NATIONAL OPEN UNIVERSITY OF NIGERIA

SCHOOL OF BUSINESS AND HUMAN RESOURCES MANAGEMENT

COURSE CODE: ENT 222

COURSE TITLE: FINANCIAL ACCOUNTING

COURSE GUIDE

ENT 222
FINANCIAL ACCOUNTING

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Introduction

ENT 222 is a semester coursework of two-credit hours, available to all students the B. Sc. Entrepreneurial and Small Business Management programme in the School of Business and Human Resources Management.

Financial Accounting provides solution to the need to have ready information to take appropriate financial decisions in business and non-business organisations. It speaks to the process of collecting, recording, presenting, and analysing/interpreting financial information. It reports, in aggregate financial terms and during a given period, the overall results of the operations of the organisation, highlighting especially, the financial strengths and weaknesses. A good manager should be equipped with the knowledge and tools required to present and analyse financial reports.

What You will Learn in this Course

The course contents include introducing financial accounting – meaning, purpose/focus, comparison between financial accounting and management accounting; financial statements and analysis; accounts of sole proprietorships; companies, partnerships and non-profit organisations; manufacturing and control accounts; and funds flow statement.

Course Aims

This course aims at equipping you with the knowledge and tools required to prepare periodic, historical accounting reports as well as their analysis which are necessary in taking financial decisions in business and non-business organisations. This will be achieved by:

Explaining the meaning and purpose of financial accounting;
Describing and demonstrating financial statements and their analysis;
Treating, with you, the accounts of sole proprietorships, companies, partnerships and non-profit organisations;
Treating, with you also, manufacturing and control accounts;
Describing and demonstrating funds flow statement.

Course Objectives

On the successful completion of this course, you will be able to:

- Define financial accounting and distinguish between it and management accounting;
- Explain the purpose/focus of financial accounting;
- Discuss the objectives and structure of financial reports;
- Discuss the components, and demonstrate the formats of the trading and profit and loss accounts as well as the balance sheet;
- Distinguish between the “capital and revenue” as well as the “debtors and creditors” items, of the financial statements;
- Discuss the usefulness of financial analysis, and demonstrate the use of trend, percentages and ratios in the analysis of financial statements;
- Discuss the characteristics, and prepare the accounts of sole proprietorships;
- Discuss and demonstrate company accounts;
- Distinguish between companies and partnerships;
- Discuss goodwill in partnerships;
- Explain the accounting treatments relative to the admission of a new partner, partnership dissolution as well as withdrawal and death of a partner;
- Prepare the accounts of non-profit organisations and manufacturers;
- Explain the meaning and advantages of control accounts, and discuss / demonstrate how they are written-up;
- Prepare funds flow statement.

Course Materials

- Course Guide
- Study Units
- Textbooks
- Assignment Guide

Study Units

There are fifteen (15) units in this course which should be studied carefully:

Module 1

Unit 1 Introducing Financial Accounting
Unit 2 Financial Statements
Unit 3 Accounts of Sole Proprietorships
Unit 4 Introducing Company Accounts
Unit 5 Company Accounts II

Module 2

Unit 1 Company Accounts III Unit
2 Accounts of Partnerships I
Unit 3 Accounts of Partnerships II
Unit 4 Accounts of Partnerships III
Unit 5 Accounts of Non-Profit Organisations

Module 3

Unit 1 Manufacturing Accounts
Unit 2 Control Accounts
Unit 3 Funds Flow Statement
Unit 4 Introducing Analysis of Financial Statements
Unit 5 Analysis of Financial Statements II

Each study unit, made up of the introduction, objectives, main content including exercises (for self-assessment), conclusion, summary, tutor-marked assignment questions, and references, will take at least two hours. You are expected to study the materials carefully and assess yourself with the exercises. Also, you are expected to consult the textbooks under reference for additional information.

Assessment

The assessment for this course will be in two parts:

(a) Continuous assessment using the tutor-marked assignments (TMAs)
(b) Written examination of three (3) hours' duration.

Tutor-Marked Assignment

The University will direct further on the number of TMAs you are to answer, when to do them and when to turn them in to your facilitator for grading. However, you are expected to utilize the information gathered from the study material and the texts under reference, in doing the assignments. Continuous assessment counts for 40% of the total course mark.

Final Examination and Grading

This will be scheduled for three hours and will attract the remaining 60% of the total course grade. You are to expect that all the areas of this course will be tested during the examination.

Summary

Managers require information to take appropriate financial decisions in business and non-business organisations. On the successful completion of this course, you would have been equipped with the knowledge and tools necessary to present and analyse financial reports as well as take decisions in the interest of the organisation.

MAIN COURSE

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MODULE 1

UNIT 1 INTRODUCING FINANCIAL ACCOUNTING

CONTENTS

1.0 INTRODUCTION

There are two major branches of accounting, namely Financial Accounting and Management Accounting. This unit is designed to define these branches, and emphasize the purpose and focus of financial accounting. In addition, there will be a comparison of these branches, which will dwell greatly on their focus.

2.0 OBJECTIVES

At the end of this unit, you will be able to:

- define Financial accounting
- explain the purpose and focus of financial accounting
- make a comparison between financial accounting and management accounting.

3.0 MAIN CONTENT

3.1 Introducing Financial Accounting

3.1.1 Definition of Financial Accounting

Financial accounting can be defined as the process of collecting, recording, presenting, and analysing/interpreting financial information for the users of financial statements. These users include: the creditors, investors and government. Financial accounting is mainly historical and reports the overall results of the firm's operations during a given period and its financial conditions.

SELF ASSESSMENT EXERCISE 1

What do you mean by Financial Accounting?

3.1.2 Purpose of Financial Accounting

The purpose of financial accounting is to report, in aggregate financial terms, and during a given period, the overall results of the organisation's operations. More importantly, the financial strengths and weaknesses feature prominently in the report since factors/parameters such as profit or loss and net worth are stressed. The reports are made available to the army of external users to make the necessary appraisals.

SELF ASSESSMENT EXERCISE 2

Explain the purpose of Financial Accounting.

3.1.3 Focus of Financial Accounting

Financial Accounting focuses on users external to the firm such as the investors (both existing and potential), government, lenders, tax authorities, credit suppliers.

For example, government uses the reports to obtain data required for compiling aggregate statistics of economic activity, economic growth, capital formation, etc. On the other hand, the banks (lenders) would need the information to appraise the credit worthiness of the borrowing firm as well as keep track of its financial soundness all through the period of indebtedness.

SELF ASSESSMENT EXERCISE 3

Explain the focus of Financial Accounting relative to the users of accounting information.

3.1.4 Financial Accounting and Management Accounting Compared

The comparison will be considered from the perspective of the following areas:

Focus

While financial accounting focuses on the users external to the organisation, management accounting attends to the internal organisation requirement for planning and control.

Scope of Report

Financial accounting reports on the overall results of the firm's operation within a given period whereas management accounting generates detailed financial and/or quantitative information relative to the different aspects of the organisations performance during a given period highlighting areas of concern to management for decision-making.

Considered Factors

Financial accounting is interested in showing profit or loss whereas management accounting considers batch/unit or process cost.

Description of Report

While financial accounting reports historically, management accounting produces more current and forward-looking information needed for decision making.

SELF ASSESSMENT EXERCISE 4

Compare Financial Accounting and Management Accounting.

4.0 CONCLUSION

Financial Accounting addresses the needs of external users of financial information. Comparatively, Management Accounting pays attention to the internal organisation's requirement for accounting information necessary for planning and control purposes.

5.0 SUMMARY

We have been able to define financial accounting, and discussed its purpose and focus. A comparative analysis of financial accounting and management accounting was made using such bases as focus, scope of report, considered factors and description of report.

6.0 TUTOR-MARKED ASSIGNMENT

1. Define financial accounting, highlighting its purpose and focus.

2. Compare Financial accounting with Management accounting.

7.0 REFERENCES/FURTHER READINGS

Anao, A.R. (1989). *An Introduction to Financial Accounting*. Ibadan: Longman Nigeria Limited.

Igben, R.O. (2004). *Financial Accounting Made Simple* (Volume 1) Lagos: ROI Publishers.

UNIT 2 FINANCIAL STATEMENTS

CONTENTS

1.0 INTRODUCTION

Accounting is a service function which is designed to inform management and other interested parties (like the investors, analysts, creditors, shareholders) about the financial implications and their effects on the organisation. Therefore, the generated accounting information are presented to various interested parties for their respective decisions.

How is accounting information presented?

This will be the focus of Unit 2. We shall find out that accounting information is presented through the medium of periodic financial statements or financial reports, done in consonance with specified accounting and legal standards relating to the style and content of presentation. We shall look at the objectives and structure of financial reports, and discuss the Trading and Profit and Loss Account, and the Balance Sheet, under the structure. Also, capital and revenue components of the structure will be explained. Finally, we shall consider the treatment of account receivable and payable items of the reports.

2.0 OBJECTIVES

At the end of this unit, you will be able to:

- discuss the objectives and structure of financial reports
- discuss the components, and demonstrate the formats of the Trading and Profit and Loss Account and the Balance Sheet

distinguish between the capital and revenue items of the financial statements; and
discuss the difference between accounts receivable and payable.

3.0 MAIN CONTENT

3.1 Financial Statements

3.1.1 Objectives and Structure of Financial Reports

The periodic financial reports comprise two major statements – the Trading and Profit and Loss Account, and the Balance Sheet. While the Trading and Profit and Loss account measures the net income or surplus arising from the operations during the period under review, in order to know how actual profits compared with the expected, the balance sheet discloses the financial position of the enterprise (relating to the assets, liabilities and capital) as at a particular date, usually the last day of the accounting period.

The Trading and Profit and Loss account provides the yardstick for measuring the extent to which an enterprise has succeeded in attaining its profit-making objective. It also shows the relationship between costs and revenues which serve as basis for decision aimed at improving future performance.

SELF ASSESSMENT EXERCISE1

Discuss the objectives and structure of financial reports.

3.1.2 Trading and Profit and Loss Account

The Trading and Profit and Loss account matches a period's revenues with the costs associated with generating those revenues. Two components of the trading and profit and loss account are:

- Trading account which discloses gross profit;
- Profit and Loss account which discloses the net profit.

However, for a manufacturer, it is also useful to prepare "Manufacturing Account" which we shall consider later.

Gross profit is the difference between sales proceeds and the cost of goods sold in a trading account while net profit is the gross profit less the expenses of the business in the profit and loss account.

The trading and profit and loss account of a sole trader (concerned with buying and selling) using the vertical format would appear as follows:

Trading and Profit and Loss account for the period ended 30/6/xx

		N	**N**
Sales			X
Opening Stock		X	
Add: Purchases		X	
Available Stock		X	
Less: Closing Stock		X	
Cost of Sales			X
Gross Profit			X
Less:	Wages	X	
	Rent	X	
	Sundry expenses	X	
	Total Expenses		X
Net Profit			X

3.1.3 The Balance Sheet

The balance sheet, which is often prepared on the historical cost basis, can be seen as a collection of the residual values of assets, liabilities and capital carried over from one accounting period to the next, to continue the running of the enterprise as a going concern. Thus, the balance sheet lists a business's assets, liabilities and capital at a particular point in time.

Assets are stated at book value, which may be historical or market value, but not at realisable value; (Book value is the amount of money that was paid to acquire a particular asset while the net realisable value of an asset is the money that might be possible to get by selling the asset).

Fixed Asset is any asset, tangible or intangible, acquired for retention by an entity for the purpose of providing a service to the business, and not held for resale in the normal course of trading.

The balance sheet of a sole trader using the vertical format would appear as follows:

Balance Sheet as at 30/6/x

	N	N
Fixed Assets:		
Vehicles		X
Current Assets:		
Stock	X	
Debtors	X	
Cash at bank	X	
Cash in hand	X	
	X	
Less: Current Liabilities:		
Creditors	X	
Net current assets (CA less CL)	X	
Total Assets		X
Capital Account:		
Balance at beginning of period	X	
Add: Net Profit for period	X	
	X	
Less: Drawings for period	X	
Retained profit		X
Balance at end of period		X

Let us look at an example:

The following trial balance was extracted from the books of Alaba Enterprises on 31st December, 2004:

	Dr.	Cr.
	N	N
Purchases	368,400	
Sales		517,900
Drawings	14,100	
Returns inwards	7,300	
Returns outwards		6,200
Discount allowed	10,200	
Discount received		8,400
Debtors	45,000	
Creditors		57,100
Stock	34,300	
Freehold Premises at cost	46,000	

Motor Vehicles at cost	12,000	
Provision for depreciation on motor vehicles		4,500
Provision for depreciation on furniture		1,000
Cash at bank	5,000	
Cash in hand	1,900	
Salaries	40,600	
Carriage inwards	22,200	
Carriage outwards	10,300	
Printing Stationery	3,600	
Electricity and water	14,900	
Insurance	6,800	
General Expenses	34,800	
Provision for bad debt		200
Bad debt written off	400	
Capital		70,000
Rent received		3,800
Commission received	-	11,200
	68,300	68,300

The following information should be taken into account:

(i) Stock 31st December, 2004 was valued at N31,800

(ii) Accrued expenses at 31/12/04 were salaries N1,800, and electricity N80

(iii) Prepaid expenses at 31/12/04 were insurance N400 and general expenses N500

(iv) Adjust provision for bad debt to 2% of debtors and create provision for discount allowable at 1% of debtors.

(v) Commission due but yet to be received on 31/12/04 amounted to N800

(vi) Charge depreciation on fixed assets as follows:

Furniture	20% on cost
Motor vehicles	10% on cost

(vii) Rent received in advance at 31/12/04 amounted to N200

(viii) Goods costing N1,200 were taken by owner for private use. This was yet to be recorded in the cash book.

Using the vertical formats, you are required to prepare the Trading and Profit and Loss Account for the year ended 31st December, 2004 and Balance Sheet as at that date.

