading.

19. The accounting periods covered by the financial statements may not reflect representative financial positions. Many businesses produce financial statements to a date on which there are relatively low amounts of trading activities. If trade is seasonal, the items in the statement of Financial Position may not be representative of values throughout the accounting period.

11.7 Chapter Summary

Users of financial statements can best appreciate the contents if they can interpret the statements and make meaning out of them. Horizontal or intra-company analysis involves comparing the current year with the previous year(s) and noting any significant changes. Intercompany analysis involves comparing an entity's performance with another entity of comparable standard

Ratios are one means of analysing financial statements. Ratios can be grouped into categories such as Profitability, Liquidity (short term financial stability), Efficiency, Gearing (Long term financial stability) hand Investor ratios. Different users of financial statements are interested in different ratios. Ratios are only as good as the underlying information and this must therefore be considered as to its reliability and the degree to which it may have been manipulated.

11.8 MULTIPLE CHOICE QUESTIIONS

1. During a year, a business sold inventory which had cost N120,000. The inventory held at the beginning of the year was N12, 000 and at the end of the year was N20,000. What was the annual rate of inventory turnover?

   A. 12times

   B. 10 times

   C. 7.5 times

   D. 7 times

   E. 6 times

2. Given a selling price of Le350, 000 and a gross profit mark up of 40%, the cost price would be

   A. Le300,000

   B. Le250,000

   C. Le210,000

   D. Le140,000

   E. Le100,000

3. A business operates on a gross profit margin of $33^{1}/_{3}$%. Gross profit on sale Was L$1,600 and expenses were L$1,360. The net profit percentage is

   A. 22.67%

   B. 11.25%

   C. 18.5%

   D. 5.0%

   E. 3,75%

4. In 2006, a company's current ratio was 2.5:1 and its acid test ratio was 0.8:1. By year 2007, the ratios are expected to be 3:1 and 0.6:1 respectively. These changes are most likely to be due to which ONE of the following

   A. Increased bank balance

   B. Decreased bank balance

   C. Increased Inventories

   D. Increased receivable and payable

   E. Decreased Inventories

11.9 SHORT ANSWER QUESTIIONS

1. State the formulae for computing inventory turnover ratio
2. State how to compute quick Asset ratio.
3. State the formulae for debt collection period
4. (Long term loan + Preference shares)/Equity is equal to
5. Which user group would be most interested in the gearing ratio?

11.10 SOLUTION TO MULTIPLE CHOICE QUESTIONS

1. C
2. B
3. D
4. D

11.11 SOLUTION TO SHORT ANSWER QUESTIONS

1. Inventory turnover ratio= $\dfrac{\text{Average Inventory x 365 days/52 weeks/12 months}}{\text{Cost of Sales}}$

2. Quick Ratio or Acid Test Ratio **=** $\dfrac{\textit{Current}\text{ Assets less Inventory}}{\textit{Current}\text{ Liabilities}}$

3. Debt Collection Period = $\dfrac{\text{Average Receivables x 365 days/52 weeks/12 months}}{\text{Credit Sales}}$

4. Gearing

5. Debenture Holders

11.12 Examination Type Question

a) It is widely recognized that in order to succeed, a business must pay regard not only to its profitability but also to its financial stability.

Required

i) State briefly what you understand to be the meaning of the terms `profitability" and "financial stability"

ii) Name three ratios which can be used for measuring profitability and three ratios for measuring financial stability.

SOLUTION

Profitability

This is the measure of relationship between profit and the resources employed in earning it: the resultant figure is usually expresses as a percentage. The resources aspect of the relationship may comprise total assets or fixed assets plus working capital or equity fund.

For other businesses which are not asset reliant, an alternative suitable measure might be adopted.

Thus in a profession such as that of an accountant or a solicitor, profit would be more appropriately related to fee income. A subsidiary measure of profitability is in the relationship between gross profit and net profit to sales.

Financial Stability

This measures the degree of safety of a business from failure due to inability to pay its way. It is necessary to consider stability in both the long and short term. Thus, in assessing financial stability, important relationships include e.g. those subsisting between total resources owned and external obligations (that is, solvency) and between short term resources owned and external obligations which have to be met in the near future (that is, liquidity). Stability is the firm's ability to remain in business in the long run, without having to sustain significant losses in the conduct of its business. Assessing a company's stability requires the use of both the income statement and the statement of financial position, as well as other financial and non-financial indicators.

Ratios that can be used to measure profitability are

- Net Profit to Total asset % (Return On Assets or ROA)
- Net Profit to Non-current assets %
- Net Profit to capital Employed (ROCE)
- Gross Profit to Sales %
- Net Profit to sales %

Ratios that can be used to measure financial stability are

- Shareholders‟ funds to total tangible assets (Proprietary ratio)
- Long term external finance to shareholders funds
- Total external finance to shareholders‟ funds
- Current ratio
- Quick ratio or acid test ratio

CHAPTER TWELVE
BRANCH ACCOUNTS

CHAPTER CONTENTS

a. Introduction
b. nature of Branch operations
c. semi –autonomous Branches
d. Independent Branches

12.0 OBJECTIVES

At the end of this chapter the reader shall be able to**:**

a. Prepare ledger accounts in respect of branch transactions;
b. Handle accounts of semi-autonomous branches
c. Combine the accounts of Head Office and branches; and
d. Reconcile the Branch Current Accounts

12.1 INTRODUCTION

In this chapter, you will be introduced to the concept of branch accounts. The chapter will cover the reasons for branch account, types of branch and the method of accounting for branch transactions. You would note the ledger accounts, the statement of profit or loss of branches and the profit and loss account of the head office, including the branches.

12.2 NATURE OF BRANCH OPERATIONS

Many entities, especially those in retailing, find it convenient to operate from various locations. A manufacturer may want to sell its produces from different spots in order to maximize sales and also attend promptly to its customers. In such cases, one option is to carry out its business from various branches.

For instance, a company manufacturing say cement in Lagos may decide opening sales outlets in Abuja, Sokoto, Ibadan or Maiduguri. In Ghana, a manufacturer of cement in Tema, in order to maximize sales may open sales outlets in Accra, Takoradi, Kumasi and

Tamale. These sales outlets may become branches of the company. The initial capital in establishing the branch (securing the offices, furnishing the offices) would be borne by the Head Office.

Let us note that the branch does not exist on its own. It is an extension of the Head Office and as such must account to the Head Office. Goods for sale would be supplied by Head Office. At times the Head Office would allow the branch to purchase some items for sale. In cases where the branch is large and has experienced personnel, the Head Office might decide to make the branch independent. With independent branches, the necessary accounting books would be kept by the branch. However, this does not make the branch a separate entity.

From the above, let us note the following:

a. Branches are normally located at a distance from the Head Office.

b. The Head Office would need to control the branch. The control would include pricing policy of the branch.

c. The Head Office would want to ascertain the profit or loss of the branch at the end of every financial year.

For accounting purposes, branches can be subdivided into three. These are:

i. Branches for which all the financial records are kept at the Head Office;

ii. Branches which maintain separate accounting records

iii. Foreign Branches:- At this level of your study, you would not be required to study the accounting technique of and methods for accounting for foreign branches.

12.3 NON-AUTONOMOUS BRANCHES

In cases where all branch records are kept in the Head Office, all expenses may be paid directly by Head Office. The Branch Manager would be given an imprest from which incidental expenses would be met. Most sales should be in cash and cash receipts should be sent to Head Office intact that is without any deduction. Where by custom there is considerable credit sales, the Head Office would keep a Trade Receivables Control Account whilst the Branch Manager would keep only copies of the sales invoice. The Branch Manager would prepare a "return" i.e. a statement periodically to Head Office.

The returns would show the following:

1. Goods received from Head Office;
2. Goods returned to Head Office
3. Cash and Credit Sales;
4. Cash received from Trade Receivables
5. Expenses;
6. Cash Banked; and
7. Closing Inventories, Cash in Hand and Closing list of Trade Receivables

There are three basic methods of invoicing goods to the branches. These are:

i. The cost Method
ii. The Cost plus a Percentage Method; and
iii. The Selling Price Method.

At this stage of your studies, you will be required to learn only the Cost Price Method and the Cost plus a Percentage Method.

12.3.1 COST PRICE METHOD

This method is very useful when the Inventory is of perishable nature or there are fluctuations in selling prices. The major Accounts that are needed will include the Branch Inventory Account, and Goods sent to Branch Account. Branch Trade Receivables Account and Branch Expenses Account,

With this method, the Branch Inventory Account performs a dual role. It serves as a Trading Account and statement of Profit or Loss to some extent.

It has been stated at the onset that with the Cost Price Method, the Branch Inventory Account is acting as a Trading Account; hence it must show the gross profit margin on the branch transactions. It follows from the above that in order not to distort the gross profit, goods stolen and cash stolen must be credited to the Branch Inventory Account. If goods are stolen you must note that the gross profit on the goods has not been earned, hence the Defalcation Account should be debited. The Defalcation Account is later closed to the statement of Profit or Loss. In the case of cash, the gross profit has been earned so the debit must be to the statement of Profit or Loss.

Let us apply the normal bookkeeping principles.

1. When goods are sent to branch:

   Debit Branch Inventory Account

   Credit Goods Sent to Branch Account with the cost price

2. When goods are returned to Head Office

   Reverse the entries: by

   Debiting: Goods Sent to Branch Account

   Crediting: Branch Inventory Account with the cost of the goods returned

3. Sales of goods made:

i	Cash Sales:	Debit	Bank
		Credit:	Branch Inventory Account with sales value
ii	Credit Sales	Debit:	Branch Trade Receivables Account
		Credit:	Branch Inventory Account with sales value

4.	Goods Stolen:	Debit:	Defalcation Account
		Credit:	Branch Inventory Account with goods stolen
5.	Cash Stolen:	Debit:	Statement of Profit or Loss
		Credit:	Branch Inventory Account with cash stolen

Let us illustrate how the accounting techniques go with the cost price method.

Illustration 12.1

Shinake opened a branch in Kumasi. The Head Office in Accra maintains all records and charges goods to branch at cost. From the information below, prepare the necessary ledger accounts for the branch for the year ended 30th September, 2016 and show the Profit or Loss.

	Ecos
Goods sent to Branch by Head Office at Cost	144,000
Returns from Branch to Head Office at Cost	6,400
Branch Credit Sales	120,000
Cash sales sent to Head Office	33,600
Cash sales stolen	480
Goods stolen	160
Branch expenses paid by head office	5,120
Closing Inventory at Branch at cost	40,000
Cash received from Trade Receivables	92,800
Discount allowed to branch Trade Receivables	4,800

Head Office

	Econs
Opening Inventory 1/10/15	192,000
Purchases	1,120,000
Sales	1,440,000
Closing Inventory 30/9/16	112,000
Expenses	64,000

SOLUTION TO ILLUSTRATION 12.1

Kumasi Branch Inventory Account

	Econs		**Econs**
Goods sent to Branch	144,000	Goods sent to Kumasi Branch	6,400
		Account	
Statement of profit or loss		Branch Trade Receives (Credit Sales)	120,000

Gross profit	56,180	Cash Account cash sales	33.600
Defalcation cash sales stolen	480	Defalcation goods stolen	160
	______	Closing stock	40,500
	200,660		200,660

Goods sent to Kumasi Branch Account

	Econs		Econs
Kumasi Branch Inventory Account	6,400	Kumasi Branch Inventory	144,000
Trading Account Branch	137,600		
	144,000		144,000

Kumasi Branch Trade Receivables

	Econs		Econs
	120,000		92,800
			4,800
	_______		22,400
Balance b/d	120,000		120,000
	22,400		

Defalcations Account

	Econs		Econs
Kumasi Branch Inventory Account:		Statement of profit or loss	640
Cash sales stolen	480		
Goods stolen	160		___
	640		640

Head Office Statement of Profit or Loss

	Econs		Econs
Opening Inventory		Sales	1,440,000
Purchases			
Less: Transfers to Kumasi Branch			
Less: Closing inventory			
Cost of Goods Sold			
Gross Profit c/d	377,600		
	1,440,000		1,440,000
Expenses – Head office	64,000	Gross profit b/d	377,600
	5,120	Kumasi branch gross profit	56,180
	640		
	4,800		
	359,220		
	433,780		433,780

12.3.2 COST PLUS A PERCENTAGE METHOD

This method is very useful where there is a fixed percentage mark up. For the purpose of accounting for the branch transactions, the Branch Inventory Account and Goods sent Branch Account would still be used. In addition, an account called Branch Inventory Adjusment Account would be needed. The Branch Inventory Adjustment Account would show the "Loading"" added to the cost to arrive at the selling price, which is Cost plus the Loading.

Because the goods are invoiced to the branch at cost plus a percentage, it would be necessary for statement of financial position purpose to set off the balance on the Branch Inventory Adjustment Account against the balance of the Branch Inventory Account, so as to arrive at the cost of the closing Inventory.

The entries in the accounts are as follows:

1. **When goods are sent to Branch:**

   Debit: Branch Inventory Account with the full invoiced price

   Credit: Goods sent to Branch Account with the cost of the

   goods Credit: Branch Inventory Adjustment Account with the loading

2. When goods are returned to head office:

Debit: Goods Sent to Branch Account with the cost

Debit: Branch Inventory Adjustment Account with the Loading

Credit: Branch Inventory Account with the full invoiced price

3. **When Sales are Made:**

Cash Sales:

Debit: Bank Account

Credit: Branch Inventory Account with the invoiced amount

Credit Sales:

Debit: Branch Trade Receivables Account

Credit: Branch Inventory Account with the invoiced value

4. **At the end of the period, close the Branch Inventory Account by:**

Crediting it with the invoiced value of closing Inventory and debit same account to form the opening balance.

5. **If goods are stolen:**

Debit: Defalcation Account with cost price of goods

Debit: Branch Inventory Adjustment Account with the loading

Credit: Branch Inventory Account with full invoiced price

6. **If goods are stolen:**

Debit: Defalcation Account with amount stolen

Debit: Branch Inventory Account with the Amount stolen

7. **Authorised reduction or allowances off selling prices:**

Debit: Branch Adjustment Account

Credit: Branch Stock Inventory with the reduction/allowances of selling prices

Let us illustrate how the bookkeeping goes using the examples below:

ILUSTRATION 12.2

Mensah Limited invoices its branch, Beetomu, at cost plus $33^{1}/_{3}$%. Prepare the necessary accounts in the Head Office books in the light of the following information.

	Ecos
Inventory at the beginning, at invoice price	7,500
Inventory at the close of the period, at invoice price	6,000
Goods sent to branch at invoice price	50,000
Credit sales	2,500
Returns to head office at Invoice price	2,500
Cash sales	45,000
Invoiced value of goods stolen	500
Normal loss due to wastage	750
Cash takings stolen	200
Allowances off selling prices	250

Solution to Illustration 12.2

Branch Inventory Account

	Ecos		**Ecos**
Inventory bal b/fwd	7,500	Trade Receivable Accounts (credit)	2,500
Goods sent to branch	50,000	Goods sent to branch (Returns)	2,500
Branch Adjustment Account Apparent Profit	200	Cash sales	45,000
		Defalcation Account	375
		Branch Inventory adjustment account	125
		Branch Inventory Adj. Account (wastage)	750
		Branch Adjustment Account (reduction)	250
		Defalcation Account (cash stolen)	200

		Closing Inventory c/d	6,000
	57,700		**57,700**
Balance b/d	6,000		

Goods Sent to Branch Account

	Ecos		Ecos
Branch Inventory Account (Returns)	1,875	Branch Inventory account Account	37,500

Branch Inventory Adjustment Account

	Ecos		Ecos
Branch Inventory Account (Returns)	625	Inventory bal b/fwd	1,875
Branch Inventory Account (goods stolen)	125	Branch Inventory Account	12,500
Branch Inventory (Normal loss)	750	Branch Inventory Account Apparent Profit	200
Branch Inventory (authorized reduction)	250		
Closing Inventory c/d	1,500		
Statement of Profit or Loss	11,325		
	14,575		**14,575**
		Opening inventory b/d	1,500

Defalcation Account

	Ecos		Ecos
Branch Inventory account	375	Insurance	Xxx
Branch Inventory Account	400	Statement of Profit or Loss	575
	575		575

Branch Trade Receivables Account

	Econs		
Branch Inventory Account	2,500		

12.4 INDEPENDENT BRANCHES

A branch may be allowed by its Head Office to keep a full set of accounts. It may be allowed to even purchase goods for sale on behalf of the Head Office. In most cases, the initial establishment cost of the branch would have been incurred by the Head Office. You should never lose sight of the fact that a branch has no legal existence. Therefore the capital of the branch belongs to the company and the branch must account to the Head Office the results of its operations.

The Head Office will continue to invoice goods to the branch and may acquire non-current assets to be used by the branch.

In order to keep track of its dealings with the branch, the Head Office will keep a Control Account to record all its dealings with the Branch. The account is termed Branch Current Account. In the same way, the Branch will also keep a Head Office Current Accounts in its books.

Since these two accounts are mirror images of each other, they are contra accounts. The import of the above statement is that the entries in the two accounts must be the same but in "contraposition", that is in opposite sides of the accounts.

Note that these two accounts are held in different sets of books, one in Head Office's books whilst the Head Office Current Account is in the branch's book. It is therefore incorrect to complete the double entry bookkeeping by debiting and crediting these accounts.

The advice is that when dealing with the branch, concentrate on the branch and try to complete the double entry system as if only the branch exists. Similarly adopt the same principle when considering the transactions from the point of view of the Head Office.

Let us illustrate the above point with the example below:

ILLUSTRATION 12.3

Mambo Limited located in Accra East opened a branch in Takoradi and transferred to or acquired the following for the branch.

	Ecos
Land and Buildings	80,000
Fixtures and Fittings	27,000
Vehicles	14,500
Inventory	120,000
Cash	65,000

The Balances on these accounts in Head office books were:

	Ecos
Land and Buildings	280,000
Fixtures and Fitting	100,000
Vehicles	40,000
Inventory	250,000
Cash	135,000

Prepare relevant Accounts in the books of

(i) The Head Office

(ii) The Branch

SOLUTION TO ILLUSTRATION 12.3

(i) In Head Office books, the Branch Current Account will serve as the link between the Head Office and the Branch. Let us assume that all the assets, apart from Cash, have been acquired and paid for by the Head Office.