Using the vertical formats

Alaba Enterprises – Trading and Profit and Loss Account for the year ended 31st December 2004

	N	N
Sales		517,900
Less: Returns inwards		(7,300)
Net Sales		**510,600**
Less:Costofgoodssold		
Opening stock (Note 1)	34,300	
Purchases (368,400 – 1,200)	367,200	
Returns outwards	(6,200)	
Carriage inwards	22,200	
Cost of goods available for sale	417,500	
Closing stock	(31,800)	385,700
Gross Profit		**124,900**
Add:Otherincomes		
Discount received	8,400	
Rent received (3,800 – 200)	3,600	
Commission (11,200 + 800)	12,000	
		24,000
		148,900
Less:Expenses		
Discount allowed	10,200	
Salaries (40,600 + 1,800)	42,400	
Printing and stationery	3,600	
Carriage outwards	10,300	
Electricity and water (14,900 + 80)	14,980	
Insurance (6,800 – 400)	6,400	
General expenses (34,800 – 500)	34,300	
Bad debt	400	
Increase in provision for bad debt	700	
Provision for discount allowable		
[1% x (45,000 – 900)]	441	
Depreciation:		
Motor vehicles (10% x 12,000)	1,200	
Furniture (20% x 2,500)	500	(125,421)
Net Profit		**23,489**

Alaba Enterprises

Balance Sheet as at 31st December 2004

	N Cost	**N Acc. Depn.**		**N NBV**
FixedAssets				
Freehold premises	46,000	-		46,000
Motor vehicles	12,000	5,700		6,300
Furniture	2,500	1,500		1,000
	60,500	7,200		53,300
CurrentAssets				
Stock			31,800	
Debtors	45,000			
Provision for bad debt	(900)			
Provision for discount all	441			
			43,659	
Prepayments (400 + 500)		900		
Accrued Income			800	
Cash at bank		5,000		
Cash in hand		1,900		
			84,059	
CurrentLiabilities				
Creditors	57,100			
Accruals (1,800 + 80)	1,880			
Interest received in advance	200	59,180		
WORKING CAPITAL				24,879
Net Assets				**78,179**

FinancedBy

Owner'sEquity	
Capital at 1/1/04	70,000
Add: Net Profit	23,479
	93,479
Less: Drawings (14,100 +1,200)	15,300
	78,179

The following points should be noted regarding the solution above:

1. Unless otherwise stated, the stock shown on the trial balance is the opening stock while the closing stock is disclosed as additional information to the trial balance.
2. The adjustments required per the additional information to the trial balance are as follows:

AdditionalinformationNo.	Natureofadjustment
(i)	Closing stock
(ii)	Accrued expenses (or accruals)
(iii)	Prepaid expenses (or prepayments)
(iv)	Provision for bad debt and provision for discount on debtors
(v)	Accrued income
(vi)	Depreciation on fixed assets
(vii)	Income received in advance
(viii)	Drawings

SELF ASSESSMENT EXERCISE2

The following is the trial balance of Bamijoko Enterprises as at 31st December 2002:

	Dr. N	Cr. N
Capital		5,000
Loan		1,000
Bank overdraft		1,000
Plant and machinery	4,000	
Furniture and fittings	1,000	
Sales		30,000
Purchases	17,500	
Carriage inwards	500	
Stock in trade (opening balance)	1,000	
Returns inwards (sales returns)	400	
Returns outwards (purchases returns)		300
Discounts allowed	800	
Discounts received		600
Rent	250	
Telephone	120	
Wages and salaries	6,000	
Lighting and power	100	
Insurance premium	360	
Sundry expenses	50	
Cash at bank	3,000	
Cash on hand	380	
Provision for bad and doubtful debts		300
Sundry creditors		2,880

Provision for depreciation:		
Plant and machinery		800
Furniture and fittings		120
	42,000	42,000

Additional information

(i) Stock in trade as at 31 December 2002 was N1,300
(ii) Rent outstanding as at December 2002 was N50
(iii) Insurance premium relating to 2003 was N120
(iv) Write off bad debts amounting to N400 and increase provision for doubtful debts to N500.
(v) Provide 10 per cent for depreciation on plant and machinery for the current year.
(vi) Provide 5 per cent for depreciation on furniture and fittings for the current year.

You are required

(a) Prepare a Trading and Profit and Loss account for the year 2002
(b) Extract a Balance Sheet for Bamijoko Enterprises as at 31st December 2002

3.1.4 Capital and Revenue Items

The ability to measure capital and revenue as well as the inter-relationship between them, is very important in accounting practice because capital generates revenue and it is this ability to generate revenue that gives value to capital. There are capital and revenue items of receipts as well as capital and revenue expenditure items. It is very important to distinguish between these items as their treatment differs in the books of account. It is also necessary in the determination of profit made by the enterprises and in explaining why certain items go to the Trading and Profit and Loss account and others go to the Balance Sheet.

CapitalandRevenueReceipts

Capital receipts comprise the initial capital paid by the owner(s) of the business as well as loans and proceeds of sale of any of the assets.

On the other hand, revenue receipts are the cash received from sales of goods, discounts received, commission, interest on investment and all such monies arising from rendering services or in the normal course of business transactions in the current period.

<u>CapitalandRevenueExpenditure</u>

"Capital expenditure consists of expenditure, the benefit of which is not fully consumed in one period, but spread over several periods". These are fixed assets like land and buildings and new factory which are acquired for the purpose of earning income or increasing the earning capacity of the business.

Revenue expenditures are those incurred in one period of account and whose full benefit is consumed within the same period. Examples include travelling and fuelling expenses, repairs, postages, interest on loan and salaries and wages. Usually, it is the revenue expenditure that is charged against revenue receipts to determine the profit made by a business in a given accounting year.

SELF ASSESSMENT EXERCISE3

1. What do you understand by capital receipts? Give two examples.
2. Distinguish between capital and revenue expenditures and give three examples of each.

3.1.5 Treatment of Accounts Receivable and Payable

Accounts receivable, also known as "Debtors", is given rise to when allowance is made for payments to be effected sometime later after the sales transactions have been concluded and the goods changed ownership for the reasons that buyers need goods and services that they cannot pay for immediately, and sellers sell more through credit sales. Credit sales are recorded in the sales journal and accounts receivables are current assets to the organisation.

Accounts payable, on the other hand, are normally current liabilities to the enterprise. They are also known as "Creditors" which arise as a result of credit purchase transactions. Accurate record of accounts payable is important to avoid omissions that will lead to an overstatement of profit. Credit purchase transactions are recorded in the purchase journal.

SELF ASSESSMENT EXERCISE4

Discuss the difference between accounts receivable and accounts payable.

4.0 CONCLUSION

Financial reports – basically, the Trading and Profit and Loss account and the Balance Sheet – are necessary to inform management and other interested outside parties about the performance as well as the financial position of the enterprise which form the basis for their respective decisions. Capital and revenue items would need to be distinguished or categorised properly to enable the financial reports give a true reflection of the financial affairs. Also, due care should be taken in deciding on, and recording matters, relating to accounts payable and accounts receivable in order to have a good relationship between current assets, current liabilities and profit.

5.0 SUMMARY

We have seen and discussed how accounting information is presented to all interested parties by focusing on the Trading and Profit and Loss account as well as the Balance Sheet. While the trading and profit and loss account ascertains the gross profit on sales and the net profit or loss for the period, the balance sheet ascertains the financial position of the business at the end of the accounting period. Also, the capital and revenue items of the financial reports have been discussed with emphasis on their proper distinction, recognition and recording. Lastly, we considered the treatment of account receivable and account payment items.

6.0 TUTOR-MARKED ASSIGNMENT

The following trial balance is drawn from the books of Tukur Mills, a sole proprietorship.

	Dr.	Cr.
	N	N
Capital		21,000
Drawings	7,100	
Sales		86,400
Purchases	55,500	
Rent (Office)	2,520	
Travelling expenses	940	
Insurance on purchases	240	
Carriage inwards	130	
Carriage outwards	150	
Insurance (Fire, etc.)	120	
Salaries	6,260	

Wages	920		
Bank charges	33		
General expenses		108	
Creditors			5,300
Motor vehicle		9,800	
Furniture and fixtures		3,600	
Stock in trade (at the beginning of period)		5,900	
Sundry and trade debtors		7,200	
Cash at bank		12,084	
Cash on hand		95	
		112,700	112,700

Additional information

(a) The value of closing stock is N6,400
(b) Accrued salaries of N366 have not been paid as at December 31, 1999 and not yet recorded in the books
(c) Sales of N1,200 made on account of Yaro Stores on December 20 were omitted in the record keeping process.

You are to ignore depreciation on motor vehicle, and furniture and fixtures.

You are required to

(a) Prepare a Trading and Profit and Loss account for Tukur Mils

(b) Extract a Balance Sheet for Tukur Mills as at December, 1999

7.0 REFERENCES/FURTHER READINGS

ACCA (2003). *Preparing Financial Statements.* Middlesex: A. T. Foulks Lynch Ltd.

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Wood, Frank (1990). *Business Accounting I,* (5th Edition). London: Longman Company Limited.

UNIT 3 ACCOUNTS OF SOLE PROPRIETORSHIPS

CONTENTS

1.0 INTRODUCTION

The content as well as the form of presentation of financial statements vary according to the nature of the organisation – sole proprietorships, partnerships, limited liability companies, government departments, clubs, associations, non-governmental organisations – because the different organisations are subject to different laws and norms which, amongst other things, prescribe the minimum information required to be disclosed in the respective financial statements.

Kindly refer to unit 2 and recall that the formats for the presentation of the Trading and Profit and Loss account, and the Balance Sheet, were those for a sole trader (sole proprietorship). Like other profit-oriented organisations, it is very necessary to keep and maintain accounts for sole proprietorships which enable the operators to ascertain the profits earned or losses incurred. Various reasons could be adduced as to why the operators would want to have an idea of profits earned such as:

(i) To ascertain or assess the capacity to obtain loans from banks or private individuals;
(ii) To assist them to make future plans;
(iii) To know how attractive their ventures are to prospective investors or would-be buyers;
(iv) To know the profit for income tax purposes;
(v) To know whether the concerns are doing well or not.

This unit will give attention to the characteristics, equity and drawings of/in sole proprietorships as well as their nature of tax.

2.0 OBJECTIVES

At the end of this unit, you will be able to:

- discuss the characteristics of one-man business
- explain the equity composition of sole proprietorship
- explain "drawings" in relation to sole proprietorship
- discuss the nature of tax in one-man business.

3.0 MAIN CONTENT

3.1 Accounts of Sole Proprietorships

3.1.1 Characteristics of One – man Business

One – man business (or sole proprietorship business), as the name implies, is a business concern owned by one person who often is also engaged actively in the running of the business. The sole owner subscribes to all of the equity capital of the business which in most cases are raised from personal savings or soft loans obtained from relations and friends. All incomes also accrue to the owner.

Other characteristics of one – man business include the following:

(i) A sole proprietorship has no distinct legal entity. Even when it is registered by the Corporate Affairs Commission under the Companies and Allied Matters Act, the owner and the business cannot be separated;
(ii) The owner has freedom to deal with the organisation's assets without any restrictions imposed by law;
(iii) Because of the limited amount of assets which a sole proprietorship business controls, it is often small and can be recognised easily;
(iv) Its capacity to borrow (especially from banks) is limited by the asset base;
(v) It has very high risk because of the inseparability of the owner with the business;
(vi) The business outfit often goes by the name of the owner, and operates within a confined location, usually, not more than two branches;
(vii) The structure is fairly simplistic in nature.

From the foregoing, it would appear that the compact nature of the sole proprietorship business should not present much difficulty in its accounting. However and often times, smallness may impede the ability of the business to engage capable/competent hands to carry out the accounting function and ensure good financial control. Consequently, the accounting records kept may be incomplete and lack the essential ingredients. These may impinge on the preparation of acceptable financial statements.

SELF ASSESSMENT EXERCISE1

Discuss the characteristics of a sole proprietorship business.

3.1.2 Equity of a Sole Proprietorship

As mentioned above, the sole owner subscribes to all of the equity of the business. The equity is made up of capital contributions in cash or kind at commencement or at a later date by self through personal savings, relations and friends, and all profits earned in the business since its inception but which have not been withdrawn. This can be shown in the annual balance sheet as follows:

		₦
Capital b/f		XX
Add: Amount introduced during the year	X	
Profit earned during the year	<u>X</u>	
		XX
Less: Drawings during the year		<u>X</u>
Capital c/f		<u>XX</u>

It is very clear, therefore, that the capital of a sole proprietor is not fixed but varies from year to year depending on the:

(i) Amount of capital introduced;
(ii) Amount of profit earned;
(iii) Extent of drawings;
(iv) Degree of disinvestment (where fixed asset of reasonable value is taken out of the business for personal use).

Let us quickly say that there are no legal restrictions on drawings; prudence is the watchword. Also, the proprietor is free to increase the capital position at anytime. However, this flexible position of the sole proprietor in his unrestricted rights in dealings that affect the equity of the firm and the absence of legal ties could be disadvantageous in terms of the ability of the business to enter into certain types of transactions – especially, borrowing-where it would appear that the rights of the other party may suffer. With this situation, the sole proprietor would be constrained in his ability to obtain capital or to grow.

SELF ASSESSMENT EXERCISE 2

The capital of a sole proprietor is not fixed but varies from year to year. Explain this statement.

3.1.3 Drawings

The sole proprietor's drawings during the year affect the equity. Drawings speak to the periodic withdrawals made by a sole proprietor (who is actively engaged in the management of the business) in anticipation of profits. As we stated earlier, drawings are not regulated and tend to fluctuate from month to month depending on the personal commitments of the proprietor. Drawings can also be taken in kind when the owner takes out some of the goods which the business trades in.

SELF ASSESSMENT EXERCISE3

Explain the features of drawings.

3.1.4 Nature of Tax

A business which has a legal entity normally pays tax on its income. In the case of sole proprietorship, however, since it is not a legal entity, it is not bound to pay tax. Recall that here is a situation where the business cannot be separated from the owner, and that being the case, the income of the business is considered to be that of the owner for tax purposes. The sole proprietor is required to declare such income, amongst others, in the annual tax returns for personal income tax assessment and payment.

SELF ASSESSMENT EXERCISE4

What are the tax implications for a sole proprietor?

4.0 CONCLUSION

The sole proprietorship business has no legal entity; both the business and the owner are inseparable. The owner subscribes to all of the equity of the business and the capital varies from year to year. The proprietor makes periodic withdrawals known as "drawings" in anticipation of profits to attend to his personal commitments. The business is not liable to tax because of its legal status. Instead, the owner is taxed as a person based on the income of the business.

5.0 SUMMARY

In this unit, we have looked at some guides necessary to keep the accounts of sole proprietorships. Apart from discussing the characteristics of one – man business, we considered the equity composition. Furthermore, we explained drawings in relation to sole proprietorship, and discussed the nature of tax. The proprietor, and not the business, is liable to tax.

6.0 TUTOR-MARKED ASSIGNMENT

1. What do you understand by sole proprietorship?

2. The following trial balance is extracted from the books of Raphael Enterprises, a sole proprietorship, specialised in manufactured goods.

	Dr.	Cr.
Capital account		15,000
Drawings account	7,600	
Purchases	40,000	
Sales		65,000
Discounts (allowed and received)	3,200	2,000
Rent of office	1,440	
Rent of warehouse	1,200	
Travelling expenses	600	
Insurance (against fire, etc.)	150	
Transit insurance on goods purchased	180	
Office (salaries)	3,200	
Wages	600	
Carriage inwards	108	
Carriage outwards	120	
Furniture and Fixtures	4,500	
Stock at beginning of period	3,800	
Sundry debtors	500	
Trade debtors	8,000	
Sundry and trade creditors		4,200
Cash at bank	10,810	
Cash in hand	50	
Bank charges	22	
General expenses	120	n
	86,200	86,200

Additional information

(a) All furniture and fixtures were acquired in the month of January, 2004. It was decided that depreciation should be charged for 2004 at the rate of 10% on cost.

(b) The value of closing stock was N3,000.00

(c) A further examination of the records revealed that the following had not been recorded in the books before extracting the above trial balance:

  (i) Wages amounting to N120.00 had accrued by December 31,2004 but were not paid.

  (ii) Accrued office salaries of N400.00 had not been paid as at the end of 2004.

  (iii) Purchases of N2,000.00 made on account in 2004 were omitted in the records.

  (iv) General expenses of N60.00 accruing as at December 31, 2004, were not recorded.

(v) Goods amounting to N1,400.00 were taken out of the business during the year by the proprietor.

(b) Prepaid rent on warehouse amounted to N300.00.

(c) Provision for doubtful debt is to be 5% of trade debt.

You are required to:

(a) Make relevant adjusting entries to the ledger balances.
(b) Extract an adjusted trial balance.
(c) Prepare a trading and profit and loss account for the year 2004 (skip closing journal entries).
(d) Prepare a balance sheet for Raphael Enterprises as at December 31, 2004, and show the up-to-date capital position.

7.0 REFERENCES/FURTHER READINGS

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UNIT 4 INTRODUCING COMPANY ACCOUNTS

CONTENTS

1.0 INTRODUCTION

Company accounts present certain notable features different from those of sole proprietorships (unit 3.0 and partnerships (to be treated later) because companies (incorporated) are legal persons whereas the others are not. Incorporation refers to the process of securing a legal personality for an enterprise with associated advantages/rights and obligations as provided for by the law.

In this unit, we shall consider the meaning of a company, its distinguishing features, and the issues and redemption of shares. We shall also consider the accounts that are prepared for companies.

2.0 OBJECTIVES

At the end of this unit, you will be able to:

- define a company
- discuss the distinguishing features of a company
- demonstrate the issues and redemption of company shares
- discuss the accounts that are prepared for companies.

3.0 MAIN CONTENT

3.1 Introducing Company Accounts

3.1.1 Definition of a Company

A company may be defined as an artificial creature, invisible, intangible and existing only in contemplation of law. As a legal (artificial) person, it is separate from the owners. It can enter into a contract, sue and be sued in its name, can affiliate with another company and open subsidiaries. Examples of big Nigerian companies include UAC, PZ, UNILEVER, FIRST BANK, and NESTLE.

A company is legally formed by meeting the conditions stipulated in the Companies and Allied Matters Act (Decree), 1990. The promoters must apply for registration at the Corporate Affairs Commission together with both a Memorandum and Articles of Association. The memorandum must contain the following information:

Name of the company, with the term "Limited" or "Public Limited Company" as the last word of the name;
Objects for which the company is formed;
Amount of the share capital with which the company proposes to be registered and the division into shares of a fixed amount;
The address of the registered office of the company;
A statement to the effect that the "liability" of the members or shareholders is "limited".

The Articles of Association, on the other hand, is a document setting out the regulations for internal organisation, and contains provisions relating to:

proceedings at meetings;
alteration of capital;
appointment of directors;
borrowing powers of directors;
transfer or transmission of shares;
winding-up procedure, etc.

The Memorandum and Articles of Association, duly stamped for stamp duties and fees and accompanied by certain other forms, are lodged with the Registrar-General of Companies who, if everything is in order, subsequently issues a Certificate of Incorporation. At that point, a Limited Liability Company is formed and those who signed the memorandum are its "foundation members".

SELF ASSESSMENT EXERCISE1

(1) Define a Company.

(2) Discuss the Memorandum and Articles of Association relative to the information they contain.

3.1.2 Distinguishing Features of a Company

The following features of a limited liability company are to be taken note of:

- Separate legal entity which is not affected by changes in its ownership;
- Can own assets and incur liabilities in its own right;
- Can sue and be sued in its own name;
- Has perpetual succession – does not cease to exist upon the death of any or all of the owners;
- Liability of owners/shareholders is limited to the amount paid for shares allocated;
- Has right to borrow on its own account;
- Audit is compulsory;
- Profits are subject to Company Income Tax;
- Statutory books and returns include the registers of members and charges; annual return; minute books; register of directors and secretaries; register of directors' shareholdings; the directors' report for the statutory meeting; the books of accounts.

SELF ASSESSMENT EXERCISE2

Discuss five features of a Limited Liability Company.

3.1.3 Company Shares: Issues and Redemption

A share may be defined as the interest of a shareholder in the company, measured by a sum of money for the purpose of liability on one hand, and of interest on the other. Two main categories of shares are the ordinary shares and preference shares.

While ordinary shares entitle the holders to the divisible profits remaining after prior interests have been satisfied, preference shares entitle the holders to a fixed rate of dividend before any dividend is paid on other classes of shares. Preference shares, which may be either cumulative or non-cumulative, may also carry the right in the Articles of

Association to repayment of capital, on a winding-up, in priority to other types of shares.
When the Directors of a public company decide to issue shares, application forms (with prospectus) are made available to the general public for subscription. Usually, subscribers are required to remit the amount payable on application, direct to the company's bankers.

A separate bank account should be opened for each issue; the company will obtain from the bank the statement of receipts and applications and these will be entered in the application and allotment sheets.

The accounting requirement for the issue is to debit the cash account and to credit an appropriately designated share capital account. The par value of the share determines the amount to be credited to share capital, and the paid-in capital in excess of the par value goes to a share premium account.

Example:

LUNA NIGERIA LTD. has the following specified in its Memorandum of Association:

Authorised Share Capital:

Preference shares: 1,000,000 8% shares: ₦5 par value.
Ordinary shares: 400,000 shares: 50k par value

Let us assume that 5,000 preference shares were issued and sold at ₦7.00 per share and 100,000 ordinary shares were issued at 75k, the entry to record the issue is as follows:

	Dr.	Cr.
	₦	₦
Cash	110,000	
Preference shares (5,000 x ₦5 each)		25,000
Premium on preference shares (5,000 x N7 – N5)		10,000
Ordinary shares (100,000 x 50k)		50,000
Premium on ordinary shares (100,000 x 75k – 50k)		25,000
	110,000	110,000

Note that the premium is usually treated as a capital reserve. It is not a profit as the company cannot make a profit by trading in its own share. One share premium account may be used for both ordinary and preference shares.

Shareholders' section in the Balance Sheet (relating to the above transaction) will look like this:

	Dr. ₦	Cr. ₦
Preference shares:		
Authorised; 1 million shares, 8%; at ₦5 each	5,000,000	
Issued and fully paid; 5,000		25,000
Ordinary shares:		
Authorised; 400,000 shares; at 50k each	200,000	
Issued and fully paid; 100,000		50,000
Capital Reserves:		
Share premium		35,000
		110,000

Shares can also be issued at a discount on the following conditions:

The shares must be of a class already issued;

There should be a resolution of the company at a General Meeting authorising the issue; the resolution must be sanctioned by the court;

The maximum discount must be stated in the resolution;

The issue cannot be made until after one year of the date on which the company was entitled to commence business;

The shares must be issued within one month after the sanction by the court.

Once these conditions are met, an entry is made to record the issue, creating a special 'Discount on Shares Account'.

Example:

If LUNA NIGERIA LTD issued for cash 200,000 of its ordinary shares at 40k per share, the entry to record would be:

	Dr. ₦	Cr. ₦
Cash	80,000	
Discount on Ordinary shares	20,000	
Ordinary share capital		100,000
	100,000	100,000

Note that the discount, like the premium, is never reflected in the profit and loss account.

SELF ASSESSMENT EXERCISE3

Discuss the conditions under which shares can be issued at a discount.

3.1.4 Accounts that are Prepared for Companies

The law requires that every company must keep proper accounting records with respect to:

- all sums of money received and expended from day to day by the company;
- the assets and liabilities of the company;
- statements of stock held at the end of each financial year (where the company's business involves dealing in goods).

The accounting records, in addition to being sufficient to show and explain the company's transactions, must disclose with reasonable accuracy, at any time, the financial position of the company at that time.

3.1.4.1 The Profit and Loss Account

The Profit and Loss Account or Income and Expenditure Account (for non-trading company) must be for the period. In the case of the first account, since the incorporation of the company; and in any other case, since the preceding account. Every profit and loss account must give a true and fair view of the profit or loss for the financial year.

The following is a summary of what is required to be disclosed by law either in the profit and loss account or in a statement annexed thereto:

1. Turnover

This is the total amount receivable by a company in the ordinary course of its business for goods sold or supplied by it as a principal or for services provided by it. What would be regarded as turnover and the method by which it is arrived at must depend upon the exact nature of the business activity carried on by the company.

2. Income

From investment and net revenue from rents (if this forms a substantial part of the company's revenue).

3. Expenditure

- Amount of interests on loans and overdrafts
- Amount for hire of plant and machinery (if substantial)
- Audit fees including expenses
- Depreciation provision for renewals or diminution in value of fixed assets
- Reserves and provisions (to include the amount provided for redemption of share capital and loans)
- Amount set aside for company income tax (Taxation)
- Dividends: the aggregate amount of the dividends proposed and paid.

4. Miscellaneous

- Salaries and wages
- Any other charge that took place in a preceding financial year unless included in a heading relating to other matters.

5. Directors' remuneration

3.1.4.2 The Balance Sheet

Every balance sheet of a company must give a true and fair view of the state of affairs of the company as at the end of its financial year.

The following information must be given in the balance sheet or statements annexed thereto:

1. Authorised share capital, issued and fully paid thereof, the share premium account and capital redemption reserve fund.
2. Reserves and provisions (under separate headings)
3. Liabilities – loans and bank overdrafts, dividends, arrears of fixed cumulative dividends, capital expenditure authorised by the directors which has not been contracted for, etc.
4. Assets – fixed and current assets; goodwill, patents and trade marks, amount of any outstanding loans for the purchase of the company's shares by its employees, quoted and unquoted investments.
5. Information and accounts relating to subsidiary companies
6. Preliminary expenses – expenses incurred in connection with the issue of share capital or debentures; commission paid in respect of shares or debentures; discount allowed in respect of debentures; discount allowed on the issue of shares at a discount.
7. Miscellaneous – the basis on which foreign currencies have been converted in Naira must be disclosed by way of note or statement annexed thereto.

SELF ASSESSMENT EXERCISE 4

What should be disclosed by a company in its profit and loss accounts?

4.0 CONCLUSION

A company is a juristic person with rights and obligations as provided for by the law. Subject to the requirements of the account, the amount of detailed information disclosed in the published accounts must be carefully considered but it should not injure the company by affording valuable information to trade rivals.

5.0 SUMMARY

Incorporation speaks to the process of securing a legal personality for an enterprise. In this unit, we have given meaning to a company. Also, we have discussed the features of a company as well as matters relating to company shares. Finally, we considered the accounts that are prepared for companies with emphasis on the contents.

6.0 TUTOR-MARKED ASSIGNMENT

1. A company is a juristic person. Discuss.
2. Explain the meaning of the following terms:

    (a) authorised capital
    (b) issued capital
    (c) called-up capital
    (d) paid-up capital
    (e) issue of shares at par
    (f) issue of shares at premium
    (g) issue of shares at discount.

3. What are the contents of the Balance sheet as required by law?

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UNIT 5 COMPANY ACCOUNTS II

CONTENTS

1.0 INTRODUCTION

The main sources of funds for the use of a company are:

- the owners (who provide equity – share capital), and
- the creditors (who allow the company to borrow cash or acquire assets on credit).

Cash borrowing and credit transactions create liabilities. Generally, liabilities are recognised obligations of an enterprise to pay money or to provide goods and services to another corporate entity or individual. This unit will discuss the matter of debentures and mortgages with emphasis on the accounting treatment of these liabilities.

2.0 OBJECTIVES

At the end of this unit, you will be able to:

- give meanings to debentures and mortgages
- explain the accounting treatment of these liabilities.

3.0 MAIN CONTENT

3.1 Company Accounts II

3.1.1 Debentures

3.1.1.1 Definition of Debenture

A debenture is a debt instrument. It is a written acknowledgement of a debt by a company, usually under seal and generally containing provisions for payment of interest and repayment of capital. For example, Cosmos Ltd. can borrow a large sum of money and will issue debt papers which can be bought by many creditors. The effect is that Cosmos Ltd. collects cash from various sources but with a firm undertaking to repay each holder of the "debenture" the loan granted and the interest on it. Let us note that a "bond" is the generic name of this kind of debt instrument.

The accounting issues with regard to liability include:

- the determination and recording of the amount of cash to be paid in the future;
- the computation and accrual of the cost of utilising credit or making use of loan over a period;
- record-keeping to know when a payment is due to a creditor and how much the payment will be.

3.1.1.2 Classification of Debentures

Debentures can be classified in a number of different ways depending on their characteristics:

- On the manner of payment of interest (registered and coupon bonds);
- On the basis of repayment of principal (single payment bonds, serial bonds);
- On the basis of the underlying security (unsecured bonds, secured bonds);
- On the basis of early retirement (callable bonds, redeemable bonds, convertible bonds).

3.1.1.3 Accounting for Debenture Issues

Debentures may be sold at par, at a discount or at a premium. Debentures are sold at par if the issue price was equal to the face value, issued at a discount if the price was less than the face value, and issued at a premium if the price was more than the face value.

Debentures are traded on the stock exchange and prices are quoted as a per centage of the face amount. Interest is incurred on bonds on the basis of time.

Let us illustrate as follows:

The Board of Directors and shareholders of CASIO Ltd. approved a bond issue with the following characteristics:

- Authorised bonds: ₦200,000 (₦1,000 per bond)
- Date on each bond: 1 July, 2000, maturing in 10 years on 30 June, 2013.
- Interest: 8% per annum, payable 30 June and 31 December.

Casio Ltd. accounting year ends on 31 December.

Bonds issued at Par

The investors who will grant the cash loan to Casio Ltd will pay ₦1,000 for each bond if the 8% interest rate represents an acceptable return on this investment. The entry to record the issuance of the bond assuming they received cash for them will be:

		₦	₦
1 July, 2000	Cash	200,000	
	Bonds payable		200,000
	Being the ₦200,000 10 year bond issue, interest at 8% per annum.		

The entries to record the interest payment in 2000 will be as follows:

		₦	₦
31 December, 2000	Bond interest expense	8,000	
	Cash		8,000
	Being half annual interest paid.		

The interest is reported in the Profit and Loss as part of the expenses of the business, deductible from the revenues of 2000. In the Balance Sheet, the bonds payable is reported at its face value as a liability.

In 2001, the bond interest expense will have a debit balance of ₦16,000 which will be reported as follows:

Profit and Loss Account 2001:

Bond Interest Expense ₦16,000

The liability will be reported in the balance sheet, thus:

Long – term Liabilities:

Bond Payable (8% due June 2010) ₦200,000

In the above situation where the bond is sold at par, CASIO Ltd received a cash of ₦200,000. It will pay as interest ₦8,000 for each half year, and repay the ₦200,000 on 30 June, 2010. The total overall payment will be ₦200,000 + ₦160,000 (₦8,000 x 20) = ₦360,000.

Bonds issued at Discount

The market price of the bond fluctuates constantly. The stated rate of interest on the face value of the bond remains the same over the life of the bond. As a result, if the current market rate of interest is higher than the stated rate, the buyer of the bond will be unwilling to pay as much cash as the principal value on the bond indicates. When a cash figure lower than the face value is paid, the bond is said to be sold at a discount.

From the example of CASIO Ltd above, assuming that the bond was issued and sold at 95, the cash received from the issue will be ₦190,000. Therefore, the entry to record the above transaction at the date of issue is:

		₦	₦
1 July, 2000	Cash	190,000	
	Discount on Bonds	10,000	
	Bonds payable		200,000

Being the record of ₦200,000 8% bond at 95.

Let us emphasise that the discount on bonds affects the effective interest rate because the total interest payment is related to the cash received at issue. The cash inflow, cash outflow and cash cost of using the debt in the above example can be analysed as follows:

	₦	₦
INFLOW		
Cash received at sale of bond		190,000
OUTFLOW		
Cash paid back on maturity (principal)	200,000	
Interest: 8% x 200,000 x 10	<u>160,000</u>	<u>360,000</u>
DIFFERENCE		
Amount of interest cost		<u>170,000</u>

₦170,000 ÷10 years = ₦17,000 per year

Approximate annual effective rate of interest:

N17,000 ÷190,000 = 8.9% per annum

From the above analysis, the discount represents an increase in bond interest expense. The effective rate of interest is higher than the stated rate. The bond discount is written-off at once to reserve or it could be allocated to every interest period from the issuance of the bond to its maturity date. In that case, it is carried as a capital expenditure and amortised. How is this done?

In the example under consideration, ₦10,000, which is the discount, is allocated equally to each of the periods from the date of issue to the bond's maturity (10 years). It means that each year bears an additional interest expense of N1,000. The amortised discount per each interest period is ₦500 (₦10,000 ÷20, since they will be paid bi-annually for 10 years).

The first 6 months will be recorded as follows:

	₦	₦
31 December, 2000:		
Bond interest expense	8,500	
Cash		8,000
Discount on bonds		500

Being the payment of ½ year interest and the amortisation of discount for six months.

The bond interest expense is deducted on the Profit and Loss Account of the period.