On the purchase of the assets, the Head Office would:

Debit: Branch Current Account

Credit: Assets Account (with the cost of the assets transferred to the Branch)

Using the above information the ledger accounts would be as following:

Land and Building Account

	Ecos		Ecos
Balance b/d	280,000	Branch Current Account	80,000

Motor Vehicles Account

	Ecos		Ecos
Balance b/d	40,000	Branch Current Account	14,500

Inventories Account

	Ecos		Ecos
Balance b/d	250,000	Branch Current Account	120,000

Cash Account

	Ecos		Ecos
Balance b/d	135,000	Branch Current Account	65,000

Fixtures and Fittings Account

	Ecos		Ecos
Balance b/d	100,000	Ecos Branch Current Account	27,000

Branch Current Account

	Ecos		Ecos
Land and building account	80,000	Bal c/d	306,500
Motor Vehicles Account	14,500		
Fixtures & Fittings	27,000		
Inventories Account	120,000		
Cash Account	65,000		
	306,500		306,500
Bal b/d	306,500		

This balance shows the total investment of the Head Office in the Branch,

(ii) In the Branch Books

Let us note that the Branch would receive these items from the Head Office but because it has a full set of accounts, it must record them in its books. That is to say the branch must follow the double entry bookkeeping principle in recording the above transactions.

On the receipt of assets, the Branch would:

Debit: The Assets Account

Credit: The Head Office Current Account (with the cost of the assets)

Hence the ledger account in the Branch Books in respect of the above transactions should be as follows:

Land and Building Account

	Ecos		Ecos
Head Office Account	80,000		

Fixtures and Fittings Account

	Ecos		Ecos
Head Office Account	27,000		

Motor Vehicles Account

	Ecos		Ecos
Head Office Account	14,500		

Inventories Account

	Ecos		Ecos
Head Office Account	120,000		

Cash Account

	Ecos		Ecos
Head Office Account	65,000		

Head Office Current Account

	Ecos		Ecos
Balance c/d	306,500	Land & building Account	80,000
		Fixtures & Fittings	27,000
		Motor Vehicles	14,500
		Inventories Account	120,000
		Cash Account	65,000
	306,500		**306,500**
		Balance b/d	306,500

In the Branch books, you should always expect the Head Office Current Account to show a credit balance. The reason for the credit balance is that it is like the capital account of the branch. The two accounts show identical entries except that they are in opposite directions. However, due to distance between Head Office and the Branch, at times items sent by the Head Office to the Branch and remittances from the Branch to Head Office might delay. The two accounts will then not show the same balance due to in-transit items.

In preparing the final accounts of the whole business, the current account should be reconciled and admitted. If the goods are invoiced by Head Office at selling price or cost plus percentage, the unrealized profit should be taken care of when considering the result of operation of the whole entity.

ILLUSTRATION 12.4

Nautwi is in retailing, Its Head Office is in the Central business area near Sakcramoto. As a result of increase in its operation it opened a branch at Takoradi Market Circle area.

The following Trial Balance has been extracted from the books of account as at 30th September, 2016.

	Head Office		**Takoradi Branch**	
	Ecos DR	**Ecos CR**	**Ecos DR**	**Ecos CR**
Drawings	40,000			
Non-Current Assets as at cost	350,000		100,000	
Accumulated depreciation		140,000		30,000
Opening Inventory 1/10/2015	8,000		20,000	
Provision for unrealized profit		4,000		
Goods sent to branch at invoice price		380,000	375,000	
Purchases	914,000			
Sales		850,000		437,000
Doubtful Debts Provision		9,000		2,500
Current Accounts	175,000			120,000
Distribution expenses	80,500		5,000	
Administrative expenses	200,000		16,500	
Trade Receivable	60,000		60,000	
Trade payables		50,000		
Cash at Bank Balance	15,500			
Capital		410,000		
	1,843,00	1,843,000	589,500	589,000

ADDITIONAL INFORMATION:

i. All goods are purchased by the Head Office. Goods sent to Takoradi branch are invoiced at cost plus 25%

ii Closing Inventory at Head Office were 12,000 Ecos at cost, closing branch Inventory were at invoiced price of 15,000 Ecos.

iii Depreciation is to be provided for the year on non-current assets at the rate of 10% on cost

iv Provision for doubtful debts is to be calculated at the rate of 5% of outstanding trade receivables at the end of the year.

v As at 30/9/2016, cash in transit from the branch to the Head Office was 50,000 Ecos, the amount was received on 11/10/2016.

Head Office had invoiced goods to the branch at invoiced price of 5,000 Ecos, the branch received the goods on 15th October 2016.

Required:

Prepare the Head Office and the Branch statement of profit and loss and the combined business statement of financial position of Nautwi as at 30/9/2016.

SUGGESTED SOLUTION TO ILLUSTRATION 12.4

NAUTWI

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 30/9/2016

	Head Office		**Branch**	
	Ecos	**Ecos**	**Ecos**	**Ecos**
Sales	**000**	**000**	**000**	**000**
Transfer to Branch		850		437
		380		
		1,230		
Less Cost of goods sold				
Opening Inventory	8		20	
Purchases	914		-	
Goods from Head Office	-		375	
	922		395	
Less closing Inventory	12		15	
		910		380
Gross profit		320		57
Less Expenses:				
Administrative	200.0		16.5	
Distribution	80.5		5.0	
Depreciation	35.0		10.0	
Changes in provision for doubtful debts	(6)		0.5	
		309.5		32
		10.5		25

NAUTW I
STATEMENTS OF FINANCIAL POSITION

	Ecos 000	Ecos 000	Ecos 000
Non Current Asset at Cost			450
Less Depreciation			215
			235
Current Asset			
Inventory(12+12+4)		28	
Trade Receivables	120		
Less provisions	(6)	114	
Cash at Bank (15.5 + 13+50)		78.5	
		220.5	
Less: Current Liabilities		50.0	170.5
			405.5
Capital b/f			410
Add Profit			35.5
			445.5
Less drawings			40.0
			405.5

ILLUSTRATIION 12.5

1. Musho Limited operates a number of retail branches. Goods are invoiced from the Head Office in Accra to branches in Kumasi, Cape Coast, Sekondi and Axim at cost plus $33^1/_3$%. Each Branch maintains a Receivable Ledger. The following information relates to the Kumasi
branch for the year to 31 December 2016.

	Ecos '000
Cash sales	34,656
Credit sales	36,825
Cash from Trade Receivables	35,862
Cash remitted to Head Office	70,518
Goods sent to branch	73,860
Cash discount to Trade Receivables	932
Expenses of Branch (paid by Head Office)	4,358

Inventory at 1 January 2016	2,100
Stock at 31 December	2,850
Goods returned by branch	600
Reduction in selling prices authorized by area Manager	108
Trade Receivables at 1 January 2016	5,103
Bad debts written off	71

A consignment of foods sent from Kumasi branch to Accra on 31st December at invoiced

price 750 Ecos was not received till 15th January 2017 and was not included in inventory.

You are required to prepare the necessary ledger accounts and the Income Statement for the year to 31 December 2016.

EXAMINATION TYPE QUESTION

1. Buruburu Ltd operates through a Head office in Kumaso and a branch at Osuoyiabai. On 30th September, 2016, the account prepared the following trial balance

	Head office		Branch	
	Ecos	Ecos	Ecos	Ecos
Share capital		260,00		
Capital surplus		70,000		
Income surplus 1/10/2015		55,000		
Trade Receivables/Payables	47,500	35,000	14,700	7,200
Head Office Current Account				51,500
Goodwill at cost	75,000			
Land & Building at cost	175,000		50,000	
Fixtures & Fittings at cost	50,000		20,000	
Motor vehicles at cost	45,000			
Accumulated depreciation 30/9/2016				
Fixtures & Fittings:		10,100		6,400

Motor vehicles:		3,600		
Inventory at cost or mark up (1/10/2015)	48,500		15,400	
Bank and Cash	15,900		3,100	
Purchase and sales	255,000	229,700		199,700
Goods from Head Office	-	-	148,500	-
Administrative expenses	25,500		9,500	
Selling & distribution expenses	10,500		2,100	
Depreciation: Fixtures	2,500		1,000	
Motor Vehicles	3,000			
Provision for unrealized profit on inventory 1/10/2015		1,400		
Branch Current Account	60,000			
Professional Expenses	5,400		500	
Goods sent to branch		154,000		
	818,800	818,800	264,800	264,800

Additional Information:

All goods sold by the branch was supplied from Head office at cost plus 10%. At 30 September, 2016, goods to the value of 5,500 Ecos were in transit to the branch.

The branch deposited 3,000 Ecos on behalf of Head Office in the local branch of the company's bankers on 30th September 2016. No record of this transaction has been made in the books of Head Office.

Inventories at 30 September 2016 excluding goods in transit were as follows: Head Office (at cost) 54,500 Ecos

Branch (at mark-up) 17,600 Ecos

i. Corporate profit tax rate applicable to Buruburu Limited is 30%

ii. A consignment of goods sent from Kumasi branch to Accra on 31st December at invoiced price of 750 Ecos was not received till 15th January and was not included in Inventory.

Required:

From the information given, prepare in columnar form to show the results for Head Office, Branch and the whole business:.

(a) Income Statements for the year ended 30th September 2016.

(b) Statement of Financial Position (students should note that the Companies – Code 1963 Act 179 requires that it should be called Stated Capital. Share capital of the company consist of 260 million equity shares. The directors have proposed a dividend of 200 Ecos per share.

SOLUTION TO ILLUSTATION 12.5
Branch Inventory Account

	Ecos		**Ecos**
	000		**000**
Bal b/f	**2,100**	Cash	**34,656**
Goods sent to branch	**73,860**	Return to Head office	**600**
		Trade receivables	**36,825**
		Reduction in selling price	**108**
		Balance c/f:	
		Goods in transit	**750**
		Closing inventory	**2,850**
		Normal loss	**171**
	75,960		**75,960**

Branch inventory adjustment account

	Ecos		**Ecos**
	000		**000**
Returns to Head Office	150	Balance b/f	525
Reduction in selling price	108	Branch Inventory account	18,465
Normal stortage	171		
Balance c/f:			
Goods in transit	188		
Closing inventory	713		
Gross profit	17,660		
	18,990		18,990

Goods sent to Branch Account

	Ecos		Ecos
	000		**000**
Returns to Head office	450	Branch inventory account	
Purchases	54,945		
	55,395		55,395

Branch Trade Receivable Account

	Ecos		Ecos
	000		**000**
Balance b/f	5,103	Cash account	35,862
Branch inventory account	36,825	Bad debt	71
		Discount allowed	932
		Balance c/f	5,063
	41,928		41,928

Statement Of profit or loss
December 2016

	Ecos '000	Eco '000
Sales: Credit	36,825	
Cash	34,656	
		71,481
Less cost of sales		
Opening inventory	1,575	
Purchases	54,945	
	56,520	
Less closing inventory	2,700	
		53,820
Gross profit		17,661
Less		
Expenses	4,358	
Bad debts	71	
Discount allowed	932	
		5,361
Net profit		12,300

Suggested solution to Examination Type Question

Buruburu Limited

Adjustment of profit or loss for the year ended 30th September 2016

	Head Office	Branch	Total
	Ecos	Ecos	Ecos
Sales	229,700	199,700	429,400
Transfer to Branch	154,000		
	383,700	199,700	429,400
Less cost of sales:			
Opening inventory	48,500	15,400	62,500
Purchases	255,000	-	255,000
Goods from Head Office	-	148,500	
Closing inventory	(54,500)	(17,600)	(75,500)
Cost of sales	249,000	146,300	242,000
Gross profit	134,700	53,400	187,400
Increase in provision for unrealized profit	(700)		
Adjusted gross profit	134,000	53,400	187,400
Less Expenses:			
Administration expenses	25,500	9,500	3,500
Selling & Distribution expenses	10,500	2,100	12,600
Professional expenses	5,400	5,000	5,900
Depreciation: Fixtures & Fittings	2,500	1,000	3,500
Motor Vehicles	3,000		3,000
	46,900	13,100	60,000
Net profit Before Tax	87,100	(12,090)	(38,220)
Taxation	(26,130)	12,270	38,220
Net Profit for the year	**60,970**	28,210	89,180

Buruburu Limited

Income Surplus Account for the year ended 30 September 2016

Buruburu Limited

Income Surplus Account for the year ended 30 September 2006

	Ecos
Balance Bfwd	55,000
Transfer statement of Profit or Loss	89,180
	144,180

BURUBURU LIMITED STATEMENT OF

STATEMENT OF FINANCIAL POSITIONAS

AT 30 SEMPTEMBER 2016

	Head Office Ecos	**Branch Ecos**	**Whole Business Ecos**
Non-Current Assets			
Goodwill (at cost)	75,000		75,000
Land& Building (at cost)	175,000	50,000	225,000
Fixture & Fittings (CA)	39,900	13,600	53,500
Motor Vehicles (CA)	41,400	-	41,400
	331,300	63,600	394,900
Branch Current Account	79,710		
Less Provision for URP	(1,600)		
	78,110		
Current Assets			
Inventory & Goods in transit	59,500	17,600	75,500
Trade Receivable	47,500	14,700	62,200
Bank & Cash (including cash in transit	18,900	3,100	22,000

	125,900	3,540	159,700
Current Liabilities:			
Trade payables	35,000	7,200	42,200
Taxation	26,130	12,090	38,220
	61,130	19,290	80,420
Working Capital	64,770	16,110	79,280
Net Assets	474,180,	79,710	474,180
Financed by:			
Share capital	260,000		260,000
Capital surplus	70,000		70,000
Income surplus	144,180	-	144,180
Head Office Current Account	-	79,710	-
	474,180	79,710	474,180

Workings Notes:

(1) Total Opening inventory

	Ecos
Head Office Inventory at cost	48,500
Branch Inventory at Invoiced Price	15,400
Less Provision for unrealized profit	(1,400)
	62,500

(2) Total Closing Inventory:

	Ecos
Head Office inventory	54,500
Branch inventory at invoiced price	17,600
Less: provision for UR	(1,600)
	70,500
Goods in transit at invoice price	5,500
Less provision for URP	(500)
	75,500

(3) Increase in provision for unrealized profit

Closing inventory at branch	17,600
Goods in transit	5,500
	23,100
Opening inventory at branch	(15,400)
:.Increase	7,700
:.Increase in unrealized profit (10/110 x 7,700)	700

(4) Branch Current Account

Balance per Trial Balance		60,000
Less: Goods in transit	5,500	
Cash in transit	3,000	(8,500)

	51,500
Branch profit per statement of profit or loss	28,210
Balance to statement of financial position	79,710

(5) Head Office Current Account

Balance per trial balance	51,500
Add profit per statement of Profit or Loss	28,210
Balance to financial position	79,710

12.5 Chapter Summary

A manufacturing company may want to sell its products from various spots so as to maximize sales and also attend promptly to its customers. In such a case, it can carry out it operations from many branches.

The branches in this example are only selling outlets and as such a branch does not own the goods. A branch is an extension of the Head Office and must account to the Head Office for sale of goods received from Head Office.

For accounting purposes, branches can be subdivided into three. These are:

a. Branches for which all the financial records are kept at the Head Office
b. Branches which maintain separate accounting records
c. Foreign branches

Where all the financial records are kept at the Head Office, the branch Manager will send returns to the Head Office.

The returns would show the following:

Goods received from Head Office

Goods returned from the Branch to head Office

Cash and Credit Sales

Cash received from trade receivables

Expenses incurred at the branch

Closing inventory, Cash in hand and closing List of trade receivables

Three methods of invoicing goods to the branch are:

i. The cost method

ii. The cost plus percentage method

iii. The selling price method

Where a branch is authorized to keep its own set of accounts, the Head Office would keep a control account to record all its dealings with the Branch. The account is termed Branch Current Account. The branch would also keep a Head Office Current Account in its books. The two are contra accounts.

12.6 MULTIPLE CHOICE QUESTIONS

Use the following information to answer questions 1 & 2

A head office sent goods at cost plus mark-up of 25% to the branch.

The invoice price of the goods was ₦144,600. During the period the branch returned ₦5,000 worth of these goods to the head office.

1. How much should be credited to goods sent to branch account during the period?
   a. ₦105,680
   b. ₦ 108,450
   c. ₦ 111,680
   d. ₦ 115,680
   e. ₦ 136,680
2. In which account should the goods returned to head office by branch be credited and at what amount?

a.	Branch inventory control	₦ 5,000
b.	Goods sent to branch account	₦ 5,000
c.	Branch inventory control account	₦ 4,000
d.	Goods sent to branch account	₦ 4,000
e.	Branch adjustments account	₦ 1,000

3. When the head office sent goods to branch at cost plus mark-up, unrealized profit would arise on
   i. Cash in transit

ii. Goods sent to branch

iii. Goods returned by customers to head office

iv. Closing inventory

a. i and ii

b. i and iii

c. ii and iv

d. iii and iv

e. ii and iii

4. When goods are returned by branch customers to the head office the double entry is in which of the following accounts?

	Debit	Credit
a.	Branch inventories control	Branch receivables
b.	Head office current	Branch receivables
c.	Goods sent to branch	Branch receivables
d.	Branch adjustment	Branch receivables
e.	Branch receivables	Branch receivables

5. The branch current account in the head office books represents

a. Cash receivables by head office

b. Head office net investment in branch

c. Balance in branch adjustments account

d. Capital account

e. Loan due from branches

6. The branches that keep a separate account of their own operations are described as……........branches

7. When reconciling the head office current account with the branch current account, what are the causes of differences?

8. The reconciling items in current accounts between the branch and head office are adjusted in ………………………current accounts.

Use the following information to answer questions 9 and 10

Goods sent to branch ₦450,000
Good

Goods are sent to its branch by head office at cost plus $33^1/_3$ %

9. Calculate the unrealized profit to be recognize in the statements of profit or loss for the year ended 31 December 2010.

10. State the amount to be reported in the statements of the financial position at the end of year 2010.

12.7 SOLUTION TO MULTIPLE CHOICE QUESTION AND SHORT ANSWER QUESTION

1. A
2. A
3. C
4. A
5. B
6. A utonomous branches
7. Goods in transit and cash in transit
8. Branch
9. ₦ 30,000 (₦ 450,00- ₦ 330,000) x $\frac{33^1/_3}{133^1/_3}$

10. ₦ 337,500 $\left(450{,}000 \times \frac{100}{33^1/_3}\right)$

CHAPTER THIRTEEN
HIRE PURCHASE TRANSACTION

Chapter Contents

13.0 OBJECTIVES

At end of this chapter, readers should:

- Understand what is meant by hire purchase transaction
- Know how to record entries for hire purchase transactions

13.1 INTRODUCTION

Hire purchase transaction is a form of EXTENDED **CREDIT AGREEMENT i.e** financing acquisition of assets through credit facilities.

Under hire purchase transaction, assets are supplied by the vendor on hire to the USER OR BUYER until the fulfilment of a certain condition (which is the payment of an agreed number of instalments) when the user or buyer of the asset will be entitled to exercise an option to purchase the asset.

Legally, until this option is exercised, the asset remains the property of the supplier (VENDOR). However, in practice the user or buyer of the assets treat the item as an asset in its own books even though the ownership is still retained by the vendor.

13.2 PARTIES TO HIRE PURCHASE TRANSACTION

There are two parties to a hire purchase transaction.

a. VENDOR: This is the seller of the asset and he retain Ownership until the byer exercises the purchase option..

b. BUYER: This is the user or the hire purchase buyer of the assets and he is expected to pay for the asset on instalmental basis.