The bond discount account will be thus:

Dr.	Discount on Bonds			Cr.
1 July, 2000	10,000	31 December, 2000		500
		31 December, 2000	Balance c/d	9,500
	10,000			10,000

The Balance Sheet will be reported as:

Bonds payable	200,000
Less: Unamortised discount	9,500
	190,500

Bonds issued at Premium

Bonds are issued at a premium when the market rate of interest is lower than the nominal rate stated on the bond. The effect is that the issuer collects more cash than the maturity value since the investor is willing to pay higher price to take advantage of the relatively higher nominal interest.

In accounting for the bonds sold at a premium, the measurement of the interest for each period and the net liability of the bonds payable at the end of each accounting period has to reflect the premium paid. Using the example of CASIO Ltd above, suppose the bonds of ₦200,000 were bought for ₦250,000, it follows that cash worth ₦250,000 would be received by CASIO Ltd. The appropriate entry will be as follows:

		₦	₦
1 July, 2000	Cash	250,000	
	Bonds payable		200,000
	Premium on Bonds		50,000
	Being the issue of ₦200,000, 8% Bond sold at premium.		

Here, the effective interest will be lower than the nominal interest and it is computed thus:

	₦	₦
INFLOW		
Cash received at sale of bond		250,000
OUTFLOW		
Cash paid back on maturity (principal)	200,000	
Interest: 8% x 200,000 x 10	160,000	360,000
DIFFERENCE (Amount of interest cost)		110,000

Approximate annual effective Rate of Interest:

₦110,000 ÷10 years = ₦11,000 per year

N11,000 ÷250,000 = 4.4% per annum

The premium on the bonds is recorded on a separate account and the periodic amortisation is used to adjust the interest expense.

At the end of 2000, the first interest period to record interest expense is as follows:

	₦	₦
31 December, 2000:		
Bond interest expense	5,500	
Premium on bonds (Amortisation)	2,500	
Cash		8,000

Being the payment of ½ year interest and the straight line amortisation of premium.

The "Premium on Bond Account" will appear thus:

Dr.	Premium on Bonds		Cr.
31 December, 2000	2,500	1 June, 2000	50,000

The balance on the premium account is added to the bonds payable to measure the realistic liability in each period.

The Balance Sheet will include the following entries:

	₦
Long-term Liability:	
Bonds payable	200,000
Add: Unamortised premium	47,500
	247,500

For the year 2001, though the cash interest paid is ₦16,000, the interest expense will be ₦11,000 (that is, ₦16,000 – ₦5,000 premium amortised). The bond premium has the effect of decreasing the interest expense; the total premium of ₦50,000 is allocated over the 20 interest periods.

The 2001 Balance sheet will appear thus:

	₦
Long-term Liability:	
Bonds payable	200,000
Add: Unamortised premium	42,500
	242,500

Note that the book value falls continuously from ₦250,000 on the issue date to ₦242,500, one and half years later and to ₦200,000 on the maturity date. The book value measures the effective liability at each date. The rate of decrease of the bonds liability reflects the amortisation pattern.

SELF ASSESSMENT EXERCISE1

1. Define “Debenture”.

2. Explain the following with emphasis on their accounting treatments:

   (i) Bonds issued at par;
   (ii) Bonds issued at a discount;
   (iii) Bonds issued at a premium.

3.1.2 Mortgages

The building or purchase of a house or office is often financed with a mortgage loan. Substantial cash is received now, to be repaid later with interest. Essentially, such a loan is a long-term note payable with equal repayments made at regular intervals (usually monthly) over the period.

The note payable incorporates a mortgage, which is a conditional conveyance of property to a creditor as security for a loan. If the loan is not paid, the holder of the note takes over the property. However, the intention of both parties is for the loan to be repaid in accordance with its terms.

Let us consider the following example:

On April 1, 1999, Rahony Ltd purchased a building for ₦1.5 million by ₦500,000 cash and assuming a 6% mortgage loan provided by Equitable Mortgage Ltd. The mortgage agreement stipulated a monthly payment of ₦12,000.

The entries will be:

	₦	₦
Building	1,500,000	
Cash		500,000
Mortgage (Loan payable)		
1,000,000		

The ₦1.0 million is the amount of liability. Each month, repayment of ₦12,000 has to be made. At the end of month one, the entries will be:

	₦	₦
30 April, 1999:		
Interest expense	5,000	
Mortgage Loan	7,000	
Cash		12,000

Being the first payment on Mortgage loan.

Note: Interest for one month = $6\% \times 1,000,000 \times \frac{1}{12}$

Mortgage Loan Account

Dr.			Cr.
30 April, 1999	7,000	1 April, 1999	1,000,000
01 May, 1999	993,000		

The interest for the second month will be based on the balance in the loan account at the beginning of the month (₦993,000). The entries at the end of May and June will illustrate the fact that every subsequent monthly payment will involve progressively lower interest amounts and increasing amounts being applied to the repayment of the loan.

	₦	₦
31 May, 1999:		
Interest expense	4,965	
Mortgage Loan	7,035	
Cash		12,000

Being the second payment on Mortgage loan.

Interest = $6\% \times 993{,}000 \times \frac{1}{12}$

	₦	₦
30 June, 1999:		
Interest expense	4,930	
Mortgage Loan	7,070	
Cash		
12,000		

Being monthly payment on the Mortgage loan.

The monthly payment will continue until the mortgage payment reduces to zero when the loan is fully repaid.

SELF ASSESSMENT EXERCISE2

Differentiate between a "mortgage" and a "mortgage loan". Is there any relationship between the two terms?

4.0 CONCLUSION

A debenture is a debt instrument used by companies to borrow money to enable them finance their activities. Mortgage loans also attract creditors to companies. Both create liabilities which are obligations of entities to pay money to other entities or individuals. The importance of accounting issues relative to these liabilities need not be over-emphasised.

5.0 SUMMARY

In this unit, we have discussed debentures and mortgages (that enable corporate entities to borrow money) with emphasis on the accounting treatment of these liabilities.

6.0 TUTOR-MARKED ASSIGNMENT

1. Attempt the classification of “Debentures” in a number of different ways.

2. On January 1, 2002, LENON Ltd obtained a 10% Mortgage loan of ₦2 million from TOWER Mortgage Ltd to purchase a building that cost ₦3 million. The mortgage agreement stipulated a monthly repayment of ₦50,000.

   You are required to show the repayment account to TOWER Mortgage Ltd in the first six months.

7.0 REFERENCES/FURTHER READINGS

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MODULE 2

UNIT 1 COMPANY ACCOUNTS III

CONTENTS

1.0 INTRODUCTION

Business combinations take different forms: two or more businesses can merge; one company may take over another; or the capital structure of an existing business may be rearranged. We shall consider all of these in this unit. Emphasis shall, however, be laid on their accounting treatments.

2.0 OBJECTIVES

At the end of this unit, you will be able to:

- give meanings to amalgamation, absorption and reconstruction/reorganisation relative to companies
- discuss and demonstrate their accounting treatments.

3.0 MAIN CONTENT

3.1 Company Accounts III

3.1.1 Amalgamation

In its business sense, amalgamation means the merger of two or more businesses or undertakings. A complete merger may result into consolidation; where two or more companies are wound-up and their businesses transferred to another company formed specifically for that purpose.

3.1.1.1 Closing the Books of the Old Companies

The terms of the agreement will determine the procedure, cash and liabilities may or may not be taken over, but generally, the following accounts should be opened:

> Business Realisation Account to which is transferred the variables taken-over. A liability has a credit balance in the books of the old company. It is closed by a debit to that account and a credit to the Business Realisation Account. Alternatively, assets taken-over are debited to the Business Realisation Account and the individual assets are credited to close the books.
>
> The new company is debited and the Business Realisation Account is credited with the amount of the purchase consideration. The balance of the Business Realisation Account is either credit (a gain) or debit (a loss). In either case, it is transferred to a Sundry Shareholders Account. In some cases, the net assets are taken-over at book values and neither a gain nor a loss occurs.
>
> Open a share account, debiting it with the value of the shares received from the new company. If there are additional assets received (like cash, debentures), new account will be opened for each.
>
> Close the share Capital Account, Reserve Account and Profit and Loss Account by debiting these individual accounts and crediting the Sundry Shareholders Account.

Debit the Sundry Shareholders Account with the value of items distributed to them (cash, shares, etc.) and credit the individual share, cash and debenture accounts.

If the agreed terms permit the old company to retain its cash balance, discharge its liabilities and pay its own expenses, these transactions are passed through the cash account. In essence, the cash is credited and the liability and expense accounts are debited for the settlement. Note, however, that the Business Realisation Account is debited for the expenses of the transactions.

3.1.1.2 Opening Books for the New Company

All assets taken-over are individually recorded by a debit, while all liabilities taken-over are recorded by a credit. Also, share capital is credited by the nominal value of the shares issued, while if there is an excess of purchase consideration over the net assets taken-over, this excess is credited to premium on shares. The procedure should be as follows:

Debit each asset account including goodwill and credit the Business Purchase Account with the total.

Credit each separate liability account and debit the Business Purchase Account with the total.

Debit Business Purchase Account with the agreed price and credit the liquidator.

Debit the liquidator with the total value of the allotment of shares, debentures and cash paid, if any, in settlement of the purchase price. Share Capital, Debentures or Cash Accounts are credited.

Where the new company obtains the benefits of any reserves or undistributed profits, this should be transferred to the credit of a capital reserve account; it cannot be used for revenue purposes. The need for such a Capital Reserve Account is usually indicated by a credit balance in the Business Purchase Account – “credit” resulting from the fact that the total value of the assets transferred is greater than the sum of the purchase price and the liabilities taken-over. Though the reserves taken-over and credited to the Capital Reserve Account cannot be used for revenue purposes, they can be used to meet the expenses of liquidation or may be debited to the Preliminary Expenses Account. A balance in the Capital Reserve Account may be used to reduce the value of goodwill.

When the total of the purchase price and the liabilities taken-over exceed the total value of the assets, the difference is debited to goodwill.

In certain cases, the new company makes a further capital issue to provide for additional working capital or even for the expansion of capacity.

SELF ASSESSMENT EXERCISE 1

1. Define Amalgamation of companies.

2. Discuss the main account to be opened when closing the books of a company during the process of amalgamation.

3.2.1 Absorption

Absorption speaks of the take-over of one company by another. In this instance, the company to be absorbed will go into voluntary liquidation, and the purchasing company will usually take-over the whole of the assets and assume the ordinary trade liabilities.

The entries in the books will be similar to those required for the purpose of closing the books of a partnership on dissolution (to be considered later).

The Realisation Account is debited with:

the book values of assets not taken-over by the purchasing company;
any loss on disposal of assets taken-over by the purchasing company;
any loss on settlement of liabilities not taken-over by the purchasing company and realisation expenses.

Also, the Realisation Account is credited with:

any profit on the disposal of assets not taken-over by the purchasing company;
any profit on settlement of liabilities discharged by the selling company itself; and
the total purchase consideration.

Individual asset, liability and equity accounts are closed in the normal way. For instance, since an asset will generally have a debit balance, it is credited to close. Any account having a credit balance (debentures, trade liabilities, provision and reserves) will be debited to have the accounts closed.

In opening the books of the purchasing company, all assets acquired are debited and the share capital, share premium, liabilities and reserves will be credited with the agreed values.

Example

NOLLY COMPANY LTD

BALANCE SHEET AS AT DECEMBER 31, 1999

Share Capital:		Land and Building	37,500
60,000 ordinary shares at N1.00 each	60,000	Plant and Machinery	18,225
Reserve Fund	30,000	Stock	22,787
Profit and Loss Account	3,264	Debtors	19,125
Sundry Payable	10,625	Cash at Bank	6,190
		Cash in hand	62
	103,889		103,889

The entire undertaking is acquired on the above date by DEBBIE LTD with the understanding that:

(a) NOLLY LTD will wind-up voluntarily;
(b) DEBBIE LTD will agree to offer a purchase consideration of N50,000 cash and the allotment of two of its fully paid ₦1.00 shares (market value ₦1.25) in exchange for 3 shares of NOLLY LTD;
(c) The liquidation expenses of NOLLY LTD are ₦750;
(d) The balance of the cash consideration is to be distributed pro rata among the shareholders.

BOOKS OF NOLLY LTD

JournalEntries

(a)	Realisation Account	₦103,889	
	Sundry Assets		₦103,889
	Being record for disposal of various assets		
(b)	Sundry Payables	₦10,625	
	Realisation Account		₦10,625
	Being liabilities taken-over in the process of acquisition		

(c)	DEBBIE LTD	₦100,000	
	Realisation Account		₦100,000
	Being the agreed purchase price		
(d)	Realisation Account	₦5,986	
	Sundry Shareholders		₦5,986
	Being the transfer of profits on realisation		
(e)	Share Account	₦50,000	
	Cash Account	₦50,000	
	DEBBIE LTD		₦100,000
	Being the receipt of purchase consideration including the 40,000 ordinary shares valued at ₦1.25		
(f)	Realisation Account	₦750	
	Cash Account		₦750
	Being the payment of liquidation expenses		
(g)	Share Capital	₦60,000	
	Reserve Fund	₦30,000	
	Profit and Loss Account	₦ 3,264	
	Sundry Shareholders		₦93,264
	Being the transfer of balance in the equity accounts to the shareholders		
(h)	Sundry Shareholders	₦99,250	
	Shares		₦50,000
	Cash		₦49,250
	Being the distribution to shareholders at liquidation 82k in the ₦ in cash and 83k in ₦ shares.		

LedgerAccounts

Two principal ledger accounts are presented below for illustration:

Realisation Account

Sundry Assets	103,889	Sundry Payables	10,625
Liquidation Expenses	750	DEBBIE LTD	100,000
Transfer to Sundry Shareholders	5,986		
	110,625		110,625

Sundry Shareholders Account

Shares:		Share Capital	60,000
40,000 ₦1.00 shares at			
N1.25	50,000	Reserve Fund	30,000
Cash	49,250	Profit and Loss Account	3,264
		Realisation Gain	5,986
	99,250		99,250

BOOKS OF DEBBIE LTD

Journal Entries

(a)	Land and Building	₦37,500	
	Plant and Machinery	₦18,225	
	Stock	₦22,787	
	Sundry debtors	₦19,125	
	Cash at Bank	₦ 6,190	
	Cash in hand	₦ 62	
	Liquidator of NOLLY LTD		₦103,889
	Being the value of all assets acquired		
(b)	Liquidator of NOLLY LTD	₦10,625	
	Sundry Payables		₦10,625
	Being the liabilities taken-over		
(c)	Liquidator of NOLLY LTD	₦93,264	
	Shares capital (Allotment of 40,000 N1.00 shares paid cash)		₦50,000
	Premium on share account (Excess of net Assets over cash paid and nominal value Of shares allotted)		₦43,264
	Being the settlement in respect of company taken-over		

Ledger Account

Liquidation of NOLLY LTD

Sundry Shareholders Account

Sundry Payable	10,625	Sundry Assets	103,889
Share capital	40,000		
Cash	50,000		
Premium on shares	3,264		

103,889	103,889

SELF ASSESSMENT EXERCISE 2

Appraise the merits for an existing company taking-over another company instead of floating a new company for the same purpose.

3.1.2 Reconstruction and Reorganisation

Reorganisation is a re-arrangement of capital structure usually necessitated by the accumulation of trading losses over time or of existing capital losses. The sale of the undertaking of an existing company to a new company specifically formed for that purpose is known as reconstruction.

These could be necessitated:

- for the purpose of raising fresh capital;
- for amalgamating two or more companies;
- for re-arranging the capital and the rights of members as between themselves for effecting a compromise with creditors.

Where a company has sustained a considerable loss of capital and is unable to satisfy its creditors in full, the reconstruction scheme commonly provides for a reduction of the original capital, a compromise with the creditors either for cash or for the issue of fully paid shares or debentures and the provision of new working capital by the issue to the existing shareholders of partly paid-up shares in exchange for the shares held in the old company.

SELF ASSESSMENT EXERCISE 3

Why would reconstruction / reorganisation take place in a company?

4.0 CONCLUSION

Amalgamation, absorption and reconstruction/reorganisation relative to companies take place depending on the prevailing circumstances of each company as well as the purpose for which they are embarked upon.

5.0 SUMMARY

In this unit, we have looked at the different forms of business combinations; companies can merge, one company can take-over another, or the capital structure of an existing company may be re-arranged by way of reorganisation. In all of these, the accounting treatments are essential.

6.0 TUTOR-MARKED ASSIGNMENT

From the example of NOLLY CO. LTD and DEBBIE LTD, assuming the liquidation expenses of NOLLY CO. LTD are N1,000, you are required to make journal entries and prepare ledger accounts for NOLLY CO. LTD and DEBBIE LTD.

7.0 REFERENCES/FURTHER READINGS

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UNIT 2 ACCOUNTS OF PARTNERSHIPS I

CONTENTS

1.0 INTRODUCTION

A partnership is generally defined as a legal relationship between two or more persons where each person contributes something in order to carry on a lawful business with a view of profit which is to be shared between the partners in a proportion agreed upon by them. Therefore, for a partnership to exist:

1. the association must be engaged in a business which may be a trade or a profession;
2. the trade or the profession must be carried on together, jointly, for the benefit of all the partners; and
3. there must be an intention to earn a profit.

The above description, therefore, distinguishes a partnership from a political, religious, social, or philanthropic club or association. A partnership agreement, which need not necessarily be in written form (although it is advisable or wiser that any agreements between the partners be put into writing as this will tend to lead to fewer possibilities of misunderstandings and disagreements between partners), will govern the relationships between the partners, including:

1. name of organisation, the type of business, and duration;
2. capital to be introduced by partners;
3. division of profits between parties, including salaries since not all the partners may be employed by the partnership on a full-time basis. Such salaries will be normal operating expenses;
4. drawings by partners;
5. arrangements for dissolution, or on the death or retirement of partners;

6. settling of disputes;
7. preparation and audit of accounts.

At this juncture, it is necessary to note that, although the partnership agreement creates a legal relationship between the partners, the partnership itself is not a legal entity.

With the above background, the unit (being the first part of the three to consider Accounts of Partnerships) will attempt to distinguish companies from partnerships. The unit will also consider accounting treatments relative to admission of a new partner, profit ratio after admission of a new partner as well as goodwill in partnerships.

2.0 OBJECTIVES

At the end of this unit, you will be able to:

- distinguish between companies and partnerships
- explain the accounting treatments relative to admission of a new partner
- work out the profit ratio after admission of a new partner
- discuss goodwill in partnerships.

3.0 MAIN CONTENT

3.1 Accounts of Partnerships I

3.1.1 Companies and Partnerships Contrasted

Let us attempt to outline the distinguishing features/characteristics of limited liability companies and partnerships as follows:

S/N	COMPANIES	S/N	PARTNERSHIPS
1.	Separate legal entity which is not affected by changes in its membership.	1.	No separate legal entity – not a juristic person.
2.	Shareholders have limited liability for debts – limited to the amount he agreed to pay for shares allotted.	2.	The liability of each member for debts of the firm is unlimited. Partners are jointly and severally liable for debts.
3.	Rights of management are delegated to the directors.	3.	Every member can partake in the management of the business.

4.	Powers and duties of directors are spelt out in the Articles of Association and can be varied by passing a special resolution of the company in a general meeting.	4.	The rights of partners themselves are governed by the partnership agreement which can be varied.
5.	The authorised capital is fixed by the Memorandum of Association.	5.	Capital is contributed by the partners by agreement. The amount, which is not fixed, can be increased by undrawn profits or reduced by losses and withdrawals.
6.	Shares are freely transferable in public companies; in private companies, shares are transferable subject to restrictions imposed by the Articles of Association.	6.	The share in a partnership cannot be transferred except by the consent of all partners.
7.	Audit is compulsory, and copies of accounts are filed with the Corporate Affairs Commission (CAC) annually.	7.	Audit is not compulsory; copies of accounts are not filed with the Corporate Affairs Commission.
8.	Profits are distributed in the form of dividend.	8.	Profits are distributed as per agreed ratios; drawings may be made by mutual agreement for accruing profits.
9.	Profits are subject to Company Income Tax.	9.	Profits are subject to Personal Income Tax; partnership is not taxed.
10.	Unlimited life.	10.	Partnerships have limited life.

SELF ASSESSMENT EXERCISE 1

Distinguish between limited liability companies and partnerships.

3.1.2 Admission of a New Partner

Before we look at the different dimensions of admitting a new member relative to the accounting procedure, let us start from the point of establishing the partnership. Each partner contributes an amount of capital. A fundamental principle for the accounting treatment is that all aspects of an individual partner's contributions, charges to and charges by the partnership must be accounted for separately. Recall that in the books of the sole proprietor, two accounts are opened for the owner:

Capital account;
Drawings account.

However, in the books of the partnership, three accounts will be opened for each of the partners, namely:

a capital account;
a drawings account;
a current account.

Partners' capital accounts are referred to as "fixed capital accounts" because they are not used to record drawings or shares of profits but rather:

capital introduced or withdrawn by new or retiring partners;
revaluation adjustments.

Current accounts are used to deal with the regular transactions between the partners and the firm. Most commonly, these transactions are share of profits, interest on capital and partners' salaries. Drawings are made against the partners' share of anticipated profits. Drawings account is debited and cash credited to record drawings. At year end, drawings account is closed off to the individual partner's current account and crediting drawings account. Let us note that drawings do not mean appropriation of profit.

Now let us look at the accounting procedures involved in the different dimensions of introducing or admitting a new partner.

(i) A new partner is admitted into the business when the capital base of the partnership is not affected:

An existing interest in a partnership (that is, each partners' share of the total capital and of the profits) can be acquired by a new partner through direct purchase from the existing partners. This means that the assets and liabilities (capital base) of the partnership remain unchanged even though a new partner is admitted.

Example

Peter, James and John, being partners agree to sell N60,000 interests to Andrew on equal basis (N20,000 each). The capital accounts of the partners prior to the purchase reflected the following balances: Peter – N50,000; James – N100,000 and John – N150,000.

The journal entries for the above will be:

	N Dr.	N Cr.
Peter	20,000	
James	20,000	
John	20,000	
Andrew		60,000

(Being the transfer of partnership capital to a new partner)

By the above journal, the capital account of the three old partners is reduced by N20,000 each and a new capital account is set up for Andrew (the new partner). Note that the admission of Andrew does not bring new cash into the partnership; the cash paid by Andrew to acquire the interests goes to the individual old partners. Total partnership capital and assets remain the same; what has changed is the structure of the partnership capital – Peter: N30,000; James – N80,000; John – N130,000; Andrew – N60,000.

(ii) A new partner can be admitted through an additional investment in the partnership:

This dimension increases total partnership capital and assets. The underlisted steps should be followed to determine the appropriate entries in the partnership accounts when a new partner invests in the partnership:

Determine the total amount of the agreed capital after the new investment.
Ascertain the new partners' share of the capital to arrive at the proper credit to the new partner's capital account.
Adjust the capital accounts of the partners if the asset values are changed or if bonuses are given to old or new partners.
<u>Adjust the book values of the partnership assets, especially, if the total capital of existing partners plus the capital invested by the new partner does not equal the agreed capital arrived at in bullet 1 above</u>. (The acquisition of a new partnership interest by investment can be effected at book value. Alternatively, the interest can be purchased at more or less than the book value).

An example

Osagie and Haruna are partners with N55,000 and N35,000 balances in the capital accounts respectively (after adjustment of assets to market value). Profits and losses are divided 60% to Osagie and 40% to Haruna. A new partner, Jumbo acquires ¼ interest in profits and in the capital by investing additional assets. The profit ratios specified in the new partnership agreement are 45%, 30% and 25% for Osagie, Haruna and Jumbo respectively. Effect the appropriate entries.

With investment at book value, Jumbo pays in N30,000 for ¼ interest. The new total capital and assets is N120,000. Jumbo's share in the book value is N30,000 and this is equal to the cash brought in. No further adjustments are required since the total assets are equal to the new agreed capital.

The journal entries will be:

	N Dr.	N Cr.
Cash	30,000	
Jumbo		30,000

(Being Jumbo's admission to a 25% interest in a total capital of N120,000)

(iii) A new partner is admitted with a bonus credited to the old partners

The partners (Osagie and Haruna) agreed that the total capital and total assets are to be N125,000, and the new partner, Jumbo, pays in N35,000 an amount, greater than the recorded value of his capital (N31,250). Jumbo is paying a bonus of N3,750 to the partnership (in expectation of superior profit performance), which is divided between Osagie and Haruna in the profit sharing ratio that existed between them.

The relevant entries are:

	N Dr.	N Cr.
Cash	35,000	
Osagie: Capital		2,250
Haruna: Capital		1,500
Jumbo: Capital		31,250

(Being Jumbo's admission by investment in a total capital of N125,000)

(iv) A new partner is admitted with Goodwill credited to the old partners

As in (iii) above, Jumbo pays in N35,000 for ¼ interest, which payment exceeds the book value of his proportionate share of tangible assets. The partners agreed that Goodwill is to be recorded, with its value determined from Jumbo's contribution.

Let us make the following deductions:

- Jumbo contributed N35,000 for ¼ interest in total capital. Therefore, total capital after his contribution is N140,000 (N35,000 x 4).
- The assets of the old partnership were valued at N90,000. So the total tangible assets are now:

	N
Assets	90,000
Cash (New investment)	35,000
	125,000

The difference between the total capital and the total tangible assets of the partnership is the value of goodwill, that is, N15,000 (140,000 – N125,000) which belongs to the old partnership and is to be shared between Osagie and Haruna in the profit ratio. (Goodwill will be treated in details in 3.4).

The following entries are relevant:

	Dr.	Cr.
	N	N
Goodwill	15,000	
Osagie: Capital		9,000
Haruna: Capital		6,000

(Being Goodwill determined by Jumbo's admission)

Jumbo's investment will be recorded in the journal as follows:

	Dr.	Cr.
	N	N
Cash	35,000	
Jumbo: Capital		35,000

(Being Jumbo's admission to a 25% interest in the total capital of N140,000).

Note: The partners' profit ratio remains as specified in the new agreement.

SELF ASSESSMENT EXERCISE 2

1. Explain the different scenarios of admitting a new partner.
2. What are the steps to be taken in determining the appropriate entries in the partnership accounts when a new partner invests in the partnership?

3.1.3 Profit Ratio after Admission of a New Partner

Here, we shall consider the method for calculating the profit and loss sharing ratio for partners after the admission of a new partner since the old sharing ratio would have been overtaken by events. The old partners, in some cases, may wish to retain their former relative positions. Sometimes too, they may prefer changes. However, whatever is the case, the new profit ratio has to be determined/established and included in the revised agreement.

AnExample:

Jerome and Shedrack, being partners in business, share profits and losses in the ratio of 60% and 40% respectively. The partners agreed to admit Lambert to a 25% interest. You are required to determine the new profit sharing ratio for the partners.

The calculation will be as follows:

Total net profits	100%
Less: Lambert's share	25%
Balance for Jerome and Shedrack	75%
Ratio for Jerome (60% of 75%)	45%
Ratio for Shedrack (40% of 75%)	30%

Therefore, the new profits ratio is 45%, 30% and 25% for Jerome, Shedrack and Lambert.

SELF ASSESSMENT EXERCISE 3

If Kay's and Kez's profits ratio in the partnership business before admitting Kan to a 15% interest was 70% and 30% respectively, what will be the partners' new sharing ratio after Kan was admitted?

3.1.4 Goodwill in Partnerships

We shall consider the meaning, valuation and treatment of goodwill relative to the partnerships.

Goodwill refers to the benefit and advantage of the good name, reputation and connection of a business which can be valued and expressed in monetary terms. It is a force that attracts customers; it makes a new partner to contribute capital over and above the saleable values of the tangible assets.

The goodwill possessed by a firm may be due to, among others, the:

- Monopoly enjoyed by the business;
- Reputation of the company in terms of quality of goods and services;
- Management skill and reputation of the partners, and the value of the labour force;
- Location of the business premises;
- Possession of the trade marks, patents, or well-known businesses name over the years.

In the valuation of goodwill, custom plays a great role in many sorts of business. Let us discuss a few of the methods:

(i) The average profits of a given number of past years multiplied by an agreed number:

Thus, it is common to learn of three years' purchase of the net profits as the basis for valuing goodwill. For example, if the average net profit made by XYZ Company for the past five (5) years is N2,000 per annum, on the basis of three years' purchase of the net profits, goodwill will be valued at N6,000 (N2,000 x 3). Please, note that this method is purely arbitrary.

(ii) The average gross income of the business for a number of past years multiplied by an agreed number:

Professional firms usually adopt this method.

(iii) The value of the business:

The value of the business is estimated by reference to the expected earnings and the yield required, and from the figure arrived at, the value of the net tangible assets is deducted, the difference being taken to represent the value of goodwill.

For example, the estimated future accrued profits of the partnership (less partners' remuneration of N2,500) is N7,500. If yield at 10% per annum is expected and the value of the tangible assets is N50,000, what is the value of the goodwill?

Capital value of business (7,500 x 10)	N75,000
Less: Value of tangible assets	N50,000
Value of goodwill	N25,000

Kindly refer to 3.2 for the treatment of goodwill in partnership accounts.

SELF ASSESSMENT EXERCISE 4

Define goodwill and discuss the methods of its valuation.

4.0 CONCLUSION

Although the partnership agreement or deed creates a legal relationship between the partners, the partnership itself is not a juristic person. Each partner, in the partnership books, has a capital account, drawings account and a current account. When a new partner is admitted, the profit sharing ratio of the old partners changes; a new ratio to include the new partner has to be established and included in the revised agreement. Goodwill is an important factor is determining a new partner's contribution to the partnership.

5.0 SUMMARY

We have been able to define partnership, and distinguished between it and company. In the partnership, we have discussed the admission of a new partner under different approaches as well as the accounting procedures. We also looked at the profit ratio after admission of a new partner which has to change and form part of the revised agreement document. Goodwill – an intangible asset, which makes a new partner contribute to the partnership over and above the saleable values of the tangible assets – was discussed as well.

6.0 TUTOR-MARKED ASSIGNMENT

1. (a) Define Goodwill.
   (b) What are the contributing factors to the goodwill possessed by a firm?

2. Alabo and Rotimi have N100,000 and N90,000 respectively. Their profit sharing ratios are 55 and 45% respectively. The profit sharing ratio in the new partnership agreement if Alfa is to be admitted on the payment of N120,000, which is to be 1/6 of the total new capital, as his interest, will be 48, 35 and 17% for Alabo, Rotimi and Alfa respectively.

   You are required to show the asset of the old and new partnership and the goodwill. Also, show the old partners' shares of goodwill since it was agreed that it should be shared in their profit and loss sharing ratio.

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UNIT 3 ACCOUNTS OF PARTNERSHIPS II

CONTENTS

1.0 INTRODUCTION

In continuation of our consideration of Accounts of Partnerships, we shall discuss the methods of dissolution of partnerships when:

1. all assets are realised in full;
2. assets are realised piecemeal.

It will be important to expose you to the order of priority by which assets are distributed as well as the accounting treatment of non-cash assets as they are converted into cash before any assets are distributed to creditors and partners.

2.0 OBJECTIVES

At the end of this unit, you will be able to:

- state the order of priority in the distribution of assets during a partnership dissolution
- treat the conversion of non-cash assets into cash for distribution to creditors and partners
- prepare dissolution of partnership accounts when assets are realised piecemeal.