13.3 DEFINITION OF TERMS UNDER HIRE PURCHASE TRANSACTION

a. CASH PRICE: This is the price at which the asset could have been purchased from the vendor if not on hire purchase i.e it is the normal selling price of the goods.

b. HIRE PURCHASE PRICE: This is the total amount due from the user or buyer of the asset for acquiring the asset through hire purchase. Simply put, it is the cash price plus the hire purchase interest. That is it is deposit plus all instalments payable by hire purchase buyer.

c. HIRE PURCHASE INTEREST: This is also known as finance charges. It is the excess of the hire purchase price over the cash price.

d. INITIAL DEPOSIT: This is the initial amount payable by the hire purchase buyer at the inception of the hire purchase transaction.

e. INSTALMENTS: This is the sum payable by hire purchase buyer at specific intervals to liquidate the balance of the purchase price after the payment of the initial deposit.

13.4 OTHER TYPES OF EXTENDED CREDIT AGREEMENT

13.4.1 CREDIT SALE TRANSACTION: Under credit sale transaction, a contract of sale is established between the seller and the purchaser, with the latter agreeing to pay by instalment. However, in this type of transaction, ownership of the asset passes to the purchaser on its delivery by the supplier and a debt is created which cannot be avoided by returning the item.

13.4.2 LEASING TRANSACTION

A lease is a contractual agreement between he owner (the lessor) and another party (the lessee) which conveys to the lessee the right to use the leased asset for an agreed period of time in return for a consideration, usually, periodic payment called lease rentals.

There are two types of leasing transaction;

a. Operating Lease

b. Finance or Capital Lease

The main difference between lease transaction and hire purchase transaction is that hire purchase transaction requires an initial deposit to be made by user while this is not necessary under lease transaction.

13.5 ACCOUNTING ENTRIES UNDER HIRE PURCHASE TRANSACTION

When accounting for hire purchase transactions, the recording of accounting entries can be considered from two points of view, i.e

a. HIRE PURCHASE BUYER‟S Point of view

Or

b. VENDOR or SUPPLIER‟S Point of view

For proper explanation, we shall view the transaction from the two points of view.

13.5.1 ACCOUNTING ENTRIES IN H.P. BUYER‟S BOOKS OF ACCOUNTS

Although in law a hire purchase contract is not more than a contract of hire carrying an option to purchase, the intention to purchase is normally presumed for accounting purposes.

Therefore, it is generally accepted practice for the hire purchase buyer to:

a. Account for the cash price of goods as non-current Asset.

b. Charge depreciation on the asset (based on the cash price).

c. Establish a liability to vendor or the finance company or the dealer.

13.5.2 METHODS OF ACCOUNTING FOR THE HIRE PURCHASE

a. There are two basic methods of accounting for hire purchase
b. Hire purchase interest suspense method.

13.5.3 HIRE PURCHASE INTEREST ACCOUNT LIMITED

Under this method, the hire purchase buyer will debit the asset account and credit vendor or finance company account with the cash price of the item.

The interest element is only recognized as it falls due.

13.5.4 HIRE PURCHASE INTEREST SUSPENSE METHOD

This method involves debiting the asset account with „CASH PRICE" of the item and hire purchase interest suspense account is debited with the TOTAL HIRE PURCHASE INTEREST OR FINANCE CHARGES while the VENDOR OR FINANCE COMPANY is Credited with total hire purchase price.

When an instalment falls due, the appropriate amount of the hire purchase interest that is due is charged to Profit & Loss Account from HIRE PURCHASE INTEREST SUSPENSE ACCOUNT.

TUTORIAL NOTE

HIRE PURCHASE PRICE = CASH PRICE plus HIRE PURCHASE INTEREST. Therefore, the accounting entry explained in paragraph 13.5.4 above will still keep to the principle of double entry book keeping (Debit entry will be equal to Credit entry).

13.5.5 BASIS OF ALLOCATING HIRE PURCHASE INTEREST OVER HIRE PURCHASE PERIOD

The hire purchase buyer may spread hire purchase interest over the period of the hire purchase using various methods or basis, which include the following:

a. Straight line method or fixed instalment method
b. Actuarial method

c. Sum-of-the-years-digit method.

(i) STRAIGHT LINE METHOD

This is the simplest method that can be used as it involves spreading the hire purchase interest equally over the hire purchase period.

(ii) ACTUARIAL METHOD

Under this method, the hire purchase interest is written off by charging a fixed rate of interest on the outstanding balance at the due date of instalment. This method produces a constant rate of return on the outstanding cash price for each period.

(iii) SUM-OF-THE YEARS-DIGIT METHOD

Under this method, hire purchase interest is written off over the period of the hire purchase in a reducing manner based on digit of the year affected.

ILLUSTRATION 13.1

Uche Ltd acquired a machine-labeling machine on hire purchase terms from a finance company, WAZOBIA Finance Ltd under the following terms and conditions

	₦"000
Cash Price	14,000
Initial Deposit	5,000

4 Yearly instalments of ₦3,750,000 each payable on 31st December, each year. Uche Ltd. makes up its account to 31 December every year. Assume an effective interest rate of 24% p.a Required:

Calculate the hire purchase interest attribute to each year using the following methods.

(a) Straight line method

(b) Actuarial method

(c) Sum-of-the years-digit method.

SUGGESTED SOLUTION TO ILLUSTRATION 13.1

(a) STRAIGHT LINE METHOD

Hire purchase interest = Hire purchase price less cash price

	₦"000	
Total instalment (4 x 3,750,000)	15,000	
Add: Initial deposit	5,000	
Hire purchase price	20,000	
Less: Cash price	(14,000)	
Total hire purchase interest due	6,000	
Therefore hire purchase interest due for each year is	$\frac{6,000,000}{4}$	= ₦1,500,000

(b) ACTUARIAL METHOD

	₦"000
Year 0 cash price	14,000
Less initial Deposit	(5,000)
	9,000
Year 1 Hire purchase interest at 24%	(2,160)
Year 2 Hire purchase interest at (24%)	1,778.4
Year 3 Hire purchase interest at (24%)	1,305.2
Year 4 Hire purchase interest at (24%)	756.4

(c) SUM –OF-THE-YEARS-DIGIT METHOD

Year	Digit Allocation	₦"000	₦"000
1	4	4/10x6,000	2,400
2	3	3/10 x 6,000	1,800
3	2	2/10 x 6,000	1,200
4	1	1/10 x 6,000	600
	10		6,000

13.6 DETAILED ENTRIES IN HIRE PURCHASE BUYER"S BOOKS USING HIRE PURCHASE INTEREST ACCOUNT METHOD

S/N	Nature of Transaction	Account to be debited or credited	
		DR	**CR**
1	With cash price asset acquired on hire purchase terms	Fixed Asset Account	Hire purchase vendor Account
2	Deposit/ Installment paid	Fixed Asset Account Vendor Account	Bank Account
3	Accounting for H.P. interest due included in the instalment paid	H.P. interest Account	H.P. Vendor Account
4	At the end of the accounting year H.P. interest due should be transferred to profit and loss Account	Profit & Loss Account	Hire purchase interest account
5	At the end of the accounting year depreciation due on asset should be charged to profit and loss account	Profit & Loss Account	Provision for depreciation Account

However, the detailed accounting entries that would be required if the second method (i.e the HIRE PURCHASE INTEREST SUSPENSE METHOD) is used are as shown in the next section.

13.7 DETAILED ENTRIES IN H.P BUYERS BOOKS USING H.P INTEREST SUSPENSE METHOD

S/N	Nature of Transaction	Account to debit or credited	
		DR	CR
1	On acquisition of asset, (and with the purchase price)	(i) Fixed asset A/c (Cash price) (ii) H.P interest suspense (total H.P Interest) (iii) H.P. Vendor A/c (Hire purchase price)	- -
2	To account for deposit and instalments paid	H.P. Vendors Account	
3	To recognize H.P interest due included in instalment payment	H.P Interest Account	H.P. Interest Account
4	To transfer H.P. interest due for the year to profit & Loss Account at year end	Profit & Loss Account	Hire purchase interest Account
5	To recognize the depreciation on the asset for the year	Profit & Loss Account	Provision for depreciation Account

The detailed accounting entries explained above are illustrated using illustration 13.2 below.

ILLUSTRATION 13.2

On 1 January 2003, Ayo a wine merchant bought a small bottling and labeling machine from Tade on hire purchase terms. The cash price of the machine was ₦7,710 while the hire purchase price was ₦10,000.

The hire purchase agreement required the immediate payment of ₦ 2,000 deposit with the balance being settled in four equal annual installments commencing on 31 December, 2003.

The hire purchase charge is to be calculated on the reducing balance of the liability during each accounting period.

Depreciation on the plant is to be provided for at the rate of 20% p.a on straight line method assuming a nil residual value.

Required:

Show all the necessary accounting entries in the books of Ayo using

(i) Hire purchase interest account method.

(ii) Hire purchase interest suspense account method

Assuming that accounting year of Ayo ends on 31 December every year.

SUGGESTED SOLUTION TO ILLUSTRATION 13.2

(i)

USING HIRE PURCHASE INTEREST ACCOUNT METHOD

PLANT AND MACHINERY ACCOUNT

	₦		₦
1 Jan 2003 H.P Vendor"s A/c	7,710	31 Dec. 2003 balc/d	7,710
1 Jan 2004 Bal b/d	7,710	31 Dec. 2004 bal c/d	7,710
1 Jan. 2005 bal b/d	7,710	31 December bal c/d	7,710

H.P VENDOR"S ACCOUNT

	₦		₦
1 Jan. 2003 Bank	2,000	1 Jan 2003 Fixed Asset A/c	7,710
31 Dec. 2003 Bank (1 Instalment)	2,000	31 Dec. 2003 H.P. Interest (wl)	856
Bal c/d	4,566		
	8,566		8,566
		1 Jan. 2004 Bal b/d	4,566
31 Dec. 2004 Bank (2nd Instalment)	2,000	31 Dec. 2004 H.P Interest (w2)	685
Balance c/d	3,251		
	5,251		5,251
		1 Jan. 2006 bal b/d	3,251
31 Dec. 2005 Bank (3rd Instalment)	2,000	31 Dec. 2005 H.P interest (w3)	488
	1,739		-
	3,739		3,739
		1 Jan 2006 Bal b/d	1,739
	2,000	31 Dec. 2006 H.P interest (w4)	261
	2,000		2,000

HIRE PURCHASE INTEREST ACCOUNT

	₦		₦
31 Dec. 2003 H.P. Vendors A/c (w1)	856	31 Dec. 2003 P&L A/c	856
31 Dec. 2004 H.P Vendors A/c (w2)	685	31 Dec. 2004 P & L A/c	685
31 Dec. 2005 H.P Vendors A/c (w3)	488	31 Dec. 2005 P&L A/c	488
31 Dec. 2006 H.P Vendors A/c (w4)	261	31 Dec. 2006 P & L A/c	261

PROVISION FOR DEPRECIATION ACCOUNT

	₦		₦
31 Dec. 2003 bal c/d	1,542	31 Dec. 2003 P& L A/c	1,542
		1 Jan 2004 Bal A/c	1,542
31 Dec. 2004 bal c/d	3,084	31 Dec. 2004 P & L A/c	1,542
	3,084		3,084
		1 Jan 2004 bal b/d A/c	3,084
31 Dec. 2005 bal c/d	4,626	31 Dec. 2005 P&L A/c	1,542
	4,626		4,626
		1 Jan 2006 bal b/d	4,626
31 Dec. 2005 bal c/d	6,168	31 Dec. 2006 P& L A/c	1,542
	6,168		6,168
		1 Jan 2007 bal b/d	6,168

WORKING NOTES A

Calculation of Hire Purchase Interest due = Cash Price – Deposit paid = Balance due

(w1) As at 31 December 2003 = 7,710 x ₦2,000 = 5,710

5,710 x 15% = ₦856

(w2) As at 31 Dec. 2004 ₦4,566 x 15% = ₦685

(w3) As at 31 Dec. 2005 3,251 x 15% = ₦488

(w4) As at 31 Dec. 2006 1.739 x 15% = ₦261

H.P Interest per annum = $\frac{\text{H.P. Interest due}}{\text{Amount Outstanding}} \times \frac{100}{1}$

WORKING NOTES B

Calculation of provision for depreciation on the asset on hire for each year 31 Dec. 2003 = 7,710 x 20% = 7,710 x 20% = ₦1,542.

(ii) **USING HIRE PURCHASE INTEREST SUSPENSE METHOD FIXED ASSET ACCOUNT**

	₦		₦
1 Jan. 2003 H.P Vendors	7,710	31 Dec. 2003 bal c/d	7,710
1 Jan. 2004 bal b/d	7,710	31 Dec. 2004 bal c/d	7,710
1 Jan 2005 bal b/d	7,710	31 Dec 2005 bal c/d	7,710

H.P VENDOR"S ACCOUNT

	₦		₦
1 Jan. 2003 Bank (Deposit)	2,000	1 Jan 2003 Fixed Asset A/c	7,710
31 Dec. 2003 Bank (1st Instal)	2,000	31 Dec. 2003 H.R Inter Susp	2,290
31 Dec. 2003 Balance c/d	6,000		10,000
	10,000		
		1 Jan 2004 Balance b/d	6,000
31 Dec. 2004 Bank (2nd Instal)	2,000		
31 Dec. Balance c/d	4,000		6,000
	6,000		
31 Dec. 2004 Bank (3rd Instal)	2,000	1 Jan 2005 Balance b/d	4,000
31 Dec. 2005 Balance c/d	2,000		
	4,000		4,000
1 Jan 2006 balance b/d	2,000		
31 Dec. 2006 Bank (4th Instal)	2,000		
	2,000		2,000

HIRE PURCHASE INTEREST SUSPENSE ACCOUNT

1 Jan 2003 Bank (Deposit)	2,000	1 Jan 2003 non-current Asset A/c	7,710
31 Dec. 2003 Bank (1st Instal)	2,000	31 Dec. 2003 HR Inter susp	2,290
31 Dec. 2003 balance c/d	6,000		10,000
	10,000		
		1 Jan 2004 balance b/d	6,000

31 Dec. 2004 Bank (2nd Instal)	2,000		
31 Dec. 2004 balance c/d	4,000		6,000
	6,000		
31 Dec. 2004 Bank (3rd Instal)	2,000	1 Jan. 2005 balance b/d	4,000
31 Dec. Dec. 2005 balance c/d	2,000		
	4,000		4,000
		1 Jan 2006 balance b/d	2,000
31 December 2006 (4th Instal)	2,000		
	2,000		2,000

HIRE PURCHASE INTEREST SUSPENSE ACCOUNT

	₦		₦
31 Dec. 2003 H.P Vendors A/c	2,290	31 Dec. 2003 H.P. Interest	856
		Balance c/d	1,434
	2,290		2,290
1 Jan 2005 bal b/d	1,434	31 Dec. 2004 H.P. Interest	685
		Balance c/d	749
	1,434		1,434
1 Jan 2006 Bal. b/d	749	31 Dec. 2005 H.P Interest	488
		Balance c/d	261
	749		749
1 Jan 2006 b/d	261	31 Dec 2006 H.P	261
	261		261

HIRE PURCHASE INTEREST ACCOUNT

	₦		₦
31 Dec. 2003 H.P Int Susp A/c	856	31 Dec. 2003 P & L A/c	856
31 Dec. 2004 H.P Int susp A/c	685	31 Dec. 2004 P & L A/c	685
31 Dec. 2005 H.P Int Susp A/c	488	31 Dec. 2005 P & L A/c	488

31 Dec. 2006 H.P Int Susp A/c	261	31 Dec. 2006 P & L A/c	261

TUTORIAL NOTES:

The double entry book keeping for depreciation on the asset is the same as in hire purchase interest account method.

13.8 INFORMATION TO BE DISCLOSED IN THE FINANCIAL STATEMENTS OF THE BUYER

Having been able to post necessary entries in the books of the hire purchase buyer, using the two methods of accounting for hire purchase, it should be noted that at the financial year end of the hire purchase buyer, certain transactions on the hire purchase should be disclosed in the financial statements of the buyer.

13.9 DISCLOSURE IN PROFIT AND LOSS ACCOUNT

The hire purchase interest due is charged to the Profit and Loss Account and it is treated as part of the Financial charges.

Depreciation for the year on the non-current asset is also charged to the profit & Loss Account.

The cost (i.e the cash price) of the non-current assets acquired on hire purchase is disclosed as

Property plant & equipment in the balance sheet. The relevant accumulated depreciation charged is also shown to determine the NET BOOK VALUE OF THE ASSET.

Similarly liabilities outstanding on the asset which is due to the vendor is also disclosed as "CURRENT LIABILITIES" OR PAYABLES failing due within one year or falling due after one year, as the case may be.

ILLUSTRATION 13.3

OJERE Company (Nigeria) Limited purchased lorries from OLUWALOGBON MOTORS Ltd on a hire purchase agreement on 1 July 2016, providing twelve yearly instalments of ₦20,000 each commencing on 31 December 2016.

The cash price of the lorries is ₦199,100 interest being computed on 6% with half yearly interest. The buyer makes up its accounts to 30 June each year, depreciation the lorries being provided on fixed instalment basis at 20% p.a of cost. All instalments were paid on the due dates.

Required:

(a) Show the relevant accounts in the books of the purchasing company for two years ending 30 June 2006.
(b) Show the entries that would appear in respect of this transaction in the balance sheet of OJERE Company (Nigeria) Limited as at 30 June 2006.

SUGGESTED SOLUTION TO 13.3

TUTORIAL NOTES:

From the illustration above the following can be deduced.