3.0 MAIN CONTENT

3.1 Accounts of Partnerships II

3.1.1 Retirement and Dissolution of Partnerships

The decision to dissolve and terminate the activities of a partnership is known as liquidation or dissolution or winding-up of affairs. While contemplating dissolution, there should be a clear perception of the order of distribution of partnership assets as well as a determination and distribution of gains and losses arising during the process of realisation. Fortunately, the Partnership Act provides for the following order of distribution of partnership assets in the event of termination and liquidation of the company, which should be respected:

- Creditors of the company;
- Creditors of the individual partners;
- Partners' loan to the company;
- Partners' capital.

At this juncture, it is important to note that during the period of liquidation, some of the company's non-cash assets may be converted into cash by realisation (and this segment deals with the situation when all assets are realised in full), liabilities are settled to the extent possible, and each partner's residual interests are settled to the limit permitted by the remaining cash. Gains and losses arising during the realisation period are given the same treatment as gains and losses from operations, thus, they are distributed to the partners' capital accounts in the profit and loss ratio.

Example

On 30th June, 2001, the partners of Oluwole, Osuji and Bamidele Company decided to dissolve the partnership and distribute all assets to the creditors and to the partners. After appropriate adjustments to reflect events since the close of the financial year, the following balance sheet was prepared:

Oluwole, Osuji and Bamidele Balance Sheet

	N	N
Fixed Asset (at cost less depreciation):		
Land		8,000
Buildings (cost N80,000; Depreciation N38,000)		42,000
Equipment (cost N140,000; Depreciation N50,000)		90,000
		140,000

Current Assets:		
Cash	20,000	
Debtors	18,000	
Stock	30,000	
Prepaid Insurance	600	68,600
		208,600
Represented by:		
Partners' Capital:		
Oluwole	84,000	
Osuji	39,200	
Bamidele	68,400	191,600
Current Liabilities:		
Creditors	6,000	
Notes payable	10,000	
Accrued interest	200	
Tax payable	800	17,000
		208,600

The partnership agreement provides for a profit and loss ratio of 50, 20 and 30% for Oluwole, Osuji and Bamidele respectively. As part of the efforts to wind-up the partnership business, the following transactions took place in July and August:

b. The equipment was sold for N72,000;
c. The land and buildings were sold to Zaki Ltd. for N60,000;
d. All stocks were sold for N24,800;
e. The insurance were surrendered for the premium of N400;
f. All creditors and taxes payable were paid;
g. N16,600 was collected from debtors and the balance written-off;
h. N10,400 representing the face value of the note and interest due to maturity was deposited in a special account with Chartered Bank;
i. All remaining assets were distributed to the partners.

We are required to give accounting treatment to the recording of the dissolution.

Solution:

Let us adopt a procedure where we treat each asset as a sub-realisation account, thus, the amount realised from the sale of an asset is debited to such an account and the loss or gain credited and the account is closed to the realisation account. The cash book is debited with the proceeds.

We journalise the individual accounts as they are realised which brings out the essence of dissolution clearly. Therefore, the journal entries for the July and August transactions will be as follows:

		N	N
(i)	Cash	72,000	
	Accummulated depreciation (Equipment)	50,000	
	Realisation Accounts	18,000	
	Equipment		140,000
	(Being the sale of Equipment at a loss)		
(ii)	Cash	60,000	
	Accummulated depreciation (Building)	38,000	
	Building		80,000
	Land		8,000
	Realisation Accounts		10,000
	(Being the sale of land and building at a gain)		
(iii)	Cash	24,800	
	Realisation Accounts	5,200	
	Stock		30,000
	(Being the disposal of stock at a loss)		
(vi)	Cash	400	
	Realisation Accounts	200	
	Prepaid insurance		600
	(Being the cancellation of insurance and collection of unexpired premium)		
(v)	Creditors	6,000	
	Tax payable	800	
	Cash		6,800
	(Being the liquidation of creditors and taxes payable)		
(vi)	Cash	16,600	
	Realisation Accounts	1,400	
	Debtors		18,000
	(Being the collection of debtors and the writing-off of bad debts)		
(vii)	Special Fund (Chartered Bank)	10,400	
	Realisation Accounts	200	
	Accrued interest		200
	Cash		10,400
	(Being the additional interest due to maturity of note and the deposit of fund in Chartered Bank)		

(viii)	Capital: Oluwole	7,500	
	Capital: Osuji	3,000	
	Capital: Bamidele	4,500	
	Loss on Realisation		15,000
	(Being the distribution of loss on realisation to partners)		

Please, note that the loss of N15,000 is the debit balance on the realisation account which after the journal entries have been posted, and appears thus:

Dr. **Realisation Account** Cr.

Particulars	**Amount (₦)**	**Particulars**	**Amount (₦)**
Equipment	18,000.00	Building	10,000.00
Stock	5,200.00		
Prepaid insurance	200.00		
Debtors	1,400.00		
Accrued interest	200.00	Balance c/d	15,000.00
	25,000.00		25,000.00
Balance b/f	15,000.00		

Sequel to the distribution of loss to the partners and consequent credit entry to the realisation account, this account stands closed as well as the other accounts except the cash and the partners' capital accounts, which are finally closed by the following entries:

Capital: Oluwole	76,500	
Capital: Osuji	36,200	
Capital: Bamidele	63,900	
Cash		176,600
(Being distribution of cash to the partners in the final dissolution)		

Note that all assets have been converted into cash except the funds deposited in the bank; there remains the notes payable and the accrued interest, the reason for the creation of the fund in the bank. The balance sheet of the partnership would appear as follows immediately after the final asset distribution:

Oluwole, Osuji and Bamidele

Dr. **Balance Sheet** Cr.

Particulars	**Amount (₦)**	**Particular**	**Amount (₦)**
Notes payable	10,000.00	Fund in Chartered Bank	10,400.00
Accrued interest	400.00		
	10,400.00		10,400.00

SELF ASSESSMENT EXERCISE 1

1. What are the issues to consider when contemplating dissolution?
2. Outline the order of priority for assets distribution at partnership liquidation.

3.1.2 Piecemeal Dissolution of Partnerships

Here, we shall consider the treatment of partnership dissolution when assets are realised piecemeal. The winding-up of partnership may take place within a short period or it may be over an extended period. The case of the extended period is when it is not possible to liquidate all obligations at the time it is convenient to end the partnership. As in the example of Oluwole, Osuji and Bamidele partnership in 3.1 above, negotiations for the disposal of assets may take sometime and the payment for assets so disposed may be delayed.

In this situation, therefore, what is usually done is to make payments to partners in instalments as cash becomes available for distribution. It is necessary, in piecemeal dissolution, to give special attention to losses which may occur. For example, all assets not yet realised could be regarded as potential losses and temporarily allocated to the partners before any cash distribution. The reason for this is to reduce the possibility of distributing more to a partner than that which he will be entitled to eventually. We can use the method of 'Greatest Possible Loss' to treat this.

Example:

Using the balance sheet of Oluwole, Osuji and Bamidele (3.1 above), the partnership agreement also provides for a profit and loss ratio of 50%, 20% and 30% respectively. As part of the efforts to wind-up the partnership, we will assume that all available cash was first distributed to the partners on 31 July, 2001, after all current assets have been realised and all liabilities settled; but before the sale of the fixed assets and immediately after the creation of the special fund in the Chartered Bank of N10,400.

On this 31st July, 2001, cash of N44,600 is available for distribution; but before this the partners' capital balance was N191,600. Therefore, the greatest possible loss will be N147,000 (N191,600 – N44,600).

At this point, let us note that two kinds of losses in the greatest possible method are:

- losses already suffered through realisation and dissolution;

- possible losses in the future.

In the above example, the past loss was N7,000 (that is, loss on the realisation of current assets) and the maximum future loss was N140,000 (that is, the book value of assets not yet converted). Throughout the process of dissolution, the maximum loss will consist of the two kinds until the process is completed when actual loss and the greatest possible loss will be identified. The greatest possible loss is allocated/distributed to the partners according to the profit and loss ratio.

Therefore, on 31st July, 2001, the amounts that can be safely paid to each partner are indicated as:

Oluwole, Osuji & Bamidele Partnership
Statement of Capital Balances as at 31st July, 2001

Particulars	**Total**	**50%**	**20%**	**30%**
	N	**Oluwole**	**Osuji**	**Bamidele**
Balances as at 30/6/2001	191,600	84,000	39,200	68,400
Greatest possible loss	147,000	73,500	29,400	44,100
Cash to be distributed	**44,600**	**10,500**	**9,800**	**24,300**

On August 31, all the assets have been realised for N132,000. Therefore, the greatest possible loss will be N15,000 (N147,000 – N132,000). The statement of capital balances in August will be:

Oluwole, Osuji & Bamidele Partnership
Statement of Capital Balances as at 31st August, 2001

Particulars	**Total**	**50%**	**20%**	**30%**
	N	**Oluwole**	**Osuji**	**Bamidele**
Balances as at 1/86/2001	147,000	73,500	29,400	44,100
Greatest possible loss	15,000	7,500	3,000	4,500
Cash to be distributed	**132,000**	**66,000**	**26,400**	**39,600**

The statement of capital balances is not the same as the statement for distribution to partners which is prepared when the affairs of the partnership are terminated. Below speaks:

Statement of Distribution of Assets to Partners
Oluwole, Osuji & Bamidele from 1st July – 31st August, 2001

Particulars	**Total N**	**50% Oluwole**	**20% Osuji**	**30% Bamidele**
Cash distributed:				
31st July, 2001	44,600	10,500	9,800	24,300
31st August, 2001	132,000	66,000	26,400	39,600
Total Distributed	176,600	76,500	36,200	63,900
Loss on Realisation	15,000	7,500	3,000	4,500
Capital Balances as At 30th June, 2001	**191,600**	**84,000**	**39,200**	**68,400**

SELF ASSESSMENT EXERCISE 2

1. What is the "Greatest Possible Loss" in relation to piecemeal asset sharing at dissolution?
2. Mention the two kinds of the "Greatest Possible Loss".

4.0 CONCLUSION

Dissolution takes place when partners decide to dissolve and terminate the activities of a partnership. Apart from having a clear perception, it is necessary to respect the order of distribution of the partnership assets in the event of termination and liquidation. Dissolution can take place when all assets are realised in full or when assets are realised piecemeal.

5.0 SUMMARY

In this unit, we have discussed the methods of dissolution of partnerships when all assets are realised in full as well as when assets are realised piecemeal. We have seen the order of priority by which assets are distributed in the course of liquidation according to the Partnership Deed. Also, we dwelt on the accounting treatment of non-cash assets as they are converted into cash before any assets are distributed to creditors and partners.

6.0 TUTOR-MARKED ASSIGNMENT

The balance sheet of STAR Partnership as at 31st December, 2002 is as follows:

STAR PARTNERSHIP
Balance Sheet as at 31st December, 2002

	N	N	N
Fixed Asset (at cost less depreciation)			1,000,000
Current Assets:			
Cash		150,000	
Debtors		580,000	
Receivables		245,000	975,000
			1,975,000
Represented by:			
Partners' Capital:			
S	240,000		
T	380,000		
A	300,000		
R	430,000		1,350,000
Current Liabilities:			
Account payable	277,000		
Accrued interest	148,000		
Bank Overdraft	200,000		625,000
			1,975,000

The following additional informations are given:

(1) The partners share profits and losses in the ratio of 15, 25, 20 and 40% for S, T, A and R respectively.

(2) Desirous of dissolution, STAR Partnership sold all the assets and settled all liabilities. The remaining cash was then distributed among the partners on the following assumptions:

(a) All current assets were realised on 1st June, the current liabilities settled and cash of N284,000 made available for distribution.

(b) On 1st July, cash of N870,000 was available for distribution as part of the realisation for assets disposal.

(c) On 1st September, the remaining assets have been realised for N385,000.

You are required to:

(i) Prepare the statement of capital balances.
(ii) Prepare statement of distribution of assets to partners of STAR Partnership.

7.0 REFERENCES/FURTHER READINGS

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UNIT 4 ACCOUNTS OF PARTNERSHIP III

CONTENTS

1.0 INTRODUCTION

We shall conclude our discussion on Accounts of Partnerships in this unit. Earlier in units 7 and 8, we had explained what a partnership is, and distinguished between it and a company. We had considered also, admission of a new partner as well as treatment of goodwill in partnership. In addition, we looked at the different dimensions of partnerships dissolution. The focus of this unit is the accounting treatment relative to the withdrawal or death of a partner. If a partner withdraws, what are the methods of repayment of his capital and other benefits? And if a partner dies, what are the procedures for closing partnership books? These questions will guide our discussion.

2.0 OBJECTIVES

At the end of this unit, you will be able to:

- prepare the books of a partnership when any partner is withdrawing
- ascertain the amount due to the retiring partner and how it should be repaid
- close the partnership accounts on the death of a partner.

3.0 MAIN CONTENT

3.1 Accounts of Partnerships III

3.1.1 Withdrawal of a Partner

A retiring partner, in the absence of any agreement, is entitled to have all partnership assets (including goodwill) revalued on a proper basis as at the retirement date. Any appreciation or depreciation so revealed should be taken into account in calculating the amount due to him. The total amount so ascertained to be due is normally a debt by the firm to the retired partner.

An agreement may, however, be made between the partners whereby, in the event of the retirement of a partner, the remaining partners should assume, personally, the liabilities for the amount due. Thus, the debt is no longer due by the firm but by the partners individually in the ratio agreed upon.

Before we go on, let us state that a retired partner remains liable for the partnership debts at the date of retirement. However, when a new partner is introduced, by a contract of novation (substituted liability), the creditor may agree to look to the new partner in place of the old.

The partnership will adopt any of the following methods in settlement of debts due (value of capital and share of goodwill) to the retired partner:

Outright payment (lump sum, once and for all).

By agreed instalments over a period of years, interest being allowed on the diminishing balance of the amount due.

The amount due may be regarded as a loan to the partnership to carry the right of either a fixed rate of interest or a share of the profits of the firm.

An annuity may be paid for life or for an agreed number of years or for the life of some of his dependants.

Let us explain and illustrate some of these.

(i) Repayment by Instalments:

Here, the value of the retired partner’s capital and share of his goodwill are ascertained and credited to a loan account, and repaid by instalments with interest running on the outstanding balance. Then, the amount due to a retired partner is removed from being part of the partnership’s capital.

Example

Zak, a partner in a firm retired on 31st March, 1990, and his share of capital and goodwill was ascertained to be N76,000. It was arranged that this should be paid out by annual instalments of N20,000 to include principal and interest on the outstanding balance at 5% per annum. The first payment was made one month after retirement, and subsequent payments were made on the anniversary of the date of retirement. Show the account in the partnership's books until liquidation. Ignore income tax.

Dr. ZAK'sAccount Cr.

		N			N
April '90	Cash	20,000	Mar '90	Capital a/c	76,000
	Balance c/f	56,317	Apr '90	Interest (1 month)	317
		76,317			76,317
March '91	Cash	20,000	Apr '90	Balance b/f	56,317
	Balance c/f	38,898	Mar '91	Interest (11 months)	2,581
		58,898			58,898
March '92	Cash	20,000	Apr '91	Balance b/f	38,898
	Balance c/f	20,843	Mar '92	Interest (1 year)	1,945
		40,843			40,843
March '93	Cash	20,000	Mar '92	Balance b/f	20,843
	Balance c/f	1,885	Mar '93	Interest (1 year)	1,042
		21,885			21,885
March '94	Cash	1,979	Mar '93	Balance b/f	1,885
	Balance c/f	-	Mar '94	Interest (1 year)	94
		1,979			1,979

(ii) Loan to Partnership:

In this case, the retiring partner's capital is transferred to a loan account. Usually, agreement in respect of the interest payable and the conditions for repayment are entered into at the date of retirement.

Where an option was given to the continuing partners to purchase the share of the retired partner and the option was exercised, the retired partner would not be entitled to further share of the partnership's profits. His capital would be transferred to the capital account of the continuing partners who must pay him according to the terms of the agreement.