- ❖ Cost of the lorries =₦199,100
- ❖ Total Instalment due (12 x 20,000) = ₦240,000
- ❖ Hire Purchase Interest = Total instalment Less Cash Price
  = (240,000 -199,100) = ₦40,900
- ❖ If method 1 (i.e Hire Purchase Interest Method) is used the following accounts must be opened in the books of OJERE Company limited.
- ❖ Fixed Asset Account or Motor Vehicle Account
- ❖ Vendor's Account or Oluwalogbon Motors Account
- ❖ Provision for Depreciation Account

(a)

MOTOR VEHICLE ACCOUNT

	₦		₦
1 July 2004 Vendor‟s A/c	199,100	30 June 2005 bal c/d	199,100
1 July 2005 bal. b/d	199,100	30 June 2006 Bal c/d	199,100
	199,100		

VENDOR‟S OLUWALOGBON MOTORS ACCOUNT

	₦		₦
		1 July 2004 Motor Vehicle	199,100
31/12/2004 Bank	20,000	31/12/2004 H.P Interest (w1)	5,970
30/6/2005 bal c/d	190,620	30/6/2005 H.P Interest (w2)	5,550
	210,620		210,620
31/12/2005 Bank	20,000	1/7/2005 bal b/d	190,620
30/6/2006 bal c/d	181,630	31/12/2005 H.P. Interest (w3)	5,720
	_____	30/6/2006 H.P Interest (w4)	5,290
	201,630		201,630
		1/7/2006 bal b/d	181,630

HIRE PURCHASE INTEREST ACCOUNT

	₦		₦
31/12/2004 Vendor A/c	5,970		
30/6/2005 Vendor	5,550		
	11,520	30/6/2005 P & L A/c	11,520
31/12/2005 Vendor A/c	5,720		
30/6/2006 Vendor A/c	5,290		
	11,010	30/6/2006 P & L A/c	11,010

PROVISION FOR DEPRECIATION ACCOUNT

	₦		₦
30/6/2005 bal c/d	39,820	30/6/2005 P & L A/c	39,820
		1/7/2005 Bal b/d	39,820
30/6/2006 bal c/d	79,640	30/6/2005 P & L A/c	39,820
	79,640		79,640
		1/7/2006 bal b/d	79,640

(b)

OJERE COMPANY (NIGERIA) LIMITED

BALANCE SHEET EXTRACT

AS AT 30/6/2006

	₦	₦
FIXED ASSETS		
Motor vehicle –cost	199,100	
Less: Depreciation	(79,640)	
Net Book Value		119,460
CURRENT LIABILITIES		
Calculation of the H.P Interest as at		181,630

WORKING NOTES

Calculation of the H.P Interest as at

(w1)	31/12/2004	$\frac{199{,}100 \times 0.06}{2}$	= 5,970
(w2)	30/6/2005	$\frac{199{,}100 + 5{,}970 - 20{,}000 \times 0.06}{2}$	= 5,550
(w3)	31/12/2005	$\frac{190{,}620 \times 0.06}{2}$	= 5,720
(w4)	30/6/2006	$\frac{190{,}620 + 5{,}720 - 20{,}000 \times 0.06}{2}$	= 5,290

13.10 ACCOUNTING FOR HIRE PURCHASE IN THE BOOKS OF THE VENDOR OR THE SELLER

Just as we have examined the accounting entries on hire purchase in the books of the BUYER or USER, Hire purchase transaction can be viewed from the VENDOR OR THE SELLER‟S point of view.

For the purpose of accounting for hire purchase transaction in the SELLER‟S BOOKS, it may be necessary to view „LARGE ITEMS‟ separately from „SMALL ITEMS‟. This is because the method of accounting for each of them differs from one another.

13.10.1 ACCOUNTING FOR HIRE PURCHASE OF LARGE ITEMS IN THE SELLER‟S OR VENDOR‟S BOOKS

In view of the fact that the amounts involved for „Large items‟ are usually substantial and also because of the fact that the transactions for such items are not always frequent, it would therefore be possible for the VENDOR OR THE SELLER OF LARGE ITEMS (i.e NON-CURRENT ASSETS) to be able to separate Gross Profit from Hire purchase interest and account for each of them separately.

Hire purchase selling price is made up of each price, gross profit and hire purchase interest.

13.10.2 METHODS OF ACCOUNTING FOR HIRE PURCHASE TRANSACTION OF LARGE ITEMS IN THE VENDOR‟S OR SELLER‟S BOOKS

As in the case of accounting for hire purchase transaction in buyer‟s books, two methods are also recognized for accounting for hire purchase in seller‟s or vendor‟s books. These methods are:

a. Hire Purchase Interest Account Method
b. Hire Purchase Interest Suspense Method

13.11 DETAILED ENTRIES FOR ACCOUNTING FOR LARGE ITEMS IN HIRE PURCHASE VENDOR‟S BOOKS USING HIRE PURCHASE INTEREST ACCOUNT METHOD

S/N	Nature of transaction	Accounts to be Debited or Credited	
		DR	**CR**
i	On selling large items on H.P (with cash price of the item)	H.P. Receivable Account	H.P Sales Account
ii	With the amount of instalment or deposit received	Bank Account	H.P. Receivable Account
iii	To recognize the H.P Interest included in the instalment received	H.P. Receivable Account	H.P. Interest received Account
iv	To recognize the cost of goods for large items sold in H.P Trading Account	H.P. Trading Account	General Trading or purchase Account
v	To recognize H.P. Sales Account in the H.P. Trading Account	H.P. Sales Account	H.P. Trading Account
vi	To recognize the H.P. Interest received in the H.P. trading	H.P. Interest received Account	H.P. Trading Account
vii	Account for unrealized profit and transfer to unrealized profit account from H.P. Trading Account	H.P. Trading Account	Provision for unrealized profit
viii	Transfer of credit balance from H.P Trading Account to General Profit & Loss Account after accounting for steps (iv) to (vii)	H.P. Trading Account	General Profit & Loss Account

13.12 DETAILED ENTRIES FOR ACCOUNTING FOR LARGE ITEMS IN HIRE PURCHASE VENDORS BOOKS USING H.P. INTEREST SUSPENSE METHOD

S/N	Nature of transaction	Accounts to be debited or credited	
		DR	**CR**
i	On selling the large items o hire purchase	(a) H.P. Receivable (with H.P. Price)	
ii	On receipt of deposit/instalment from the buyer	Bank Account	H.P. Sales (with cash price) H.P. Interest suspense (Total H.P. Interest)
iii	To recognize H.P. Interest included in the instalment received	H.P. Interest Suspense Account	H.P. Interest received Account

Steps (iv) to (viii) are the same as in the case of the first method above i.e hire purchase interest account method.

TUTORIAL NOTES

In order to calculate the unrealized profit mentioned in step (vii) under the two methods above the formula below may be a useful guide.

$$\text{Unrealised profit} = \frac{\text{Balance of cash price outstanding}}{\text{Cash Price}} \times (\text{Cash price} - \text{Cost})$$

Subsequently movements in the provision for unrealized profit are reflected in the hire purchase trading account and the provision account.

ILLUSTRATION 13.4

CORPORATE TRANSPORT COMPANY LIMITED acquired a TOYOTA Bus on 1 January 2006 for ₦774,900. The cost price of the bus to the supplier was ₦ 360,000 and cash selling price was ₦540,000.

The transaction was financed by Memory Finance Company Ltd and the terms of the hire purchase contract required a deposit of ₦180,000 on delivery followed by three instalments on 31 December of years 2006, 2007 and 2008 of ₦198,000, ₦198,000 and ₦ 198,900 respectively. The time rate of interest was 30% per annum.

Required

Prepare all the necessary accounts in the books of Memory Finance Company Ltd (The vendor) to record the above transactions using

(a) Hire purchase Interest Account Method.

(b) Hire Purchase Interest Suspense Method.

SOLUTION 13.4

(a)

USING HIRE PURCHASE INTEREST ACCOUNT METHOD H.P. DEBTORS ACCOUNT (OR CORPORATE TRANSPORT COMPANY LTD)

	₦		₦
1/1/2006 H.P. Sales	540,000	1/1/2006 Bank	180,000
31/12/2006 H.P Int. Rec.	108,000	31/12/2006 Bank	198,000
	_____	31/12/2006 Balance c/d	270,000
	648,000		648,000
1/1/2007 bal b/d	270,000	31/12/2007 Bank	198,000
31/12/2007 H.P. Int. Rec.	81,000	31/12/2007 Balance c/d	153,000
	351,000		351,000
1/1/2008 bal b/d	153,000	31/12/2008 Bank	198,900
31/12/2008 H.P Int Rec	45,900		
	198,900		198,900

H.P. INTEREST RECEIVED ACCOUNT

	₦		₦
31/12/2006 H.P. Trading	108,000	31/12/2006 H.P. Debtor	108,000
31/12/2007 H.P. Trading	81,000	31/12/2007 H.P Debtor	81,000
31/12/2008 H.P. Trading	45,900	31/12/2008 H.P. Debtors	45,000

H.P. SALES

	₦		₦
31/12/2006 H.P. Trading	540,000	1/1/2006 H.P. Debtors	540,000

H.P. TRADING ACCOUNT FOR THE YEAR ENDED 31/12/2006

	₦		₦
H.P. Sales	540,000	H.P. cost of sales	360,000
H.P. Interest Received	108,000	Provision for unrealized profit (w1)	90,000
		Gross profit	198,000
	648,000		648,000

H.P. TRADING ACCOUNT FOR THE YEAR ENDED 21/12/2007

	₦		₦
Gross profit	120,000	H.P Interest received	81,000
		Provision for unrealized profit realized (w2)	39,000
	120,000		120,000

H.P.TRADING ACCOUNT FOR THE YEAR END 31/12/2008

	₦		₦
Gross profit	96,900	H.P. Interest Received	45,900
		Provision for unrealized profit realized (w3)	51,000
	96,900		96,900

PROVISION FOR UNREALISED PROFIT

	₦		₦
31/12/2006 bal c/d	90,000	31/12/2006 H.P. Trading	90,000
31/12/2007		1/1/2007 bal b/d	90,000
H.P. Trading	39,000		
Bal c/d	51,000		
	90,000		90,000
31/12/2008 H.P. Trading	51,000	1/1/2008 bal b/d	51,000

WORKING NOTES

Provision for unrealized profit =

Balance of cash selling price not yet due x Gross profit

Total Cash selling price

Gross Profit = Cash selling price – Cost price

= 540,000-360,000

= 180,000

(w1) Provision for unrealized profit 2006

= 540,000-(180,000+198,000-108,000) x 180,000

540,000

= 270,000 x 180,000 = ₦90,000

= 540,000

(w2) Provision for unrealized profit realized in 2007

= Cash selling price realized in the year x Provision for unrealized profit in the year of sale

Cash selling price not yet due in the 1st year (2006)

= 198,000-81,000 x 90,000 = ₦39,000

270,0000

(w3) Provision for unrealized profit realized in 2008

$$= \frac{198,900 - 45,900 \times 90,000}{\mathbf{270,000}}$$

$= \quad$ ₦51,000

(b) **USING H.P. INTEREST SUSPENSE METHOD TUTORIAL NOTES**

In order to solve illustration 9.4 above using the 2nd method (Hire Purchase Interest Suspense Method), readers should note that the only area of difference is in the preparation of the following accounts.

(i) H.P. Debtors account or Corporate Transport Co. Ltd. account

(ii) H.P. Interest suspense account

(iii) H.P. Interest received account

(iv) H.P Sales account

All other accounts prepared under method 1 (Hire Purchase Interest Account Method) will remain the same and require the same procedure.

In view of this, we shall only show the accounting entries in the four accounts highlighted above.

H.P DEBTORS OR CORPORATE TRANSPORT CO. LTD. ACCOUNT

	₦	₦		₦
1/1/2006			1/1/2006 Bank	180,000
H.P. Sales	540,000		31/12/2006 Bank	198,000
H.P Interest	234,900	774,900	Balance c/d	396,900
		774,900		
1/1/2007 bal b/d	396,900		31/12/2007 Bank	198,000
		396,900	Balance c/d	198,900
				396,900
31/12/2008 bal	198,900			774,900
b/d		198,000	Bank	198,900
				198,900

H.P INTEREST SUSPENSE ACCOUNT

	₦		₦
31/12/2006		1/1/2006 H.P. debtors	126,900
H.P Interest Received	108,000	HP Debtors	108,00
Balance c/d	126,900		
	234,900		234,900
31/12/2007		1/1/2007 Balance b/d	126,900
H.P. Interest Received	81,000		
Balance c/d	45,900		
	126,900		126,900
31/12/2008 H.P. Interest received	45,900	1/1/2007 balance b/d	45,900

INTEREST RECEIVED ACCOUNT

	₦		₦
31/12/2006 H.P. Trading A/c	108,000	31/12/2006 H.P. Int. Susp. A/c	126,900
31/12/2007 H.P. Trading A/c	81,000	31/12/2007 H.P. Int Susp A/c	81,000
31/12/2008 H.P. Trading A/c	45,900	31/12/2008 H.P. Int Susp A/c	45,900

H.P. SALES ACCOUNT

	₦		₦
31/12/2006 H.P. Trading A/c	540,000	31/12/2006 H.P. Debtors	540,000

13.13 ACCOUNTING ENTRIES IN SELLER"S BOOKS FOR SMALL ITEMS

Small items sold on hire purchase are counted for using different methods from those earlier highlighted for large items.

There are two methods that are used for accounting for hire purchase of small items in the seller's or vendor's books. The two recognized methods are:

a. Stock on hire method

b. Provision for unrealized profit method.

However, these two methods shall be dealt with at a higher level as this is beyond the scope of this syllabus.

13.14 ACCOUNTING FOR LEASES

13.14.1 INTRODUCTION

A lease is an agreement between a lessor and another party the lesee, which granted the lessee the right to use an agreed period of time in return for periodic payments called rents.

13.14.2 TWO TYPES OF LEASES

A finance lease: This is a lease that transfer to the lessee substantially all risks and rewards incidental to the ownership of an asset, although title may or may not eventually be transferred.

An operating lease: is one in which the lessor, while granting the lessee the use of the leased property, retained all the risks and rewards of ownership.

Risks include technological obsolescence, loss from idle capacity and variation in return. Returns include rights to sell the asset and gain from it capital value.

13.14.3 OTHER VARIANTS OF FINANCE LEASES

(a) Leverage lease: this is a three party lease involving a lender, (often a financial institution), in addition to usual lessor or lessee. The lender supplier the greater part of the purchase price of the leased asset.

(b) Sales-type lease: This is one in which the lessor (usually a dealer or manufacturer) transfers substantially all the ownership risks and benefits of the property to the lessee. At the inception of the lease, the fair value of the leased property is greater or less than the carrying amount in the books of the lessor resulting in a profit or loss the lessor.

13.14.4 SUBSTANCE OVER FORM

The accounting concept that is principally used to satisfy leases into finance operating and finance lease is the commercial (economic) substance of the transaction and not the legal form.

Characteristics of a finance lease:

a. Ownership is transferred to the lessee

b. Lessee has the option to purchase the asset at the end of its useful life

c. The lease term covers eventually the economic useful life of the asset

d. The assets are of special nature

e. The present value of the minimum lease payments is almost equal to the fair value of the leased assets.

f. If the lessee cancels the lease, he bears the losses of cancelation

Therefore Bolu Plc will record the leased asset and lease liability at the inception of the lease at ₦29.7m.

Finance charge

Depreciation = $\frac{\text{₦.7m}}{5}$ = ₦5.97m

Finance charge would be allocated as follows:

Year –June 30	Opening Balance	Finance Charges	Lease Payments	Balance Closing
	₦"000	₦"000	₦"000	₦"000
2010	29,700	-	-	29,700
2011	29,700	4,446	(10,000)	24,146
2012	24,146	3,615	(10,000)	17,761
2013	17,761	2,659	(10,000)	10,420
2014	10,420	1,560	(10,000)	1,980

The ₦1,980,000- ₦2,000,000 representing the residual value.

Disclosures

The following minimum disclosures are required to be made in the financial statements

1. The net carrying value for each financial asset at reporting date.
2. Reconciliation between the total of the minimum lease payments and their present value.
3. Total of the further minimum lease payments analysed either as
    - Less than one year
    - Between one year and five years
    - More than five years
4. Contingent rents
5. Total future minimum lease payments expected to be received under non-cancellable leases.
6. General description of lessee's material leasing arrangements

Operating lease

1. Lease payment is recognized as an expense on a straight line basis over the lease term.
2. When the lessee received incentive or rebates, like a free period, the total reduce rent must be allocated over the period of the lease.

Illustration 13.5

The facts are as in illustration 1.

What is the amount to be recognized in the book of the lessee annually, if the lease contact is an operating lease?

Solution 13.5

Total lease payments	₦42m
Lease term	4 years
Annual lease payment	₦42/4 = ₦10.2m

₦10.2m will be recognized as expenses (rentals payment) in the income statement annually.

Operating lease in the book of the lessor

1. The lessor capitalises the purchase cost of the leased asset and depreciates it according to the normal depreciation policy for similar assets.
2. Rental receivable are credited to revenue account over the lease term.

Illustration 13.6

On July 1, 2009, Ayomide Ltd purchased a truck at cost of N48 million for leasing purpose. On that date, Ayomide Limited lease the truck to Joas construction Limited under an operating lease term of five years. The annual lease rental being N8million. The useful life of the truck is 10 years with no residual value.

You are required to show how these transactions would be treated in Ayomide Ltd books

a. Income statement for the year ended June 30, 2010
b. Statement of financial position as at 30 June 2010.

Solution 13.6

Income statement (extracts)	₦"000
Revenue (lease rental)	8,000
Provision for depreciation	4,800

Statements of financial position (extracts)

	₦"000
Non-current assets	

Motor vehicle truck on lease (cost)	48,000
Provision for depreciation	4,800
	43,300

Provision for depreciation

$\frac{\text{₦}48\text{m}}{10} = 4.8\text{m}$

Disclosures

1. Total future minimum lease payments under non-calculable operating leases for each of the following:
   a. less than one year
   b. between one year and five years
   c. more than five years

2. A contingent rental recognized as income
3. A general description of the significant leasing arrangement

Finance leases in the book of the lessor

1. The lessor recognizes asset held on a finance lease as a receivable
2. The receivable is the total of the minimum lease payment and any unguaranteed residual value discounted at the rate implicit in the lease.

Subsequent to the initial recognition

1. Finance income is recognized at a constant rate of return on the net investment in the lease
2. Receipts are apportioned to the gross investment to reduce receivable and to the finance income element.

Disclosures

1. Gross investment in the lease and minimum lease for each of the following
    a. less than one year
    b. between one year and five years
2. **Unearned finance income**

   The leases that do not have these characteristics is an operating lease. The classification of a lease to either finance or operation is determined at the inception of the leased contract.

13.15 OTHER KEY TERMS IN A LEASE

Bargain purchase option is an agreement granting the lessee the option to purchase the asset for a nominal sum considered lower than the fair value of the asset at the time the option is exercised.

Minimum lease payments: These are the payment over the lease term that are required to be made. For a lessee, these include any amounts guaranteed to be paid, for the lessor, these include any residual value guaranteed to the lessor.

Hire purchase contact: The definition of a lease includes those contracts for hire of an asset that contain provisions for the hirer to acquire title to the asset upon fulfillment of agreed conditions.

Fair value: This is the amount that can be realized upon the sale of property in a free market and at arm's length.

Accounting for leases:

The finance and operating leases would be counted for both the lease and the lessor.

Finance lease in the books of the lessee

Initial recognition

1. Recognition of the lease as an asset and liability.
2. Recognition is made at the LOWER of the fair value of the leased asset or the present value of the minimum lease payment.