(iii) Repayment by Annuity:

It could be agreed to settle the retiring partner by way of annuity for a certain number of years or for life. A method of dealing with this matter in the partnership's books is to transfer the amount due to an annuity suspense account (which must be credited with interest at a fixed rate per annum) and profit and loss account is debited annually with the annuity paid. If the credit balance on the Annuity Suspense Account is exhausted during the life time of the annuitant, subsequent instalments be borne by the partners and debited to divisible profit.

If the annuitant should die before the credit on the Annuity Suspense Account exhausts, the balance remaining on the account would be a profit to the continuing partners and should be transferred to their capital accounts in the proportion in which they share profits. It is not advisable to transfer such profits to the profit and loss accounts or to the partners' current accounts since they do not normally represent liquid resources.

Revaluation Approaches

Two methods of revaluation approach may be applied in ascertaining the amount due to a retiring partner:

(i) Payment in excess of book value of assets

Suppose P, Q and R, being partners, with capital balances of N600,000, N800,000 and N600,000 respectively, and sharing profits in the ratio of 5:3:2. P retires, and after revaluation of assets, the other partners agreed to pay him N800,000. Therefore, the remaining partners, Q and R, will be charged with the excess of payment over book value of the capital balance of the retiring partner. Usually, the bonus paid to the retiring partner is allocated to the remaining partners on the basis of their profit and loss ratio, which is 3:2.

The entries will be:

	Dr	Cr
	N	N
Capital: P	600,000	
Capital: Q	120,000	
Capital: R	80,000	
Liability to P		800,000
(Being the withdrawal of P from the partnership)		

This approach is highly favoured where the recognition of goodwill is difficult to be justified.

(ii) Payment less than book value:

A partner may sell his interest in a partnership by accepting less than the book value of his interest if he sees a poor prospect for the firm or needs working capital for personal reasons.

Using the example of P Q R partnership, suppose P is willing to withdraw and accepts to be paid N500,000, a bonus of N100,000 (which will be allocated on the basis of their 3:2 profit and loss ratio) will accrue to the remaining partners.

The entry will be:

	Dr	Cr
	N	N
Capital: P	600,000	
Capital: Q	60,000	
Capital: R	40,000	
Liability to P	500,000	
(Being the withdrawal of P from the partnership)		

However, it will be observed from the above entry that the net assets of the partnership were not revalued.

Example

T, K and O were in partnership, sharing profits and losses in the ratio of 3:2:1. T retired on 31st December, 1999, and it was agreed that an annuity of N9,000 per annum should be paid to him by the continuing partners, through the partnership, and he accepted this undertaking in full settlement of the balance due to him. The balance sheet of the outfit before revaluation of assets on 31st December was as follows:

T K O Balance Sheet

	N	N
Partners' Capital:		
T	90,000	
K	50,000	
O	40,000	180,000
Net assets (excluding goodwill)		180,000

To ascertain the amount due to T, goodwill was valued at N60,000, and the net assets were valued at N30,000 in excess of the amounts at which they stood in the books. No goodwill account was raised and there was to be no alteration in the book amounts of the net assets.

Prepare the new capital account and the new balance sheet after T's retirement.

Solution

New Capital Account

		T	K	O
Balance b/f		90,000	50,000	40,000
Revaluation of assets:				
Goodwill	60,000			
Net assets	30,000			
Net assets	90,000	45,000	30,000	15,000
Transfer of T's to K and O	-		90,000	45,000
		135,000	170,000	100,000

	T	K	O
Surplus on revaluation of assets per contra written-off in new profit sharing ratio		60,000	30,000
'K' and 'O' – Balance of T's capital transferred			135,000
Balance c/f	-	110,000	70,000
	135,000	170,000	100,000

TheNewBalanceSheetafterT'sRetirement:

		N	N
Partners' Capital:	K	110,000	
	O	70,000	180,000
Represented by:			
Net assets (excluding goodwill)			180,000

SELF ASSESSMENT EXERCISE 1

1. What alternatives may be taken by a partnership in settlement of a retiring partner?
2. Discuss the revaluation approaches in determining the amount payable to a retiring partner.

3.1.2 Death of a Partner

Usually, a partnership is dissolved at the death of a partner. The surviving partners and the executor of the estate of the deceased partner must negotiate a settlement for the partner's interest in the firm where there are no specific provisions for settlement. Alternatively, and as provided for in the Partnership Act 1890 (Section 42), where any member has died and the surviving partners carry on the business of the firm with its capital without any final settlement of account between the firm and the executors of the dead partner, the executors, in the absence of an agreement, is entitled to 5% interest per annum on the amount of his share of the partnership assets.

Example

O, A and U are partners in business, sharing profits and losses in the ratio of ¼: 1/8: 5/8. The yearly accounts are made up to 30th September. O died on 31st March, 1999, and A and U continued the business without paying out O's share of the partnership's assets or settling accounts with his trustee until 30th September, 1999.

The balance sheet as at 30th September, 1998 showed O's capital to be N16,000. The partners' drawings during the year to 30th September, 1999 were N1,800, N500 and N3,500 for O, A and U respectively. There was no agreement for interest on capital but O and A were each to be credited with a salary of N1,000 per annum. Subject to this charge, the profits for the year ended 30th September, 1999 were N11,600, which may be assumed to have accrued evenly throughout the year.

You are required to: Show the balance of profits and salary due to each partner, and the total amount due by A and U to O's Estate at 30/9/99, assuming that O's trustee does not propose to apply to the court for a share of profits.

O A U Partnership
Profit and Loss Account for the period of six months ended 31/3/1999

Dr.			Cr.		
		N			N
Partners' Salaries			Profit for 6 months to-date		
O:	500		(N11,600 ÷ 2)		5,800
A:	500	1,000			
Balance c/d		4,800			
		5,800		5,800	
Appropriation:			Balance b/d		4,800
O: ¼		1,200			
A: 1/8		600			
U: 5/8		3,000			
		4,800			4,800

A & U Partnership
Profit and Loss Account for the period of six months ended 30/9/1999

Dr.		Cr.	
	N		N A's
salary	500	Profits for 6 months to-date	
Interest: O	398	(N11,600 ÷ 2)	5,800
(5% per annum of N15,900 – Balance of capital account And current account – 16,000 + 1200 + 500 – 1800)			
Balance c/d	4,902		
	5,800		5,800
Appropriation:		Balance b/d	4,902
A: 1/6	817		
U: 5/6	4,085		
	4,902		4,902

Current Account of O

Dr.		Cr.	
	N		N
Drawings	1,800	Salary to Mar 31	500
		Profit	1,200
		Balance to Capital account	100
	1,800		1,800

O's Capital Account

Dr.		Cr.	
	N		N
Current Account	100	Balance c/f	16,000
Balance c/d (total sum due to O's estate)	16,298	Interest for 6 months to 30/9/99	*398*
	16,398		16,398

3.1.2.1 Procedure for Closing Partnership Books

Apart from specific occasions, the following outline is relevant when closing the books of a partnership and when the assets are sold en-bloc:

(i) Open a realisation account, and debit thereto the book value of the assets, crediting the various Assets Accounts. The Realisation account will also be debited with any expenses of realisation, and cash credited.

(ii) Debit cash and credit realisation account with the amount realised on the sale of the assets. Where any of the assets is taken over at a valuation by any of the partners, debit such partners' capital accounts and credit realisation account with the agreed price.

(iii) Pay-off the liabilities, crediting cash and debiting sundry creditors. Any discount allowed by creditors on discharging liabilities should be debited to the creditors accounts and credited to Realisation Account.

(iv) The balance of Realisation Account will be the amount of the profit or loss on realisation, which will be divided between the partners in the proportion in which they share profits and losses, and transferred to their capital accounts.

(v) Pay-off any partners' advances as distinct from capital, first setting-off any debit balance on the capital account of a partner against his loan account.

(vi) The balance of the cash book will now be exactly equal to the balances on the capital accounts, provided they are in credit; credit cash and debit the partners' capital accounts with the amounts paid to them to close their accounts.

In case the capital account of any partner be in debit after being debited with his share of the loss, or credited with his share of the profit on realisation, the cash will be insufficient by the amount of such debit balance to pay the other partners the amount due to them. If the partner whose account is in debit pays to the firm the amount of his indebtedness, the other partners' capital accounts can then be closed by the payment of cash. However, if he is unable to do so, the deficiency must be borne by the solvent partners, in proportion to their capitals and not in the proportion in which they share profits and losses (Refer to the case of Garner Versus Murray).

Example

A, B and C with unequal capitals, share profits and losses equally. They decided to dissolve the partnership, and the Balance Sheet after asset realisation and liabilities discharged is stated as follows:

Balance Sheet of ABC

Dr.	N		N Cr.
Capitals: A	600	Cash	500
B	400	Capital: C – Overdrawn	200
		Deficiency of assets	300
	1,000		1,000

"C" is insolvent, and is unable to contribute to anything towards either his overdraft on capital or his share of the loss on realisation. Close their books.

Solution

The loss on realisation of N300 should first be debited in the profit sharing ratio to the partners' accounts, thus, reducing A's capital to N500 and B's to N300; and increasing C's deficit to N300.

A and B would introduce cash of N100 each to make good their shares of the deficiency, and thus, restore their capitals to N600 respectively. Then, the balances remaining in the books would be as shown by the reconstructed balance sheet below:

Reconstructed Balance Sheet

Dr.	N		N Cr.
Capitals: A	600	Cash	700
B	400	C's Capital overdrawn	300
	1,000		1,000

The only true assets which the cash of N700 represents would be shared between the solvent partners of A and B in proportion to their capitals as follows:

A	-	60% of N700	=	N420
B	-	40% of N700	=	N280

The only balances remaining in the books would be the debt balance on C's capital account of N300 and the credit balances on the capital accounts of A and B – N180 and N120 respectively. As "C" is insolvent, the debt balance on his Account will be written-off against A and B in the ratio of their respective capitals, thus, closing their accounts.

SELF ASSESSMENT EXERCISE 2

Outline the procedure for closing partnership books.

4.0 CONCLUSION

A retiring partner is entitled to have all partnership assets revalued on a proper basis as at the retirement date so as to reveal appreciation or depreciation, which should be taken into account in ascertaining the amount due to him. Depending on the arrangement, his due is either a debt by the firm or by the remaining partners who may continue to carry on the partnership business thereafter.

On the other hand, and in most cases, the death of a partner dissolves the partnership. Where the surviving partners decide to continue in the business after the demise of a partner, the deceased partner's interest in the partnership must be settled appropriately, and the partnership books closed. It is important to be conversant with the outline of the procedure for closing partnership books.

5.0 SUMMARY

In this unit, we have been able to deal with the accounting treatment relative to the withdrawal or death of a partner. We have been able to answer the question as to the methods of repayment of a partner's interests when he withdraws as well as the procedure for closing partnership books at the demise of any of the partners.

6.0 TUTOR-MARKED ASSIGNMENT

1. Explain the contract of substituted liability relative to the withdrawal of a partner.

2. A, B, C were partners sharing profits and losses in the ratio of 3:2:1. 'A' retired from the firm with effect from 31/12/2000, the determined amount of his share being N10,000. It was agreed that this should be commuted by an annuity of N1,500, the first payment to be made on the following day and subsequent payments on 1st January of each year. 'A' died after the receipt of the fifth annuity payment.

   You are required to show the annuity suspense account in the books of the firm, assuming that the amount outstanding is deemed to earn interest at the rate of 6% per annum.

7.0 REFERENCES/FURTHER READINGS

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Larson, K.D. (1989). *Financial Accounting*. Boston: Van Hogmann Press Inc.

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UNIT 5 ACCOUNTS OF NON-PROFIT ORGANISATIONS

CONTENTS

1.0 INTRODUCTION

Accounting, as a tool for measurement and communication, is relevant to both business and non-business situations, to all forms of organisations, whether they exist to make profit or not. So far in this course, we have assumed accounting situations where the primary goal is profit-making.

A non-profit organisation such as a church association, school, social club, sports club or charitable institution is one which is funded by members' subscriptions or donations and such funds are used to achieve the objectives of the organisations. In its book-keeping, although the basic principles appear the same, the kind of final accounts prepared by a non-profit organisation tend to differ from those prepared by a profit-making outfit.

This unit will attempt to explore into the nature of non-profit organisations, their accounting requirements as well as the nature of final accounts prepared by them.

2.0 OBJECTIVES

At the end of this unit, you will be able to:

- explain the characteristics of non-profit organisations
- explain the accounting requirements of clubs and associations
- prepare receipts and payments accounts
- prepare income and expenditure accounts.

3.0 MAIN CONTENT

3.1 Accounts of Non-Profit Organisations

3.1.1 Characteristics of Non-Profit Organisations

It is the nature of non-profit organisations, as their name implies, to carry on their activities without the profit motive. They may trade or carry on any other type of business but with the aim of rendering service at the minimum cost. This suggests that they may charge for the services just to recover costs with little or no surplus. The surplus (not profit) they may make could be regarded as a by-product.

Usually, by way of capital, there is little permanent investment by members. Any permanent fund is usually the outcome of periodic surpluses of receipts over payments or income over expenditure accumulated over a number of years. Non-profit organisations usually have "Accumulated Fund" (as we shall see later) in place of "Capital", and as a result, members have no proprietary right which they may withdraw or transfer upon cessation of membership.

The usual sources of revenue for non-profit concerns are fees, periodic subscriptions and donations. At times, some trading activities may be carried out and a little margin made there from, for example, sale of magazines or journals, sale of food and drinks in a club house, etc. Also, fund-raising activities like exhibitions and variety nights may be organised, from time to time, to get money.

The kind of final accounts prepared by non-profit organisations are either 'Receipts and Payments' accounts or 'Income and Expenditure' accounts.

SELF ASSESSMENT EXERCISE 1

Discuss the features of non-profit organisations.

3.1.2 Clubs and Associations – Accounting Requirements

The final accounts which are presented to members of non-profit organisations usually reports to what extent incomes from all sources were enough to meet the expenses incurred during a particular period. Here, "income" can be viewed or adopted either on cash or accrual basis. When the cash basis is adopted, a receipts and payments account is prepared but if situation warrants adopting the accrual basis, an income and expenditure account is prepared. We shall explain these statements shortly.

A balance sheet, as in the case of profit-making concerns, is also usually prepared which shows the summarised values of assets, liabilities and the accumulated fund being carried forward to the next period.

SELF ASSESSMENT EXERCISE 2

What are the accounting requirements of non-profit organisations?

3.1.3 Receipts and Payments Accounts

Receipts and payments accounts are merely a summary of the cash book for the period. In other words, it is a summary of all the cash transactions carried out during a period. This may be adopted when a very small non-profit concern carries out transactions on cash basis and does not feel the need for more sophisticated information other than merely being interested in assessing the entity's liquidity position.

As a measure of success or otherwise of the activities of the period, the receipts and payments accounts suffer some drawbacks arising mainly from the exclusive reliance on receipts and payments (cash movements) as the evidence that the transaction has taken place. Thus, they do not adequately disclose the results of the organisation's activities during a period because:

- they do not take account of credit transactions – debtors and creditors are not disclosed;
- they fail to make a distinction between capital and revenue items;
- they take no account of accruals and prepayments.

Example

Fitness Sports Club was formally established on 1st January, 2004 and was granted the free use of a clubhouse at Kokoma. The following are its financial transactions for the year ended 31st December, 2004 as recorded in the treasurer's only financial record, the cash book:

Receipts and Payments Account

Dr. **Cr.**

Date	Particulars	Folio	Amount (₦)	Date	Particulars	Folio	Amount (₦)
	Balance b/d		16,500.00		Wages		1,300.00
	Subscriptions		800.00		Equipment		4,000.00
	Admission fees		1,500.00		Wages		1,300.00
	Proceeds from journal sales		2,000.00		Wages		1,200.00
	Subscriptions		4,000.00				
	Donations		2,300.00		Balance c/d		19,300.00
			27,100.00				27,100.00
	Balance b/d		19,300.00				

You are required to prepare a statement of receipts and payments for the year ended 31st December, 2004.