Subsequent recognition

1. The lease payments are apportioned between the amount paid to reduce the liability and the finance charges.

2. Finance charge is allocated over the period of the lease term using

   a. Sum of the digits methods

   b. Straight hire method

   c. Accrual method

Procedures

1. Determine the lease payments:

   Instalment payments x number of instalments

2. Determine the cash /fair value of the leased assets as follows:

   a. If instalment are paid in arrears

   Determine the finance charges

Total lease payment	xx
Cash/fair value	(xx)
Finance charges	xx

Depreciation:

The depreciation policy for leased assets shall be based on the economic useful life of the asset unless the lessee may not obtain title at the end of the lease terms, then the asset shall be fully depreciated over the shorter of the lease term and its useful life.

Illustrations 13.7

Bolu Plc has been taken asset on lease from Tife Plc. On June 30, 2010 the following information is given:

Lease terms 4 year

Fair value at inception of lease	₦32 million
Annual lease rental payable at the end of the year	₦10 million
Guaranteed residual value	2 million
Expected residual value	6 million
Implicit interest rate	14.97%

The lease has been classified as a finance lease. Economic useful life of the asset 5 years. It is probable that the lease will obtain till the lease term.

Required:

Calculate

a. The amount at which Bolu will record the lease asset and liability at the inception of the lease

b. The annual depreciation

c. The finance charges

13.16 Chapter Summary

Hire purchase transaction is a form of extended credit agreement and there are two parties to hire purchase agreement; they are BUYER or USER and VENDOR or FINANCE Company, although sometimes the vendor and finance company may be different parties. In law, ownership of the item subject to hire purchase is retained by the VENDOR or finance company until the fulfilment of a certain condition usually payment of all instalments.

However, in accounting for transactions on hire purchase the items are treated as if ownership was given to the buyer immediately.

There are two methods of accounting for the hire purchase transaction, Hire purchase Interest Account Method and Hire Purchase Interest Suspense Method. In the former method, interest paid or received is only accounted for when due. However, in the latter method, total interest on the hire purchase transaction is recognized and realized on periodic basis i.e when due.

Similarly, the accounting entries required for effecting hire purchase transaction in VENDOR‟S & BUYER‟S books differ from one another and this was shown in all the various illustrations used.

Accounting for hire purchase of small items involves the use of two methods, stock on hire method and provision for unrealized profit method.

13.17 Multiple choice questions

Use the following information to answer questions 1 & 2.

Going-Concern Plc sold a motor-car to Baba-Alayo on hire purchases basis under the following terms.

Cash price	₦68,000
Initial deposit	₦150,000
Instalment	85,000 (payable half yearly)
Hire Period	4 Years

1. Calculate the hire purchase price of the car
   - a. ₦850,000
   - b. ₦830,000
   - c. ₦685,000
   - d. ₦680,000
   - e. ₦490,000

2. Compute the hire purchase interest to be charged in year one using sum of the digits methods.
   - a. ₦1,250
   - b. ₦2,222

c. ₦16,667

d. ₦37,500

e. ₦66,667

3. The profit on hire purchase transaction is calculated, by the hire purchase vendor as

   a. Cash selling price less cost price

   b. Hire purchase price less cost price

   c. Hire purchase price less cash selling price

   d. Cash selling price less high purchase

   e. Cash selling price less deposit

4. In the book of the lessee the accounting treatment for the lease payment is to:

	Debit	Credit
a	Operating lease rentals	Cash
b	Operating lease rent	Asset leased
c	Cash	Opening lease rental
d	Asset leased	Cash
e.	Cash	Asset leased

5. Which of the following is not a characteristic of a finance lease?

   a. The lease term is not the major part of the economic useful life of the asset

   b. The leased assets are specially built for the lessee

   c. The lessee could take title of the asset at the end of the lease term

   d. The losses on cancellation of a leased asset is borne by the lessee

   e. Only the losses can capitalized the leased asset

6. State the methods by which finance charge on a leased asset can be spread over its useful life.

7. State the accounting concept that is used to classify into operation and finance lease.

8. The depreciation of a finance lease asset is based on the period of the ……… of the asset.

9. The payments over the lease term that are required to be made are called ……..payment.

10. When a lessee recognizes an asset and liability at the higher of the fair value of the leased asset or at the present value of the minimum lease payment, it is a ……………lease.

SOLUTION

1. B
2. E

3. A
4. A
5. E
6. i) Straight line
   ii) Sum of the digits
   iii) Accrual
7. Substance over form
8. Economic useful life
9. Minimum lease
10. Finance.

CHAPTER FOURTEEN
ACCOUNTING FOR GOODS ON SALE OR RETURN

14.0 Chapter Introduction

At times, in order to boost sale, a trader may not wait for a regular customer to come to his shop to buy or place an order for items to be supplied before goods are sent to the customer. Goods can be sent to a regular and trusted customer in the hope that the customer may buy them either for his own use or resell them to others. It is also not out of place for A to send goods to be with a clear instruction that if the goods are not returned or if B does not indicate his rejection of the goods by a certain date, A will assume that B had accepted the goods and as such a sale has been made by A. Thus, where goods are sent on Sale or Return basis, title in the goods rests with the owner until the buyer signifies his acceptance. The prospective customer to whom the goods are sent is not obliged to buy them if no buyer is found. The amount payable to the owner when the goods are sold is re-agreed.

14.0 Objectives

At the end of the chapter, readers will be able to:

i. Note the difference between transfer and sale of goods; and
ii. Be able to prepare Sale or Return Day Books

14.1 Constituents of a Sale

From the introduction, we can conclude that a mere transfer of goods by A to B does not constitute sales for A. In order to complete the sale, property in the goods should pass from A to B. Property in the goods can be assumed to have passed from the seller to the buyer, if the buyer signifies to the seller his (the buyer's) acceptance of the goods or does some act by means of which sales is expressed or implied, for example the prospective buyer starts using the goods.

14.2 Effect of Treating Goods on Approval or Return as Sales

If goods on approval are treated as sales, profit which has not been earned will be recognized. It is good to note that when sales are made, normally profit is assumed since the sales price usually includes the cost price and gross profit margin.

Hence, if goods on approval are recorded as sale, profit will be anticipated; whereas the profit may not be actually realized. This will be contrary to the prudency concept. The statement of financial position will understate the inventory, whilst the Income Statement will overstate the profit of the period.

14.3 Accounting Treatment for Goods Sent on Sale or Return

There are three types of situations that can be encountered where Goods are sent on Sale or Return. These are situations where the number and amount of goods involved are: (a) small (b) considerable (c) large and the goods are of considerable value. Different treatment will be needed for these situations as discussed below.

14.3.1 Accounting Treatment Where Transaction is Small

In the case where the transaction is small, the double entry system is not used, only memorandum records are kept. It is usually to record these transactions by using a specially ruled form of day book. It is necessary to show distinct columns for the following:

- **(a)** Goods sent on Sale or Return
- **(b)** Goods Returned
- **(c)** Goods Sold

In addition to the above, normal accounting practice and convention requires that in recording transactions, we show the particulars, dates and often link with the ledger that is the folio. The following ruled columns must be used.

Date	**Particulars**	**Goods sent on Sale or Return**	**Date**	**Goods returned**	**Goods sold**	**Sale ledger**
(1)	(2)	(3)	(4)	(5)	(6)	(7)

A number of steps are to be taken:

(1) When goods are sent out: Record the transactions in the Goods sent on sale or return column at the selling price.

(2) In the event where the goods are returned

(3) When the goods are sold: Extend the sale into Goods sold column. Post the total of Goods sold, by debiting the Customer's account in the sales ledger and crediting the sales account in the Impersonal Ledger to complete the entry.

(4) To find the selling price of the goods sent out on approval at any given date

Illustration 14.1

Mama Ayodele sent to Mrs. Onu, a regular customer 500 calculators each costing Mama Ayodele ₦2,000 at an invoiced price of ₦ 2,500 per set on Goods sent out on sale or return on the 1st of October 2007. Mr. Onu returned fifty five sets, back to Mama Ayodele on 15th October and sixty five sets on 5th November.On 31st December 2007, mama Ayodele received an amount of ₦735,000 from Mrs. Onu as sales during the period.

Required:

(a) Show the necessary recording in sale or return day book

(b) Determine the closing inventory i.e. Goods sent on sale or return for statement of financial position purpose

Suggested Solution to Illustration 14.1

As was stated at the outset, it is necessary to follow the normal accounting practice of recording transactions by showing the dates that transaction took place and the relevant particulars or details of the transactions.

We also need to have columns for the following:

Goods sent on sale or return,

Goods sold and goods returned

In view of the above, let us draw the columns

Sales or Return Day Book

Date	Particulars	Goods sent on Sale or Return	Date	Goods returned	Goods sold	Sale ledger folio
1/10/2007	500 calculators to Mr. Onu	₦"000 1,250		₦"000	₦"000	
	55 calculators back to Mama		15/10/2007	137.5		
	65 calculators back to Mama		5/11/2007	162.5		
	Sales of Calculators	**319** 31/12/2007			735	
				300.0	735	

At the end of the period closing inventory, that is goods sent out on sale or return still with Mrs. Onu would be determined as follows:

		₦"000
Selling price on goods sent out on sale or return		1,2 50
	₦"000	
Less the following:		
Selling price of returns (137.5 + 162.5)	300	
Sale of calculators	735	
		(1,035)
Sales value of goods sent out on sale or returns outstanding		215
Cost of goods with Mrs. Onu $\frac{215 \times 2000}{2500} =$	172	

14.3.2 Where the Number of Sale or Return Transactions is Considerable

In cases where the number of sale or return transactions is considerable, there is the likelihood that many transactions will be outstanding at the end of the period, if we use the previous approach, it would be necessary to bring forward in details the full particulars of the outsourcing transactions to a new section of the day book so that the various columns could be properly balanced off.

This, depending on the number of transactions could waste a lot of time, be prone to errors and also be laborious. To get around the problem, an extended ruling of the day book is suggested. The entire columns that were used in the first method would be used again. The only difference is that the columns would be extended, that is they would be repeated. An illustration of the ruling is as follows:

Sale or return day book

Half year ending (say) 30th June 2007 Half year ending

Date	Particulars	Good sent on sale or returns	Date returned or sold	Goods sold	Sales ledger folio	Balance June 30	Date returned or sold	Goods sold	Sales ledger folio	Remarks
		₦"000		₦"000	₦"000		₦"000	₦"000	₦"000	

As at 30th June, 2007, the Sales Value of calculators with Onu should be ₦1,500,000. Since inventories are valued at cost, in absence of information about the net realizable value, the value should be reduced by eliminating the gross profit margin.

Cost of calculators on sale or return $\dfrac{₦1,150,000 \times 4000}{5,000} = ₦920,000$

The sale or return ledger is self-balancing and therefore not part of the double entry system. To arrive at the closing inventory of goods sent out on sale or return, the balance of each account in the sale or return ledger must be reduced to cost.

In preparing the final accounts, be on the look out to see if goods on sale or return have been wrongly treated as sale. Occasionally, this error has been made. It becomes necessary to correct the error, by debiting the sales account and crediting the debtors account with the appropriate figure. It is also necessary to include the inventory figure at cost in the Trading Account and the statement of financial position.

If the errors affect many customers, it would be more convenient to pass one entry to correct the errors instead of adjusting each customer's account. This is done by debiting sales account and crediting sales or return suspense account with the total selling price of all outstanding items. The balance on this account must be deducted from total Receivables.

Illustration 14.3

In preparing the final accounts of "Oluwanju" it is found that the amount of Sundry Receivables ₦42,167,000 includes ₦4,000,000 worth of goods sent out on sale or return which has been debited to customers' accounts. The time for returning the goods is yet to expire. These goods have been invoice at 331/3% above cost.

Show the necessary adjustments and explain why those adjustments are needed.

Solution to Illustration 14.3

In preparing the final accounts of "Oluwanju", a journal entry should be made.

	₦
Sales account	4,000,000
Sales or return suspense account	4,000,000
Adjusting goods sent out on sale or return treated as sales	

The debit to the sales accounts will reduce the sales credited to the trading account, whilst the credit to the sale or return suspense account will be deducted from sundry debtors. In the statement of financial position, sundry debtors should appear as ₦38,167,000. The goods will then be valued at ₦3,000,000 and included in the inventory. This should be credited to trading account and debited to inventory account.

14.3.3 Where the Number of Sale or Return Transactions is Large and the Goods are of Considerable Value

In circumstances where the number of "Sale or return" transactions is high and the goods involved are of considerable value, it is not advisable to rely on memorandum system since that system does not lend itself to proof. It is better to have a separate set of books kept on double entry principles. Three books will be needed; which are: i. Sales or Return Ledger, ii. Sales or Return Day Book and iii. Sales or Return Journal. A separate double entry type sale or return ledger may be continued with the usual sale or return day book. This set of books makes it easy to ascertain at any given time, the total selling value of goods sent out on "Sale or Return".

The accounting entries are as follows:

a. When goods are sent out on sale or return;

Record in sale or return day book as usual and post therefrom as follows:

Debit:	Customers Personal Account	in a Sale or Return
Credit:	Sales or Return Total Account	Ledger at selling price

Note that the total of balances on prospective customers' personal accounts should be equal to the balance on the Sale or Return Total Account.

b. When the customer signifies acceptance of the goods, a sale is deemed to have been made. An entry is therefore required to reduce the sale or return total account balance to the value of goods not yet accepted and to change the status of the customer from a prospective buyer to a debtor. To achieve that:

Debit: Sales or Return Total Account	in a Sale or Return
Credit: Customers Personal Account	Ledger with selling value of

The goods at the stage is now set for recording the sale transaction in the normal double entry system

Debit:	Customer's Personal Account	in Sales Ledger
Credit:	Sale Account	in the General Ledger

c. When goods are returned

Debit: Sale or return Total Account

Credit: Customers Personal Account

With the selling value of the goods returned

14.4 Chapter Summary

A trader may want to sell more of his goods. He may attempt to "push" the sales by sending goods to a trusted customer on Goods sent out on Sale or Return. In this instance, the transfer of goods to the customer does not amount to sale, since the right of ownership has not passed to the customer. In other words, the ownership of the goods vests with the sender, until the expiration of time within which the goods are to be returned. Until the passage of time and the acceptance of the goods are signified, it would be incorrect to debit customer's accounts and credit sales account.

14.5 Short Answers Questions

1. When goods are sent on approval in goods sent out on sale-or-return transaction. State the accounting entry to be made.
2. The total value of goods retained after the approval period by a customer to whom goods have been sent on sale-or-return basis shall be regarded as………………….
3. The goods yet to be returned before the expiration of the approval date shall be valued at the …………………

14.6 Solutions to Short Answers Questions

1. Debit the customer's account and credit the goods-on-approval account
2. Sales (normal sales transaction)
3. Lower of cost and net realizable value.

CHAPTER FIFTEEN

ROYALTIES

CHAPTER CONTENTS

15.0 OBJECTIVES

At the end of the Chapter, readers should have learnt:

a. The nature of royalty arrangements;
b. Key terms associated with royalty contracts, such as lessor, lessee, short-workings and dead rent;
c. Accounting for royalty transactions in the books of the lessor of legal rights,
d. Accounting for royalty transactions in the books of the lessee of legal rights,
e. Accounting for royalties under subletting arrangements; and
f. The statement of financial position treatment of year-end balances on relevant royalty accounts

15.1 INTRODUCTION

This chapter teaches royalty arrangements and the double entry recording of royalty transactions in the books of the major parties involved in such arrangements.

It begins with explanations of key terms which you need to know in order to understand the nature of royalty contracts.

In the section which follow, the book keeping entries peculiar to royalty transactions are shown and explained with appropriate illustrations.

15.2 Definitions

Royalty

The consideration paid to a lessor for allowing another party to utilize a legal right owned by him is called a royalty.

This usually happens as a business arrangement whereby a mine, a patent, a trade mark, or a copyright is leased to another person. The owner of the right may be called a landlord, grantor, lessor or author.

The party to whom the right is granted or leased is called a lessee, tenant, or grantee. The royalty payable is determined by the extent to which the lessee utilized the owner's rights such as tons of ore mined or number of copies sold.

Short workings

It is usual for the royalty arrangement to stipulate a minimum rent. A minimum rent is a guaranteed minimum payment to the lessor where the royalty calculated on the basis of actual production falls short of the guaranteed minimum. The shortfall or the amount needed to make up the minimum rent is called short workings.

15.3 Operating Arrangements

The royalty agreement normally allows the lessee to recoup short workings out of future royalties if they exceed the minimum rent.

However, it is usual for the contract to stipulate a time limit within which short workings may be recovered. Once the recoupment period has expired, short workings are irrecoverable.

15.4 Accounting for Royalties in the Books of the Lessee/Tenant

The accounts used are:

Royalties Payable Account (*an expense account)*

Land lord‟s Account (*a liability account)* Short

workings Recoverable (*an current asset)*

When royalties based on actual production has been ascertained:

Debit Royalties Payable A/C

Credit Landlord's A/C

When short workings (***i.e the amount required to increase royalties payabale to the guaranteed minimum)*** are ascertained

Debit Short workings Recoverable

Credit Landlord's Account

To close off Royalties payable account at the end of the period, transfer balance on royalties payable account to the Manufacturing Account or Opening Account as the case may be.

That is, **Debit** Operating Account

Credit Royalties Payable Account

When the royalty is paid to the Landlord

Debit Landlord's Account (to discharge the liability)

Credit Bank Account

Where the royalty, based on actual production exceeds the guaranteed minimum payment and the contract allows for recoupment of past short workings:

Credit Short workings Recoverable Account

Debit Landlord's Account (***to reduce liability to the landlord by the shortworkings recoverable)***

Note:

(a) The amount of short workings recouped should not reduce the royalty payable to the landlord to an amount which falls short of the guaranteed minimum.

(b) The balance on short workings recoverable account should be carried down until it is recouped or written off the Profit or Loss Account when the time allowed for recoupment expires.

If short workings become irrecoverable:

Debit Profit or loss Account

Credit Short workings Recoverable Account with the amount no longer recoverable

Illustration 15.1

O. W. Narr, a Landlord granted a lease to Sika Mines Ltd to mine gold from land owned by him. The contract stipulated the following:

(a) A royalty of 4 Ecos per kilogram of gold mined

(b) A minimum rent of 2,000,000 Ecos per annum

(c) Short workings are recoverable up to the end of the fourth year of operations only. During the first four years, the following quantities of gold were mined

2001	400,000	Kilograms
2002	480,000	Kilograms
2003	540,000	Kilograms
2004	560,000	Kilograms

The accounting year of the lessee, Sika Mines Ltd, end on 31st December, the date on which payment to O. W. Narrrh the Lord, is made.

Required:

Prepare the appropriate accounts in the books of the lessee, Sika Mines Ltd., for each of the four years.

Solution to Illustration 15.1

O. W. Narh Account (i.e Landlord's Account)

2001	**Ecos**	**2001**	**Ecos**
Dec. 31 Bank	2,000,000	Royalties Payable	1,600,000
		Short workings Recoverable	400,000
	2,000,000		2,000,000
2002		2002	
Dec 31 Bank	2,000,000	Dec. 31 Royalties payable	1,920,000
		Shortworkings Recoverable	80,000
	2,000,000		2,000,000
2003		2003	
Dec. 31 Short workings Recoverable	160,000	Dec. 31 Royalties Payable	2,160,000
Bank	2,000,000		------------
	2,160,000		2,160,000
2004		2004	
Dec. 31 Short workings	240,000	Dec. Royalties Payable	2,240,000
Dec. Bank	2,000,000		------------
	2,240,000		**2,240,000**

Short workings Recoverable Account

2001	**Ecos**	**2001**	**Ecos**
Dec. 31 O.W. Narr	400,000	Dec 31 2001 balance c/d	400,000
2002 Jan 1 balance b/d	400,000		
Dec. 31 O.W. Narr	80,000	Dec 31 Balance c/d	480,000
	480,000		480,000

2003 Jan 1 Balance b/d	480,000	2003	
		Dec. 31 O. W. Narr	160,000
	----------	Dec. 31 Balance c/d	320,000
	480,000		480,000
2004 Jan. 1 Bal. b/d	320,000	2004	
		Dec. 31 O. W. Narr	240,000
		Dec. 31 Profit and Loss	80,000
	320,000		**320,000**

Note:

Where the lessee or tenant pays the lessor or landlord after the statement of financial position balance sheet date, a closing balance would occur on the landlord's account at the end of the tenant's financial year. For example in the above solution, a credit balance of 2,000,000 Ecos would occur on O. W. Narr"s account on 31st December. This would be included in payables (as a current liability) on the statement of financial position of Sika Mines Ltd. Short workings Recoverable (i.e. not yet expired) would also be shown as a Current Asset.

Illustration 15.2

Now we continue with an illustration of how the above royalty arrangement would be recorded in the books of O. W. Narr, the Landlord.

Solution to Illustration 15.2

The following double entry accounts would be used:

(a) Royalties Receivable (a revenue account)

(b) Tenant or Lessee A/C. (an asset account)

(c) short workings Allowable A/C (a current liability which represents a rebate to the tenant and deductible from royalties receivable if actual royalties exceed the minimum guaranteed by the agreement)

In The Books of O. W. Narr

Royalties receivable Account

2001	**Ecos**	**2001**	**Ecos**
Dec. 31 Profit & Loss A/C	1,600,000	Dec 31 Sika Mines	1,600,000
2002		2002	
Dec. 31 Profit & Loss A/C	1,920,000	Dec 31 Sika Mines	1,920,000
2003		2003	
Dec. 31 Profit & Loss A/C	2,160,000	Dec. 31 Sika Mines	2,160,000
2004		2004	
Dec. 31 Profit & Loss A/C	2,240,000	Dec. 31 Sika Mines	2,240,000

Short workings Allowable Account

2001	**Ecos**	**2001**	**Ecos**
Dec. 31 Bal. c/d	400,000	Dec 31 Sika Mines	400,000
2002		2002	
Dec. 31 bal. c/d	480,000	Jan. 1 Bal. b/d	400,000
	-----------		80,000
	480,000		480,000
2003		2003	
Dec. 31 Sika Mines	160,000	Jan. 1 Bal. b/d	480,000
Profit and Loss A/C	320,000		-----------
	480,000		480,000
2004		2004	
Dec. 31 Sika Mines	240,000	Jan. 1 Bal. b/d	320,000
Dec. 31 c/d	80,000		----------
	320,000		**320,000**

2001	**Ecos**	**2001**	**Ecos**
Dec. Royalties Receivable	1,600,000	Dec 31 Bank	2,000,000
Short workings Allow.	400,000		------------
	2,000,000		2,000,000
2002		2002	
Dec. 31 Royalties Dec	1,920,000	Dec. 31 Bank	2,000,000
Shortworkings All.	80,000		------------
	2,000,000		2,000,000
2003		2003	
Dec. 31 Royalties	2,160,000	Dec. Shortworkings	160,000
	------------	Allowable	2,000,000
	2,160,000		2,160,000
2004		2004	
Dec. 31 Royalties Receivable	2,240,000	Dec. 31 Shortworkings Allowable	240,000
	------------	Dec. 31 Bank	2,000,000
	2,240,000		**2,240,000**

Note:

Where the landlord receives payment after the Statement of Financial Position, a debit balance would occur on the tenant's account at the end of the financial year. In the above solution, Sika Mines Ltd‟s account would show a debit balance of 2,000,000 Ecos at the end of each financial year. This would be shown as a current asset in O. W. Narr‟s statement of financial position. Similarly the Short workings Allowance account would show a credit balance of 480,000 Ecos at the end of 2002 which would be included liabilities.

15.5 Sub-Letting

It is a common practice that a tenant (or a lessee of certain rights) in turn sub-lets to a sub-tenant. Where this happens the original tenant has business relationships with two parties, namely, the original landlord and the sub-tenant.

The original tenant therefore plays two roles at the same time. To the original landlord he is in the position of a tenant. But in his relationship with the sub-tenant he plays the role of a landlord. We have already learnt accounting for royalties in the books of the landlord and in the books of the tenant.

We are therefore in a position to prepare the account in the books of one who plays the dual role of tenant and landlord at the same time.

(a) The accounts required to record transactions with original landlord are:

- Royalties Payable A/C.
- Landlord Account
- Short workings Recoverable A/C

(b) The accounts required to record transactions with the sub-tenant, are:

- Royalties Receivable A/C
- Sub-Tenants Account
- Short workings Allowable A/C

15.6 Chapter Summary

Royalty is the consideration paid by a lessee, to the lessor of legal rights, for utilizing the lessor‟s rights.

In straight forward cases royalty arrangements involve two parties, the lessor (or landlord) and the lessee (or tenant). In such cases the accounts required to rcord the transactions in the books of the lessee are usually:

a. Royalties Payable
b. Landlord Account
c. Short workings Recoverable A/C

Sub-royalty arrangements occur in slightly more complicated cases, where the original lessee (tenant) in turn sub-lets the acquired rights to a sub-lessee. Sub-royalty is the payment made by the sub-lessee to the original lessee (tenant). Here three parties are involved viz:

a. Landlord (Lessor)
b. Tenant (Lessee)
c. Sub-Tenant (Sub-lessee).

15.7 MULTIPLE CHOICE QUESTIONS AND SHORT ANSWER QUESTION

1. Which of the following form of tax is imposed on royalty paid?
   a. Sales tax
   b. Withholding tax
   c. Capital gains tax
   d. Pay-as-you-earn
   e. Income tax

2. In a royalty arrangement, the following accounts are normally used to record transactions in the books to original landlord and sub-tenant except.
   a. Royalties payable account
   b. Landlord account
   c. Short working recoverable account
   d. Memorandum account
   e. Royalties receivable account

3. The credit entry for short-working recoupable is recorded in the
   a. Tenants‟ account
   b. Landlord's account

c. Royalty receivable account

d. Royalty payable account

e. Minimum rent account

4. Which of the following statements are true in a royalty arrangements?

   i. The balance at the end of the period, in royalty payable account is transferred by the lessee to the manufacturing account

   ii. The short workings are credited by the lessee to the lessee account

   iii. Royalty received from the lessee is debited to cash account by the lessor.

   a. i and ii

   b. i and iii

   c. ii and iii

   d. i, ii and iii

   e. iii only

5. In the lessee books which of the following entries would not be recorded in the lessor account; there is also a contract with a sub-lessee?

   a. Royalty payable

   b. Royalty receivable

   c. Short workings receivable

   d. Royalty paid

   e. Short workings allowable

6. In a royalty arrangement, when the lessee leases part of the lease to another person it is called……………………..

7. The guaranteed amount payable where the royalty calculated on the basis of actual production falls short of the estimated level is………………..

8. The consideration paid to a lessor for allowing another party to utilize a legal right owned by him is called………………..

9. In the book of the lessor state the double entry for the short working reoccupied by the lessee

10. When short working recoupable by the lessee lapsed, state the double entry in the book of the lessor.

15.8 SOLUTIONS TO MULTIPLE CHOICE AND SHORT ANSWER QUESTIONS

1. B
2. D
3. A
4. B
5. E
6. Sub-letting
7. Minimum rent
8. Royalty
9. Dr Short working allowable account
   Cr. Lessee account
10. Dr. Short working allowable account
    Cr. Income statement

CHAPTER SIXTEEN

JOINT VENTURE ACCOUNTS AND CONTAINERS ACCOUNT

Chapter Contents

a. Introduction

b. Main features of joint ventures

c. Accounting arrangement relating to joint ventures

d. Book keeping for joint ventures

e. Inventories of Goods

16.0 Objectives

At the end of this chapter, the reader should:

a. Gets an understanding of the nature of joint venture;

b. Knows the normal operating and accounting arrangements relating to joint ventures;

c. Knows the difference between joint ventures and partnerships; and

d. Knows how to prepare the containers account.

16.1 Introduction

Businessman sometimes pools their resources. These resources may be in the form of finance, manufacturing facilities, business expertise, sales or other services. This pooling may be a permanent arrangement which necessitates entering into a partnership agreement, or it may be a temporary arrangement with a specific, limited objective(s).

A joint venture is simply a venture undertaken jointly by two or more persons with a view to making a profit. It differs from a partnership in that it is more temporary in nature and has more specific limited objective(s).

Joint Ventures can be found in almost every business sphere but they are often associated with one-off transaction, such as buying up the inventory of a bankrupt business or engaging in other short term operations. A party to a joint venture may be called a co-venture or simply a venture.

16.2 Main Features of a Joint Venture

a. The ratio in which business profits (losses) are to be shared must be clearly stated and agreed by the venture. Where this has not been explicitly stated, profit is assumed to be shared to be shared equally.

b. The scope of the venture and the respective responsibilities of each venturer must be agreed upon, e.g. one venturer does the buying and the other the selling; but often each venture makes a financial contribution.

c. The parties may agree to pay a venture for services rendered e.g. handling or selling and such payment is deducted from revenue before the profit (or loss) of the venture is ascertained.

16.3 Accounting Arrangements Relating to Joint Ventures

Where the magnitude of the business makes it necessary, a separate set of books is maintained for the venture. In this case, there are no special accounting problems and all transactions of the joint venture are passed through the set of books in the normal way. However, because of their temporary nature, this is very often not the case. No separate books are kept to record the transactions. Instead, each venture records in his own ledger, the transactions undertaken by him on behalf of the venture.

This is done by each venture opening in his own books a personal account for his co-venturer. This account is called Joint Venturer Account (or Joint Venture with X, being the same of the co-venturer).

16.4 Book keeping for Joint Venture Accounts

(i) If cash is paid out:

DR Joint Venture A/C

CR Cash A/C

(ii) If cash is received: (from sales or from co-venturer):

DR Cash

CR Joint Venture Account

(iii) Any charges agreed upon e.g. Sales Commission:

DR Joint Venture Account

CR Commissions Account in the books of the venture who is to receive the Commission

(iv) When it is time to ascertain profit (or loss), the Joint Venture Account of each party (venture) are combined together in a Memorandum Joint Venture Account. This account does not form part of double entry in the books of any venturer.

It is purely a memorandum of what has occurred and it is used to ascertain profit (or loss) of the venture.

(v) When profit (or loss) is found, each venture will:

DR Joint Venture Account with his share

CR Profit or Loss on Joint Venture Account with the same amount

(vi) In the event of a loss, each venture must:

DR Profit or Loss on Joint Venture Account with his share of the loss

CR Joint Venture Account, with the same amount

(vii) When all these entries have been made correctly, the Joint Venture Account in the books of each venturer will now be found to show the same balance. The balances will however appear on the opposite sides in the respective books. For example, if A"s books show a credit balance in favour of B, B"s books will show a debit balance of the same amount against A.

Illustration 16.1

Femi and Chukwu enter into a joint venture to buy up and sell the inventory of a bankrupt manufacturer. Femi pays for inventory GHc/ 1,000 and pays expenses GHc/ 400. They share profit in the ratio 3:2.

Required

Show the relevant accounts in the books of the ventures

Solution to Illustration 16.1

Femi's Books

Joint Venture (with Chukwu) Account

	GH¢		GH¢
Cash: (Cost of goods)	1,000	Balance c/d	1,400
Cash: expenses	100		
P & L A/C	300		-------
	1,400		**1,400**
Balance b/d	**1,400**	Balance b/d	**1400**

Chukwu"s Books

Joint Venture (with Femi) Account

	GH¢		GH¢
Cash expenses	400	Cash sales goods	2,000
P & L A/C	200		-------
Balance b/d	1,400		2,000
	2,000	Balance b/d	**1400**

The balances on the accounts (which must agree) will be settled by Chukwu giving Femi a cheque for GH01,400

16.5 Inventories of Goods

If at the close of the venture, there are goods on hand and one of the parties takes them over at an agreed valuation, that venture taking over the goods must: Dr: Purchases Account (of his own) CR: Joint Venturer Account.

Since this figure appears on the credit side of the Joint Venture Account, the same amount will be entered on the "CREDIT"" side of the Memorandum Joint Venture Account when the Joint Venture Accounts are combined for profit or loss determination.

Where there remains some inventory in the hands of either or both ventures, not taken over, e.g. When the venture is to be completed at a subsequent period, such Inventories represents asset still employed in the venture. The necessary accounting treatment is as follows:

Each venture will bring down on the debit side of the Joint Venture Account in his books the amount of the stock held by him. Consequently the total value of the stock is brought down on the "DEBIT" side of the Memorandum Joint Venture Account as a balance.

Illustration 16.2

Chukwu and Emeka entered into a joint venture to sell stationery on January 1st, 2008. They share profits and losses equally. Chukwu provided the stationery from Inventory at an agreed valuation of GH¢5,000. He paid expenses amounting to GH¢250 up to 31st January, 2008. During January, Emeka"s expenses amounted to GH¢650 and received cash from sales of GH¢3,000. He also took over goods valued GH¢1,000 for use in his own business. On 31st January, the inventory in the hands of Chukwu was valued GH¢1,100. The remaining inventory of GH¢1,100 was taken over by Chukwu for 1,200 on February, 10th
2008.

Required

Show the accounts for January and February in the books of the ventures

Solution to Illustration 16.2

In Chukwu"s Books

Joint Venture (with Emeka) Account

	GH¢		GH¢
January 1 Purchases Account	5,000	January 31 P & L (shares of loss)	400
31 Cash: expenses	250	Inventory c/d	1,100
	-------	Balance c/d	3,750
	5,250		**5,250**
Balance b/d	**1,400**	Balance b/d	**1400**

In Emeka"s Books

Joint Venture (with Chukwu) Account

	GH¢		GH¢
January 21 Cash: Expenses	650	January 31 Cash Sales	3,000
Balance c/d	3,750	Purchases	1,000
	-------	P & L (share of loss)	400
	4,400		**4,400**
February P & L (shares of profit)	50	Balance b/d	3750
Balance c/d	3,700		-------
	3,750		**3,750**
		Balance b/d	3,750

Memorandum Joint Venture Account

		GH¢		GH¢
Jan 1	Cost stationery	5,000	January 31 Sales: Emeka	3,000
31	Expenses:		Inventory taken over	
	Chukwu	250	Emeka	1,000
	Emeka	650	Inventory c/d	1,100
			Loss: Chukwu	400
		------	Emeka	400

		5,900		**5,900**
Feb 1	Inventory b/d	1,100	Inventory taken over	1,200
10	Profit: Chukwu	50		
	Emeka	50		--------
		1,200		**1,200**

16.6 Chapter Summary

Joint Ventures can be found in almost any sphere of business activity. The parties to the venture are called co-ventures or simply venture's. Sometimes a separate set of books is maintained for the venture. No special accounting problems emerge in this case and all the transactions of the venture are passed through in the normal way.

In most cases, however, each venture records in his own ledger the transactions undertaken by him on behalf of the venture. When this happens, as is usually the case, each venture opens in his own books, an account in the name of his co-venture(s). This account is called the Joint Venture Account. When all entries relating to the venture have been made correctly, the Joint Venture Account of each venture should show the same balance but on the opposite side in their respective books. If, as is usual in examination questions, there are only two venturers, cash will be paid by one venture to the other and the venture comes to a close.

16.7 Multiple Choice Questions and Short Answers Questions

1. Joint Ventures differ from partnership in that

   (a) Joint ventures are formed to deal in bankrupt inventory only
   (b) Co-venturers do not contribute capital
   (c) No prior agreements are required to form a joint venture
   (d) Joint ventures are usually for a more limited period
   (e) Joint ventures are carried on indefinitely

2. A venturer‟s personal account in the books of a co-venturer is called

(a) Commission Account

(b) Memorandum Joint Venture Account

(c) Joint Venture Account

(d) Joint Venture Profit or Loss Account

(e) Joint Venture Bank Account

3. Which of the following accounts associated with joint ventures does not form part of the venture‟s double entry records?

(a) Joint Venture Profit & Loss Account

(b) Joint Venture Account

(c) Memorandum Joint Venture Account

(d) Co-ventures Personal Accounts

4. After all entries relating to a joint venture between Chukwu and Emeka had been completed in the books of the venturers, the Joint Venture, with Chukwu Account showed a debit balance of GH¢1,000. The same amount showed on the Joint Venture with Emeka Account but as a credit balance.

Which of the venturers made a book keeping error?

(a) Chukwu

(b) Emeka

(c) Both

(d) None of them

5. Why is a Memorandum Joint Venture Account needed by the venturers?

(a) To show the indebtedness of one venture to another

(b) For profit (or loss) determination

(c) To show the venturers capital contributions

(d) To enable the venturers to memorise the accounts

(e) For determination of ventures borrowings

6. Goods taken over by a venture in a joint venture arrangement is ……… to memorandum joint venture account.

7. In a joint venture remittance to other ventures is …… to joint venture account.

8. A and B formed a joint venture to buy and sell second hand clothing. B financed A by sending him a cheque of N5 million. Show the accounting entry in the book of B.

9. Which of the accounts prepared by joint venture do not form part of the double entry?

10. In a memorandum joint venture accounts, sales are …………. entries

16.8 Solutions to Multiple Choice and Short Answers Questions

1. D
2. C
3. C
4. D
5. B
6. Credited
7. Debited
8. Dr. Joint venture account with A
   Cr. Bank account
9. Memorandum joint venture account
10. Credit

CHAPTER SEVENTEEN

CONTRACT ACCOUNTS

CHAPTER CONTENTS

a. Introduction

b. Combining segment of construction contracts c.

Types of construction contracts

d. Nature of construction contracts

e. The completed contract method

f. Provision of expected loss on contract

g. Valuation of long term contracts

h. Work in progress

i. Definition of basic terms

j. Methods of accounting for construction contracts

k. Methods of recognizing revenue and costs

l. Accounting entries

m. Other actual issues

n. Disclosure requirements

17.0 OBJECTIVES

At the end of this chapter, readers should be able to:

a. Understand the methods prescribed for accounting for contract;

b. Calculate profit to be recognized under each of the method;

c. Calculate the value of work in progress; and

d. Prepare contract accounts

17.1 INTRODUCTION

17.1.1 The objective of contract accounts.

The allocation of contract revenue and contract cost to the accounting period in which construction is performed.

17.1.2 Construction contract: is a contract negotiated for the construction of an asset or combination of assets that are closely interrelated or independent in terms of their design, technology, function or use. Examples are, contracts for construction of bridge, building, dam, road, pipeline. Others are contract for services that relate to the construction of assets such as contract for destruction and restoration of an asset and for the restoration of environment following the deterioration of an asset. Many construction contracts are long-term in nature.

17.2 COMBINING OR SEGMENTING CONSTRUCTION CONTRACTS

17.2.1 Segmenting Contracts: When a contract covers a number of assets, the contract for construction of each asset shall be considered a separate contract in the following situations.

a. Separate proposals has been submitted for each asset.

b. Each contract has been subject to separate negotiation and both contractor and customer (contractee) were able to accept or reject that part of the contract relating to each asset.

c. The costs and revenues of each asset are separately identifiable.

17.2.2 Combining Contracts:

A group contract with a single customer or multiple customers can be treated as a single Construction contract in the following situations:

a. The group contract has been negotiated and finished as a single package

b. The contracts are very closely related to each other and in fact are part of a single contract with overall profit margin.

c. The contracts are performed in a continuous sequence.

Sometimes the customer may require the contractor to construct an additional asset. The additional asset shall be treated as a separate contract if

i. It differs significantly from the original asset

ii. The price is negotiated without regard to the price of the original contract

17.3 TYPES OF CONSTRUCTION CONTRACT

There are several types of construction contracts. They include;

a. Fixed Sum Contract,

b. Cost plus a Fixed Rate Contract,

c. Variable Price Contract,

d. Re-measure Contract

17.3.1 Fixed Sum Contract

Under this type of contract, the contractor agrees to a fixed contract price or sum, in some cases subject to cost escalation clauses. For fixed price contract to be used the following conditions must be obtainable:

a. Total contract revenue must be reliably estimated

b. Cost of completion can be reliably estimated

c. Percentage of contract performance completed at the reporting state can be reliably estimated

17.3.2 Cost Plus a Fixed Rate Contract

Under this method, the contractor is reimbursed for allowable or otherwise defined costs incurred plus a fixed fee or percentage uplift on the agreed costs incurred. The following conditions must be met for the application of cost plus contract:

(a) Attributable cost can be reliably and clearly identified.

(b) Costs other than those that will be specifically reimbursable can be reliably estimated

17.3.3 Variable Price Contract

This type of contract contains one or more clauses regarding:

a. Price variation that allows adjustment to the base price

b. Work variations for an additional work order from the employer

c. Prolongation that takes care of additional cost resulting from delays not caused by the contractor

17.3.4 Re-Measure Contract

This type of contract allows final contract price to be determined by the measurement of final quantities.

17.4 NATURE OF CONSTRUCTION CONTRACT

There are two forms of construction contract, namely:

a. Short term construction contract

b. Long term construction contract

i. **Short Term Construction Contract**

This is a contract which is expected to be completed within a period of not more than twelve months

ii. **Long Term Construction Contract**

This is a contract which is expected to take a period of more than twelve months to complete.

It should be noted that long-term contracts may be faced with the following problems:

a. Persistent changing prices of materials and labour which may adversely affect the contract price and cost.

b. It may be difficult for the contractor to accurately predict the future of the contract

c. Changes in government policies may also affect the execution of the contract.

All the factors highlighted above are usually taken into consideration in estimating profit that would be recognized on long-term contract work.

17.5 THE COMPLETED CONTRACT METHOD

The completed contract method does not recognize profits until the contracts are completed or substantially completed. Costs and progress payments received are accumulated during the course of the contract. No interim profit is recognized.

17.6 PROVISION OF EXPECTED LOSES ON CONTRACT

When it is expected that the total contract cost will exceed the total contract revenue such excess must be recognized immediately in the statement of profit or loss, irrespective of

a. Whether the contract work has commenced
b. The stage of completion of the contract
c. The amount of profits expected on other contracts that are not treated as a single contract may cover the losses

17.7 VALUATION OF LONG TERM CONTRACT WORK IN PROGRESS

International Accounting Standard (IAS) No. 11 states that valuation of contract work-in- progress in the financial statements should be based on cost plus attributable profit less foreseeable losses, progress payments received and receivable.

VALUATION OF LONG TERM CONTRACT WORK-IN-PROGRESS

	₦
Cost of contract to date	X
Add:	
Profit recognized to date	X
	XX
Less foreseeable losses	(X)
	XX
Less	
Progress payments received & receivable	(XX)
Contract work-in-progress	XX

17.8 DEFINITION OF BASIC TERMS UNDER CONSTRUCTION CONTRACT

a. Mobilisation Fee:- Is the advance payment by an employer to the contractor to enable the commencement of the contract work. Usually, such a payment is treated as a liability or unearned revenue until fully recovered in accordance with the contract agreement. It is also called ADVANCE PAYMENT.

b. **Retention Fee:-** This is a part of the contract price withheld by the contractee after the successful execution of contract work and released after the expiration of a stated period subject to no adverse event on the contract. Retention fees are usually recorded in the books of accounts of the contractor as ASSET or treated as a Memorandum entry and shown as note to the accounts.

In practice, where there are no retention fees, the contractor may be required to provide a third party guarantee.

c. **Sub-Contractors:-** Sometimes, the contract work may be so big or complex that a sole contractor may not be able to handle the contract in all its entirety and therefore the main contractor may engage the services of other contractors. These other contractors are referred to as "Sub-Contractors".

The sub-contractor is expected to enter into an agreement with the main contractor subject to the fact that the agreement does not contradict the clauses in the main contract.

d. **Contract Certification:-** This is the process by which the project Architect/Engineer issues a certificate to evidence the value of work done on a construction contract as at a particular date.

e. **Deferred Costs:-** These are costs that relate to aspects of a contract which are not immediately certifiable.

f. **Contract Work-In-Progress:-** These are accumulated certifiable costs relating to a contract that is yet to be completed. Progress payments recovered and receivable are generally deducted from it.

g. **Progress Payments:-** These are settlements of fees for work already billed. Some companies take only a portion of the billing that represents work already performed as revenue and the other part is deferred. However, under the completed contract method of accounting for contract the whole revenue is deferred.

h. **Under Billing:-** This arises where the rates used for progress billings for payment are lower than those used for revenue recognition.

i. **Overbilling:-** This arises where the rates used for progress billings for payment are higher than those used for revenue recognition.

17.9 METHODS OF ACCOUNTING FOR CONSTRUCTION CONTRACT

The problems that affect accounting for construction contract are the timing, measurement and recognition of revenue and the assets created during construction. This would affect Profit or Loss and Current Asset reported.

In order to overcome some of these problems, IAS No. 11 recognises two methods of accounting for construction contract which are:

a. The completed-contract method
b. The percentage-of-completion method, and.

17.9.1 CONTRACT REVENUE

Contract revenue is the amount of revenue initially agreed upon with the customer and the amount on account of variations from the agreed terms, claims made and the incentives claimed to the extent that is probable that they will result in revenue and they are capable of being reliably measured. For instance, there could be variation in price due to escalation in price or increase in the units of output. There could also be variation as a result of incentives payment received or receivable on account of early completion of the contract.

17.9.2 CONTRACT COSTS

Contract costs are made-up of

a. Costs that relate directly to the specific contract.
b. Costs that are attributable to the contract in general and can be allocated to the

contract.

c. All other costs that can be specifically charged to the customer on the basis of the terms of contract cost are:

   (i) Materials used in construction
   (ii) Labour cost, including supervision costs
   (iii) Depreciation of plant and equipment used in construction
   (iv) Cost of hiring plant and equipment used in construction
   (v) Cost of moving materials and equipment to the contract site
   (vi) Cost of design and technical assistance related to the contract
   (vii) Claims from third parties
   (viii) Cost of rectification work or work executed during a warranty period. These costs may be reduced by any incidental income resulting from sale of surplus material and disposal of equipment at the end of the contract. General costs that can be allocated to contract are:
      - Construction overhead, like payroll preparation charges
      - Insurance like professional indemnity insurance
      - All other general and administrative overheads that the customer has specifically agreed to reimburse under the terms of the contract that be charged to the customer.

17.9.3 COSTS THAT ARE NOT ATTRIBUTABLE AND CANNOT BE CHARGED ARE:

(a) Selling and marketing costs

(b) General administrative costs for which there is no reimbursement agreement from the customer

(c) Research and development cost for which there is no reimbursement agreement from the customer

(d) Depreciation of idle equipment whose use cannot be attributable to the construction of the contract

17.9.4 PRE-CONTRACT COSTS

Pre-contract costs can be included as part of the contract costs if such costs can be measured reliably and it is probable that the contract will be secured. Example of pre-contract costs are costs of travelling, promotion and meetings.

17.9.5 RECOGNITION OF REVENUE AND COSTS

When the outcome of a contract can be measured reliably, the contract revenue and contract cost must be recognized with reference to stage of completion of contract at the financial position date.

When it is likely that contract costs will exceed revenue, then the entire loss must be recognized in the statement of income immediately regardless of the stage of completion.

The following are the indications that contract cost can be measured reliably. For a fixed-price contract.

(a) The total contract revenue can be measured reliably

(b) It is probable that the economic benefits associated with the contract will flow to the entity

(c) Both the cost to complete the contract will flow to the entity

(d) The costs attributable to the contract can be clearly identified and measured

17.9.6 FOR A COST-PLUS CONTRACT

(a) It is probable that the economic benefit of the contract will flow to the entity

(b) The costs attributable to the contract can be clearly identified and measured

17.10 METHODS OF RECOGNISING REVENUE AND EXPENSES

There are two methods:

Percentage of completion method and completed contract method.

17.10.1 PERCENTAGE OF COMPLETION METHOD

The recognition of revenue and expenses by references to the stage of completion of the contract is referred to as percentage of completion method.

The method is applicable where cost to completion of the contract can be estimated with a degree of certainty. The contract revenues are matched with the contract costs incurred in reaching the stage of completion so that only the revenue expenses and profit/loss attributable to the proportion of work completed is recognized.

The following are some of the methods that reliably measure the extent of work completed.

(a. The proportion that cost incurred at the reporting date bear to expected total required to complete the contract.

(b) By physical survey of work performed or issue of Architect certificate

(c) Completion of physical proportion of the contract work

Illustration 17.1

Make Construction Company has signed a fixed price contract at N600million for the construction of a big housing estate in Lagos.

The details of the cost incurred to the end of the first accounting period.

	₦"000
Material costs delivered to site	150,000
Labour cost	50,000
Depreciation of plant & equipment used	25,000
Selling and promotion of awareness for the estate	50,000
Total	275,000
The estimated cost of the contract to completion was	275,000

Required: Calculate the percentage of completion method and the profit taken

SOLUTION

	₦"000
Cost incurred to date:	
Material cost	150,000
Labour cost	50,000
Depreciation of plant & equipment	25,000
Cost to date	225,000
Estimated cost to completion	275,000
Total cost to complete	500,000

Percentage of completion = 225/500 x 100/1 =
45% Profit taken ₦600m x 45% = ₦270million.

The selling and promotion cost is excluded in the calculation of cost to date because it is not allowed under IAS 11 – Construction contracts.

Illustration 17.2

Panama Ltd undertook a contract for building a factory for ₦150million. The contract cost of ₦ 30million was incurred up to 31 December 2016 and expects that further cost to complete the construction will be ₦150million.

How much should be recognized in the statement of profit or loss in 2016?

SOLUTION

Since it is probable that the total costs of N180million will exceed the total contract revenue, the expected loss of N30 million should be recognized as expense at the end of year 2016 notwithstanding that the contract is in the early stage of completion.

17.10.2 PROCEDURES FOR GATHERING COST FOR CONTRACT ACCOUNTS

Under contract costing each project is given a contract number to facilitate referencing in the books and in vouchers to be used. This number identifies the cost account to which the elements of cost are charged in order to ascertain profit or loss on the contract.

a. **Materials:-** These are materials specifically ordered for the contract work or those obtained from the central store. They are usually charged to contract accounts.

   Also, it is possible that materials are transferred from one contract to another. If this is so, the contract account transferring the material is credited with the value of materials transferred and the contract account receiving is debited.

b. **Labour:-** All labour used on site having direct relationship with the contract at hand is charged to the contract account.

c. **Direct Expenses:-** All expenses incurred in respect of a particular contract should be charged to the contract account in the same way as material and labour have been charged.

d. **Overheads:-** General overhead expenses that cannot be directly attributed to a particular contract are usually charged to the various contract accounts when it has been apportioned usually on percentage basis.

e. **Plant and Equipment:-** Plant and equipment are either used for a long period of time for contract work or for a short time. Where plant are to be used for a long time they are usually charged to the contract account on Time Basis, and they may be charged on Revaluation Basis.

Where a plant which has been used for a particular contract for a long period of time is to be used for another contract work, such plant and equipment should be charged out of the contract account at its second hand value and should be debited to a new contract account where it is to be used.

17.11 ACCOUNTING ENTRIES IN CONTRACT ACCOUNTS

There are two methods of maintaining a contract account, namely:

- Architect Certificate Method
- Work-in-Progress Method

17.11.1 ARCHITECT CERTIFICATE METHOD

Under this method, a contract account is opened and debited with cost of materials, labour, direct expenses, plant and equipment acquired specifically for the contract, payment to sub contractors and any other expenditure incurred on site wholly for the purpose of the contract.

On the credit side of the contract account are value of Unused materials on site, written down value of plant and equipment, Value of Architect Certificate, and Work awaiting certification

The pro-format for preparing contract account using Architect Certificate method is shown below:-

CONTRACT ACCOUNT

	₦		₦
Cost of materials supplied	X	Architect or Engineering Certificate	X
Wages	X	Value of work awaiting	
Contract Overhead	X		
Direct Expenses	X	Certification	X
Plant and Equipment	X		
Payment to sub-contractors	X	Value of unused materials	X
General Expenses	X	Written down value of plant and	
		equipment at the end of the year	X
		Less in contract (if any)	X
Site Direct Expenses	X	(Balancing figure)	XX
Non-current Asset cost (specifically for			
the contract)	X		
Depreciation on non-current cost	X		
Profit on contract (Balance fig)	XX		—
	XX		XX

17.11.2Work-In-Progress Method

This method would be useful where value of work awaiting certification and value of Architect Certification are unknown or cannot be deduced.

Work-in-progress at the beginning of the year is debited along with all relevant costs. Also profit to be recognized during the year is debited while written down value of unused resources is then credited.

Any balance on the contract (after adjusting for losses) represents the value of work-in-progress at cost plus attributable profit.

The format required for preparing the contract account is as follows:

CONTRACT ACCOUNT

	₦		₦
Work-in-progress b/d	X	Written down value of equipment	X
Cost of Equipment	X	Unused material c/d	X
Cost of direct materials	X	WIP c/d (Balancing Figure)	X
Cost of direct wages	X		
Cost of overheads on site	X		
Recognised profit (Calculated)	X		----
	XX		XX

In order to understand the preparation of the construction contract account, let us illustrate the explanations above with practical examples:

ILLUSTRATION 17.3

The following trial balance was extracted on 31st December 2015 from the books of ARON Contractors Ltd.

	Dr.	Cr.
	₦	₦
Share capital @ ₦1 each		1,407,200
Profit or loss Account b/f		100,000
Provision for Depreciation		252,000
Cash received on account (Contract JOL/9/2015)		5,120,000

Trade payables		324,800
Land & Building @ cost	296,000	
Plant & Tools @ cost	208,000	
Bank	180,000	
Contract JOL/9/2015		
Materials Issued	2,400,000	
Direct Labour	3,320,000	
Expenses	160,000	
Plant & tool on site at cost	640,000	------------
	7,204,000	7,204,000

Contract JOL/9/2015 was started on 1st January 2015, the contract price is ₦9,600,000 and the customer has so far paid ₦5,120,000 being 80% of the work certified.

The cost of work done since certification was estimated to be ₦64,000. On 31st December 2015, after the above trial balance was extracted, the plant costing ₦128,000 was returned to store and material then on site were valued at ₦108,000.

Provision is to be made for direct labour accrued of ₦24,000 and depreciation of all plant and tool at 12½ % on cost.

Required:

a. Prepare the contract account JOL/9/2015

b Compute the profit that should be recognized

c Prepare statement of financial position of Aron Contractors as at 31 December, 2015

SUGGESTED SOLUTION TO ILLUSTRATION 17.3

(i) **CONTRACT ACCOUNT JOL/9/2015**

	₦		₦
Material	2,400,000	Plant returned ($87^1/_2$ % 128,000)	112,000
Direct labour	3,320,000	Materials unused	108,000
Expenses	160,000	Plant & Tools ($87^1/_2$ % 640,000 – 112,000)	448,000
		Cost of work not yet certified	64,000
		Work certification (Bal. Figure)	6,125,600
			6857,600
Plant & Equipment	640,000		
Provision for labour due	24,000		
Profit recognized	31360		
	6,857,600		

(ii) CALCULATION OF PROFIT RECOGNISED ON CONTRACT JOL/9/2015

	₦	₦
Material	2,400,000	
Less value on site	(108,000)	2,292,000
Direct cost	3,320,000	
Add Accruals	24,000	3,344,000
Expenses		160,000
Plant:		
Plant cost	640,000	
Less: Returned to store	(112,000)	
Written down value balance	(448,000)	80,000
Total Expenditure of contract to date		5,876,000
Less:		
Costs of work not yet certified		64,000
Cost of work certified		5,812,000
Value of work certified (5,120,000/80%)		6,400,000
Apparent profit or Estimated profit		588,000

Contract Profit Recognised:

$$\frac{\text{Cash received}}{\text{Value of work certified}} \times 2/3 \times \text{Apparent or Estimated Profit}$$

$$= \frac{5,120,000}{6,400,000} \times 2/3 \times 588,000$$

= ₦,600

=N313,600

(WI) **Statement of Profit or Loss**

	₦		₦
		Balance b/d	100,000
		Profit on contract JOL/9/2015	313,600
Depreciation A/C Plant & tools ($12^1/_2$ % 208,000)	26,000		
Bal. c/d	387,600		
	413,600		413,600

Plant & Tools

(W2)

	Cost (₦)	Cumulative Depreciation (₦)

As per Trial Balance	208,000	252,000
Transfer from contract JOL/9/2015	128,000	16,000
On contract JOL/9/2007	512,000	64,000
Statement of Profit or Loss (208,000 x $12^{1}/_{2}$ %)	-----------	26,000
	848,000	358,000

(W2) Calculation of Work in Progress (WIP)

	(₦)	
Cost of work not certified	64,000	
Cost of work certified	5,812,000	
Profit taken	313,600	
		6,189,600

(i) A RON CONTRACTORS LTD.

Statement of Financial Position as at 31st December 2015

	₦	₦	₦
NON-CURRENT ASSETS	**Cost**	**Depreciation**	**NBV**
Land & Buildings	296,000	----	296,000
Plant & Tools	848,000	358,000	490,000
			786,000
CURRENT ASSETS			
Inventory		108,000	
W. I. P. (W3)		6,189,600	
Bank		180,000	
		6,477,600	
Less CURRENT LIABILITIES			
Trade payables	324,800		
Payment on Accounts	5,120,000		

Accruals Labour	24,000	(5,468,800)	
Working Capital			1,008,800
			1,794,800
Financed by:			
Share capital of ₦1 each			1,407,200
Statement of Profit or loss (WI)			387,600
			1,794,800

ILLUSTRATION 17.4

The following information was obtained from the books of AYELABOLA CONSTRUCTION COMPANY LTD for the year ended 31st December 2016 in respect of branch office block commissioned by OPIC.

Branch office block during the year 2016

	₦
Plant	150,000
Wages	260,000
Materials	330,000
Subcontract work	200,000
Sundries	30,000
Contract overheads	240,000
Balance as at 31st December 2016	
Plant	100,000
Materials	50,000
Value of Work certified during the year 2016	1,500,000
Work awaiting certification at 31/12/2016	20,000
Retention January 2016	100,000
Progress payment received in the year 2016	1,100,000
Progress payment receivable at 31st December 2016	250,000
Retention during the year 2016	150,000
Assumed profit on contract to be taken for the year 2016	180,000

Required:

Prepared the following in the books of AYELABOLA CONSTRUCTION COMPANY LTD.

(i) Branch Office Block Contract Account

(ii) OPIC Account

(iii) Architects Certificate Account

(iv) Retention Account

SUGGESTED SOLUTION TO ILLUSTRATION 17.4

(i) BRANCH OFFICE BLOCK CONTRACT ACCOUNT

	₦		₦
Plant	150,000	Bal. c/d	
Wages	260,000	Plant	100,000
Materials	330,000	Materials	50,000
Sub contract work	200,000	Work not certified (at cost)	20,000
Sundries	30,000	Work certified c/d	1,040,000
Contract overheads	240,000		
	1,210,000		1,210,000
Work certified b/d	1,040,000	Architect certificate (at current prices)	1,500,000
Profit or Loss	180,000		
Profit or Loss (Bal. figure)	280,000		
	1,500,000		1,500,000
Bal. b/d			
Plant	100,000		
Materials	50,000		
Work not certified	20,000		

(ii) OPIC ACCOUNT

	₦		₦
Architect certificate	1,500,000	Bank	1,100,000
		Retention	150,000
		Bal. c/d (Progress payment receivable)	250,000
	1,500,000		1,500,000
Bal. b/d	250,000		

(iii) ARCHITECT CERTIFICATE ACCOUNT

	₦		₦
Office Block Contract A/C	1,500,000	OPIC Account	1,500,000

(iv) RETENTION ACCOUNT

	₦		₦
Bal. b/d	100,000	Bal. c/d	250,000
OPIC Account	150,000		
	250,000		250,000

17.12 OTHER GENERAL ISSUES

a. Where a guarantee or warranty is given on a contract, on completion, adequate provision should be made against possible claims on the warranty or guarantee.

b. Mobilisation fees and other advance payments received from the employee should have been treated as revenue but carried forward and recovered over the contract period.

c. Interest relating to funds specifically arranged for specific contract should be charged to the contract, all other interests should be expensed.

d. Retentions should be recognized as revenue only when certified.

e. When a contract is at its early stage of completion, no profits should be recognized but costs and billings thereon must be aggregated separately.

17.13 DISCLOSURE REQUIREMENTS

The following information should be disclosed:

a. The amount of contracts revenue recognized in the contract period
b. The method used to determine the contracts revenue recognized in the period
c. The methods used to determine the stage of completion of contracts in progress
d. The total contracts costs incurred and recognized profits up to the reporting date
e. Total advances received
f. The total amount of retentions
g. Gross amount due from customers for contract work as an asset
h. Gross amounts due to customers for contract work, as a liability
i. Contingent liabilities or contingent assets that may arise on warranties claims and so on

17.14 CHAPTER SUMMARY

Construction contract refers to execution of building civil engineering, mechanical, and electrical engineering and other similar activities which may involve installation, fabrication etc.

There are several types of construction contract, including fixed price contracts, cost plus a fixed rate contract, variable price contract and re-measure contract. However, the nature of most contracts is such that it may be short term or long term.

Also there are two methods of recognizing profit in construction contract. These are Percentage of Completion Method and Completed Contract Method.

17.15 **Multiple Choice Questions and Short Answers Questions**

Use the following information to answer 1 to 3

	₦'000
Contract price	8,500
Contract cost incurred to date	5,200
Estimated cost to complete	2,500
Cash received and receivable	5,164
Cost of advertisement	1,500

1. Calculate the percentage of completion
   A. 90%
   B. 67.5%
   C. 61.1%
   D. 56.5%
   E. 48%

2. Calculate the profit taken
   A. ₦7,650,000
   B. ₦5,737,500
   C. ₦5,197,500
   D. ₦4,803,500
   E. ₦4,000,000

3. Calculate the work-in-progress
   A. ₦5,773,500
   B. ₦5,164,000
   C. ₦7,700,000
   D. ₦6,664,000
   E. ₦4,000,000

4. Which of the following statement is true?

   (i) Foreseeable losses should be written off immediately in the period even if the contract has not commenced

   (ii) All anticipated profits should be recognized immediately in the contract account

   (iii) All cash advances received in respect of contracts should be recognized immediately

   A. I and II
   B. I and III
   C. I, II and III
   D. II and III
   E. III only

5. A building contractor company signed a contract for construction and maintenance of a housing estate. The housing estate would be built over 4 years and maintenance is for 10 years. Both contracts are negotiated as a single package and they are closely interrelated to each other.
   Both contracts should be

   A. Recognised under the completed contract method
   B. Accounted for as a single contract
   C. Accounted for a separate contract
   D. Be accounted for under different methods – completed contract method and percentage of completion method
   E. Carried out by different contractors

6. Additional amounts paid to the contractor if specified standard performances are met is called ……………………

7. The percentage of completion of a contract at the reporting date is estimated on …………………..basis

8. The aggregate amount of cost incurred and recognized profit less cash received and receivable is …………………..

9. The contract costs may be reduced by ………….. resulting from sale of surplus materials at the end of the contract.

10. How should pre-contract cost be accounted for?

17.16 SOLUTION

1. B
2. B
3. A
4. E
5. B
6. Incentive payment
7. Accumulated
8. Work-in-progress
9. Incidental income
10. Expensed unless it is probable that the contract would be won

CONTRACT ACCOUNT

EXAMINATION TYPE QUESTION

Mensa Construction Company Limited undertakes a variety of construction contracts. On July 1, 2013, the company won a contract of ₦1,260 million over a period of four years.

The contract marked Mm406 commenced immediately and the following details are available as at 30th June 2015.

	₦'000
Work in progress b/f	206,360
Materials purchased	110.250
Materials transferred from another site	5,220
Materials at site 30th June, 2015	7,680
Site direct wages	68,420
Site overhead	16,886
Sub-contract cost	12,445
Professional charges	6,450
Site direct wages accrued	3,648
Plant delivered to site	28,000
Hire of equipment	5,996
Head office overhead charged to contract	8,128
Cost of work done not yet certified	23,650
Cash received on contract	280,500
Plant at site 30th June, 2015	18,500

There is a retention policy of 15% on the contract and assume that the profit taken for the accounting year ended 30th June, 2015 was ₦18,566,000.

Required:

Prepare the contract Mm406 Account for the year ended 30th June, 2015. Show also the contractee's Account and reconciliation of work in progress.

Suggested solution examination type question

Mesa Construction Company Limited

			₦'000		₦'000
Work in-progress b/f		206,360	Materials at site 30/6/15 c/f		7,680
Materials purchased		110,250			
Materials transferred form		5,220	Plant at site 30/6/15 c/f		18,500
Site direct wages	68,420				
Accrued site wages	3,648	72,068	Work-in-progress c/f		464,189
Site overheads		16,886			
Sub-contract cost		12.446			
Professional charges		6,450			
Plant delivered t site		28,000			
Hire of equipment		5,996			
Head officer overhead		8,128			
Profit taken in the year		18,566			
		490,369			490,369
Work-in-progress b/f		464,189			
Materials at site b/f		7,680			
Plant at site b/f		18,500			

Contractee's Account

	₦'000		₦'000
Architect's value of certificate	330,000	Cash received	280,000
		Retention c/f	49,500
	330,000		330,000
Retention b/f	49,500		

Reconciliation of work-in-progress	₦'000	₦'000
Opening work-in-progress b/d		206,360
Add: Cost of work certified in the year	215,613	
Cost of work not yet certified	23,650	
Profit taken in the year	18,566	
Increase in W.I.P during the year	257,829	257,829
		464,189

CHAPTER EIGHTEEN
ACCOUNTING FOR LOSS OF INVENTORY AND CLAIM FOR LOSS OF INVENTORY

18.0 Chapter Introduction

A number of situations may lead to inventory losses whether for goods sent on consignment to Agents or goods sent on Sales or Return to customers. Some of the inventory may get lost, damaged or stolen in transit. Apart from goods in transit, inventories in a company's warehouse are also prone to risk of theft, fire and adverse weather. Fire outbreak is the most disastrous of all the risk inventories are exposed to. Therefore, such risk is transferred to insurance companies by taking loss of stock insurance policy.

18.1 Objectives

At the end of this chapter, the readers will be able to:

a. Understand the procedures for computing a claim for loss of inventory;
b. Calculate the average rate of gross profit;
c. Calculate the value of stock loss through theft or loss through fire;
d. Apply the average clause to derive final claim; and
e. Account for inventories purchased and sold after the cut-off point

18.2 Procedures for Computing a Claim for Loss of Inventory

The following procedures are normally followed in the determination of the inventory loss and the amount of claim from insurance company.

a. Calculate the gross profit, % for the previous accounting period immediately before the period of the fire.
b. Prepare a trading account for the period of fire and insert the available data which are most likely to be:

i. Opening inventory which is the closing inventory of the previous year brought forward
ii. Purchases made from the beginning of the year to the date of the incident

iii. Sales from the beginning of the period to the time of the fire

c. Apply the gross profit percentage calculated in (1) above to the sales figure in (2) to obtain gross profit made to the time of the incident.

d. Obtain cost of sales by deducting the gross profit from the sales

e. The inventory lost is equal to the amount obtained by this formula:

Inventory Lost = Opening Inventory + Purchases – Cost of Goods Sold.

<u>Illustration 18.1</u>

Gbago Enterprises sells artefacts. On 30 June 2009, the premises and the goods therein were destroyed by fire. Some artefacts valued at ₦30,000 and some financial records were removed through rescue efforts. The following information was extracted from the record:

	₦'000
Inventory:	
01/01/08	1,750,000
31/12/08	1,855,000
Purchases:	
For the year ended 31/12/08	13,941,000
Jan 1 to 30 June 2009	10,529,000
Sales:	
For the year ended 31/12/08	19,200,000
January – June 30, 2009	14,356,000

The gross profit percentage in 2009 was the same as those disclosed for the year ended 31 December, 2008. You are to compute the claims to be presented to the insurance company.

Solution 18.1

Computation of Gross Profit Percentage for the year ended 31 December 2008

	₦ '000	₦ '000
Sales		19,200
Opening inventory	(1,750)	
Purchases	(13,941)	
	(15,691)	
Closing inventory	1,855	
Cost of goods sold		(13,836)
Gross Profit		5,364

Gross Profit % = $\frac{5364}{19,200} \times \frac{100}{1}$ % = 28%

Computation of Inventory on 30 June 2009

	₦ '000	₦ '000
Sales		14,356
Opening inventory	1,855	
Purchases	10,529	
Goods available for sale	12,384	
Closing inventory	2,048	
Cost of goods sold		(10,336)
Gross Profit (28% x 14.356m)		4,020

Insurance Claim

Inventory at the time of fire	2,048
Inventory salvaged	(300)
Claims	1,748

Note:

(1) The gross profit is deducted from sales to obtain cost of sales.

	₦ '000
Sales	14,356
Cost of sales	10,336
Gross Profit	2,048

(2) The Closing Inventory

	₦ '000
Cost of goods available for sale	12,384
Cost of sales	(10,336)
Closing inventory	2,084

18.3 Inventory Adjustment

In order to get the normal gross-profit percentage of the previous period, the value and the sale proceed of inventory written down must be segregated from the normal stock during the period.

a. The proceeds from the sales of inventory must be removed from the total sales figure.

b. The value of the inventory at its written down value must also be removed from the value of the opening inventory.

c. If any part of the inventory was sold in the previous accounting period, the proportion not yet sold is multiplied into the inventory at its written down value and the results is deducted from the closing inventory of that period.

d. The amount realized from the inventory written down in the year of fire incident is deducted from the sales proceed for the period.

e. The unsold part of the written down inventory is added to the inventory at the date of incident

f. The other steps as in illustration 18.1 would then be applied to arrive at the inventory cost.

<u>Illustration 18.2</u>

Bonjour Enterprises sells foot wears and prepares accounts to 31 December annually.

The store was destroyed by fire on 30 June 2010. However, some records were saved from which the following information was obtained:

	₦'000
Value of inventory 1/1/2009	19,200
Value of inventory 31/12/2009	20,000
Purchases for the year 2009	164,665
From 1/1/2010 – 30/6/2010	107,125
Sales for the year 2009	233,965
From 1/1/2010 to 30/6/2010	156,500

The value of inventory 1/1/2009 was inclusive of certain goods bought for ₦2,400,000 but were valued at half the purchase price because the expiry date was approaching. During the year ended 31 December 2009, one half of these goods were sold for ₦788,000 and further one-quarter sold during the period to June 2010 realising ₦150,000. The proceeds have been included in the sales figure shown above. The remainder were yet to be sold when the fire incident occurred. The value of goods undamaged amounted to ₦4,875,000.

Required:

Calculate the value of the inventory consume by fire assuming the same profit percentage as that of the year ended 31 December 2009.

Solution18.2

Computation of Gross Profit Percentage for the year ended 31 December 2009

	₦ '000	₦ '000
Sales (w1)		233,177
Opening inventory (w2)	18,600	
Purchases	164,665	
	183,265	
Closing inventory	19,700	
Cost of goods sold		(163,565)
Gross Profit		69,612

$$\text{Gross Profit \%} = \frac{69,612}{233,177} \times \frac{100}{1}\% = 29.9\%$$

Determination of inventory on 30 June 2010

Sales		156,500
Opening inventory	19,700	
Purchases	107,125	
Goods available for sale	126,825	
Closing inventory	17,745	
Cost of goods sold		(109,080)
Gross Profit (28% x 14.356m)		47,420

	₦ '000
Value of inventory on 30 June 2010	47,420
Add unsold inventory written down	300
Estimate value of stock lost	47,720
Less inventory sold	150
Value of inventory destroyed	47,570

Unsold inventory written down = ¼ x ₦1.2m

Working Note:

1 Sales proceed of goods sold at normal selling price

	₦'000
Total sales for the year ended 31/12/09	233,965
Less value of inventory written down	
½ x ₦2.4m	(788)
Sales proceed at normal selling price	233,177

2 Opening inventory to be sold at normal price

	₦'000
Value of opening inventory	19,200
Less value of inventory w/Down	
½ x ₦1.2m	(600)
Goods to be sold at normal price	18,600

3 Total value of closing inventory	20,000
Less value of remaining inventory w/Down	
¼ x ₦1.2m	(300)
Goods to be sold at normal price	19,700

4 Total sales 1/1/10 – 30/6/10	156,500
Less proceeds from sale of inventory w/Down	(150)
Sales proceeds of goods at normal s/price	156,350

Amount insured is less than Insurable Amount

We have assumed all along that the amount insured is equal to or greater than the insurable amount, therefore the amount calculated represents the amount due from the insurance company. However, if the amount insured had been less, the claim would have been averaged.

Illustration 18.3

Assume that in the above illustration 18.2, Bonjour took insurance cover for loss of inventory for

₦40million, calculate the amount of claim from the insurance company.

Solution18.3

$$\text{Claim} = \frac{\text{Amount Of Insurance}}{\text{Estimated Value Of Inventory}} \text{ X } \frac{\text{Stock Lost}}{1} = \frac{\text{₦}40{,}000}{\text{₦}47{,}720} \text{ x } \frac{\text{₦}47{,}570{,}000}{1} = \text{₦}39{,}874{,}000$$

18.4 Effect of Cut-Off Point on Inventory Valuation

The cut-off point may not coincide with the accounting year end of an entity but sales and purchases of inventory must continue.

a. The accounting issues are that the goods that were sold after the cut-off date but before the account year end will still be regarded as sales and they should be excluded from the inventory at the year end.

b. All goods that were purchased after the cut-off point but before the year end must be included in the valuation of inventory.

c. The returns of goods would also be affected. Returns inwards should be included as part of sales while returns outwards are excluded.

d. If the value of the closing inventory falls below the cost at the cut-off date, the net realizable value should be recorded. The difference between the net realizable value and the cost should be expensed in the income statement.

18.5 Chapter Summary

Inventory losses occur in an entity in a number if situations such as when goods are sent on consignment, on Sale or return basis or even as a result of theft, fire incidence and adverse weather for stock items in the warehouse. Fire outbreak is the most disastrous of all the causes of stock loss and the risk is transferred to insurance companies by taking loss of stock insurance policy. The accounting issue involved is how to calculate the cost of stock destroyed by fire to be able to process necessary claim from the insurance company. It is important to ascertaining cut-off point to be able to determine what should constitute the components of stock loss valuation.

18.6 Multiple Choice Questions

1. Which of the following is not one of the steps in calculating inventory of goods lost to fire?
   A. Calculate the gross profit percentage for the previous year
   B. Apply the gross profit percentage on the sales of the period to date of fire to obtain gross profit
   C. Deduct the gross profit from sales to obtain cost of sales
   D. Add the inventory salvaged from fire
   E. Apply the average clause

2. Which of the following is true of goods valued at amount written down for calculation of claim for loss of inventory?
   I. The cost is included in opening inventory
   II. The proceeds from the sale of the inventory deducted from the sales for the previous period before fire
   III. The value of the inventory at its written down value is removed from opening inventory
   IV. The unsold part of the inventory is deducted from inventory at the date of loss of stock

A. I and II

B. I and III

C. I and IV

D. II and III

E. III and IV

3. Given:

I. Total value of inventory at the date of fire – ₦15m.

II. Inventory salvage from fire = ₦2m

III. Opening stock at the period of fire = ₦5m

IV. Amount insured = ₦12m

Calculate the amount of claim from insurance company

A. ₦13m

B. ₦10.4m

C. ₦10m

D. ₦9.6m

E. ₦8m