FITNESS SPORTS CLUB STATEMENT OF RECEIPTS AND PAYMENTS FOR THE YEAR ENDED 31ST DECEMBER, 2004

		₦	₦
Balance b/d (opening balance)			16,500.00
Add:	Receipts:		
	Subscriptions	4,800.00	
	Admission fees	1,500.00	
	Sales of journals	2,000.00	
	Donations	2,300.00	10,600.00
			27,100.00
Less:	Payments:		
	Wages	3,800.00	
	Equipment	4,000.00	7,800.00
	Balance c/d (closing balance)		19,300.00

Explanation

The statement is prepared on a cash flow basis and reflects only the receipts and payments of cash.

No cognisance is taken of the fact that income and expenditure of a capital nature, such as the purchase of equipment, has taken place.

No cognisance is taken of items such as subscriptions which may be in arrears or prepaid.

SELF ASSESSMENT EXERCISE 3

Discuss the disadvantages inherent in adopting the receipts and payments accounts as a measure of the performance of non-profit organisations' activities during a period.

3.1.4 Income and Expenditure Accounts

The limitations of the receipts and payments accounts make it necessary for many non-profit organisations to present reports which are prepared on the accrual basis and in accordance with the principles of double entry. Income is recognised once it is realised whether or not proceeds have actually been received. In like manner, all costs would be taken into account once they have been incurred whether or not they have actually been paid. In effect, income and expenditure accounts have to be prepared on the basis of systematic standard procedures of book-keeping. The income concept, as disclosed by the income and expenditure account, is much more accurate than that disclosed by the receipts and payments account. Note that income and expenditure account, and the profit and loss account are the same in form and structure, but differ conceptually, for example:

> In the income and expenditure account, revenue refers to fees, subscriptions, donations received as against "Sales" in the profit and loss account.
>
> The difference between revenue and expenditure is known as "surplus" or "deficit" as against "profit" or "loss".

Example

Assume that in addition to the transactions recorded in the receipts and payments of Fitness Sports Club in 3.3 above, the following information is made available by the Treasurer:

(i) On 1st January, 2004, the club had the following assets:

	Bank Balance	N16,500.00
	Equipment at carrying value	6,000.00
(ii)	The register of club members shows:	
	Membership at 1st January, 2004	20
	Joined during the year	5
	Membership at 31st December, 2004	25

Club members each pay an annual subscription of N300.00 and new members pay an additional admission fee of N300.00. At 31st December, 2004, one member had already paid his subscription for the year to 31st December, 2005. It is not the club's practice to treat admission fees as income but as a contribution towards accumulated funds.

(iii) At the end of each year, 20% of the carrying value of equipment is to be treated as depreciation.

(iv) The Editor/Marketer of the journal provided documentation indicating that N6,100.00 had been raised and that expenses had totalled N4,100.00.

You are required to:

Prepare a statement of income and expenditure for the year ended 31st December, 2004, and a balance sheet as at that date.

Solution

FITNESS SPORTS CLUB STATEMENT OF INCOME AND EXPENDITURE FOR THE YEAR ENDED 31ST DECEMBER, 2004

		₦	₦
	Income:		
	Subscriptions (25 x N300)	7,500.00	
	Sales of journals	6,100.00	
	Donations	2,300.00	15,900.00
Less:	Expenses:		
	Journal expenses	4,100.00	
	Wages	3,800.00	
	Depreciation (20% of N10,000)	2,000.00	9,900.00
	Surplus of income over expenditure		6,000.00

FITNESS SPORTS CLUB
BALANCE SHEET AS AT 31ST DECEMBER, 2004

		₦	₦
ASSET:			
Fixed Assets:			
Equipment at cost less depreciation (10,000 – 2,000)			8,000.00
Current Assets:			
Subscriptions in arrears		3,000.00	
Cash at bank		19,300.00	22,300.00
Total Assets			30,300.00
EQUITY AND LIABILITIES:			
Accumulated Funds:			
Balance beginning of year (16,500 + 6,000)		22,500.00	
Add:	Surplus	6,000.00	
	Admission fees (5 x 300)	1,500.00	30,000.00
Current Liabilities:			
Subscriptions in advance			300.00
Total Equity and Liabilities			30,300.00

Explanation:

The opening accumulated fund of N22,500.00 is the bank balance (16,500) plus the equipment (N6,000) as these were the only assets on hand on 1st January.

The adjustments for subscriptions (nominal account) and depreciation were made.

SELF ASSESSMENT EXERCISE 4

Distinguish between Receipts and Payments account and Income and Expenditure account relative to non-profit organisations.

4.0 CONCLUSION

May we wish to conclude that non-profit organisations, as the name suggests, exist not for profit-making but to achieve the objectives for which they are established. They could be churches, sports clubs, charitable organisations, etc. What appears to be ‘profit’ at the end of their accounting period is regarded as ‘surplus’ which results from receipts in excess of payments. Between the profit-making and non-profit organisations, although they adopt similar basic principles of book-keeping, they prepare different final accounts. Non-profit organisations prepare receipts and payments account or income and expenditure account instead of profit and loss account. Also, they have "accumulated fund" in place of "capital" in the balance sheet.

Receipts and payments accounts are not actually accounts but summary statements – summarise all cash transactions carried out during the period. Their major limitation lies their being prepared on cash basis hence they do not adequately disclose the organisation's results at the end of the period.

On the other hand, the income and expenditure accounts are prepared on accrual basis and according to the principles of double entry. Therefore, cognisance is taken of credit transactions (debtors and creditors), accruals and prepayments as well as the distinction between capital and revenue items.

5.0 SUMMARY

In this unit, you have been exposed to the nature of non-profit organisations and their accounting requirements. We have also considered the preparation of their final accounts – receipts and payments accounts, income and expenditure accounts, and the balance sheet. However, because of the limitations of the receipts and payments accounts, income and expenditure accounts are preferred.

6.0 TUTOR-MARKED ASSIGNMENT

The treasurer of the Inland Football Club gives you the following summary of his cash book for the year ended 30 June, 1997:

	N		N
Balance at commencement of Year		Salaries and wages	19,600
At bank	6,000	Rent and rates	3,800
In hand	1,000	Printing and stationery	1,800
Subscriptions:		Affiliation fees	1,200
Supporters	15,000	Captain's and treasurer's exps.	3,700
Supporters – 1998 season	2,000	Refreshments for visiting teams	6,100
Share of gate takings	32,000	Annual social fund	10,200
Annual social	13,400	Equipment purchased	2,600
		Balances at close of year:	
		At bank	19,900
		In hand	800
	69,700		69,700

The Secretary also gives you the following information:

	30 June 1996	30 June 1997
Amounts due to the club: Supporters' subscriptions	1,400	1,200
Share of gate takings	7,800	5,300
Re: Annual social fund (deficit)	600	-
Amounts owing by the club:		
Rent and rates	1,200	1,400
Printing	-	300
Treasurer's expenses	400	800
Refreshments	1,300	1,200

On 30 June, 1996, the club's equipment appeared in the books at N15,000. It is desired that 20 per cent be written off the book value of the equipment as it appears on 30 June, 1997.

You are required to:
Prepare the income and expenditure account showing the result for the year ended 30 June, 1997, and the balance sheet as at that date.

7.0 REFERENCES/FURTHER READINGS

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MODULE 3

UNIT 1 MANUFACTURING ACCOUNTS

CONTENTS

1.0 INTRODUCTION

The final accounts prepared in the previous units have been those for firms that engage in trading activities (buying and selling) or those for the non-profit organisations and profit-oriented firms as well, whose functions are limited to rendering services. The goods (merchandise) are valued at the actual cost to the firm, usually obtained from the supplier's invoice. However, there are firms whose main activity is in the manufacture of goods for sale. For these concerns, in addition to the trading and profit and loss account, a manufacturing account is prepared.

The manufacturing firm transforms basic raw materials into marketable goods, and during the manufacturing process, costs are incurred in order to complete the products. These end products are valued at cost to the firm, usually the aggregate of the manufacturing costs. Obviously, at the end of the accounting period, stock or inventory in this kind of concern will be at various stages of completion since manufacturing is a continuous process. Three stages of completion can be identified:

Raw materials (unprocessed and uncompleted stock)
Work-in-progress (partly – completed stock)
Finished goods (completed stock)

The main difference between the trading and profit and loss account of a manufacturing business and a trading firm is the ascertainment of cost of goods manufactured as against the cost of goods purchased for reselling.

In this unit therefore, we shall highlight the objectives of a manufacturing account. We shall also classify the manufacturing costs and draw a line of division between them and the non-manufacturing costs. In addition, we shall discuss the valuation of closing stock/ work-in-progress in accordance with the basic principles. Lastly, we shall look into the matter of ascertaining profit or loss on manufacture to determine the relative advantage of manufacturing instead of buying the goods for resale.

2.0 OBJECTIVES

At the end of this unit, you will be able to:

- explain the objectives of a manufacturing account
- discuss the classification of manufacturing costs
- distinguish between manufacturing costs and non-manufacturing costs
- explain the valuation of closing stock relative to manufacturing concerns
- ascertain the profit or loss on manufacture
- prepare a manufacturing account.

3.0 MAIN CONTENT

3.1 Manufacturing Accounts

3.1.1 Objectives of a Manufacturing Account

When a firm engages in manufacture, there arises the need to ascertain the cost of manufacture as a basis for fixing the eventual selling price. This need is met by the manufacturing account, which is prepared in such situation in addition to the normal trading and profit and loss accounts. Therefore the aims of the manufacturing account are:

- to disclose the total cost of manufacture;
- to enable the firm to determine the relative efficiency of its manufacturing activity separate from its trading activities. This is achieved by computing the profit or loss arising from manufacture on one hand as distinct from its selling operations.

SELF ASSESSMENT EXERCISE 1

Explain the objectives of a manufacturing account.

3.1.2 Classification of Manufacturing Costs

There is an obvious link with the costing records because the costs in the manufacturing account are involved with production, and the concepts of the manufacturing account are in fact really costing concepts. Therefore, we shall examine the main elements and divisions of cost as used in costing.

Manufacturing (or production) costs are the costs incurred by a manufacturer in the process of transforming raw materials into finished products, which should be distinguished from non-manufacturing costs such as administrative and selling/distribution expenses.

The classification can be done as follows:

Direct or Prime Cost

- Direct materials
- Direct labour
- Direct expenses

Indirect or Factory/Works Overhead Expenses

By "direct" is meant that the materials, labour and expenses involved can be traced to the particular unit of goods produced. Factory overhead expenses consist of all those expenses which are not easily traceable to the units being manufactured. Examples include wages of cleaners and crane drivers, rent and rates of the factory, depreciation of plant and machinery used in the factory and factory power. To summarise, therefore, direct costs and factory overhead make up the manufacturing or production cost.

However, to ascertain the total costs, which guide in fixing the relevant selling price, the non-manufacturing costs of administrative and selling/ distribution expenses, are added to the manufacturing costs.

Administrative expenses include such items as manager's salaries, legal and accounting charges, the depreciation of accountancy machinery and secretarial salaries.

Selling and distribution expenses are items such as salesmen's salaries and commission, carriage outwards, depreciation of delivery vans, advertising and display expenses.

In the manufacturing account, the manufacturing cost of goods completed during the accounting period is ascertained. This means that all the elements of the production cost – direct materials, direct labour, direct expenses and factory overhead expenses – are charged to the manufacturing account. All administrative and selling and distribution expenses are charged to the profit and loss account. You are to note that the manufacturing account is concerned with the production cost of goods completed in the year irrespective of when work started on them. Therefore, semi-finished goods (work-in-progress) must be taken into account.

SELF ASSESSMENT EXERCISE 2

1. Attempt a classification of the production costs with examples.
2. Distinguish between manufacturing and non-manufacturing costs.

3.1.3 Valuation of Closing Stock

The inventory of a manufacturing concern may comprise raw materials, work-in-progress and finished goods at any one time. It is often necessary to ascertain accurately the cost at which work-in-progress is carried over from one period to another.

The basic principle followed in valuing stock is to relate to each type of stock a proportion of the total cost incurred up to the level where the stock accrues. Thus:

raw materials are valued at the cost of purchase (if lower than current market price);
finished goods are valued as a proportion of the total cost of production;
semi-finished goods (work-in-progress) are valued at prime cost only (although debate had it that it might have been more accurate to attribute to them a proportion of factory overhead once they have received some benefits from these indirect costs).

At this juncture, let us illustrate the preparation of a manufacturing, trading and profit and loss account.

Example

The following are extracted from the trial balance of TEKI LTD, a manufacturing outfit, in respect of the year ended 30th September, 1993:

	₦
Opening stock:	
Raw material	12,500
Work-in-progress	8,600
Finished goods	14,800
Purchase of raw materials	68,200
Carriage inwards	3,410
Factory wages	18,390
Rent of factory	4,800
Factory general expenses	8,360
Salaries of factory supervisors	8,740
Salaries of salesmen and office staff	22,570
Rent of office	5,400
Insurance of factory equipment	2,840
Bad debts	960
Office general expenses	12,930
Depreciation:	
Factory equipment	16,280
Office and distribution equipment	14,880
Sales less returns	215,000
Power and lighting (factory)	5,610
Power and lighting (general)	3,200

Closing stocks were valued at the following amounts at year end:

Raw materials	14,480
Work-in-progress	10,250
Finished goods	18,390

Work-in-progress is normally valued in this firm at prime cost plus a portion of factory overheads.

You are required to prepare the manufacturing, trading, and profit and loss accounts as at end of year.

Solution

TEKI LTD.
MANUFACTURING, TRADING AND PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 30TH SEPTEMBER, 1993

		N	N
Raw materials:			
	Opening stock	12,500	
	Purchases	68,200	
	Carriage inwards	3,410	
		84,110	
Less:	Closing stock	14,480	
Cost of materials consumed		69,630	
	Direct Wages	18,390	
PRIME COST			88,020
Add:	Factory overheads		
	Rent on factory	4,800	
	Supervisors' salaries	8,740	
	Insurance of equipment	2,840	
	Power and lighting	5,610	
	Factory general expenses	8,360	
	Depreciation of equipment	16,280	46,630
COST OF PRODUCTION			134,650
Add:	Opening work-in-progress		8,600
Less:	Closing work-in-progress		10,250
COST OF GOODS COMPLETED			133,000
Sales			215,000
Finished goods:			
	Opening stock	14,800	
	Cost of goods completed	133,000	
	Less closing stock	18,390	
	Cost of Goods Sold		129,410
GROSS PROFIT			85,590
Less:	Administrative, Selling and Distribution Expenses		
	Office and salesmen's salaries	22,570	
	Rent on office space	5,400	
	Power and lighting	3,200	
	Office general expenses	12,930	
	Bad debts	960	
	Depreciation	14,880	59,940
NET PROFIT			N25,650

SELF ASSESSMENT EXERCISE 3

Explain the basic principle in valuing closing stock, and how each type of closing stock in a manufacturing concern should be valued.

3.1.4 Ascertainment of Profit or Loss on Manufacture

In the last example, we disclosed a composite gross profit of N85,590, which represents what was realised from both manufacturing and selling operations. When we desire to ascertain the relative advantage of manufacturing instead of buying the goods for resale, the manufacturing account will have to be restructured so as to disclose separately the gross profit or loss accruing from manufacturing as well as trading operations. The profit or loss on manufacture is ascertained on the basis of the opportunity cost principle, that is, by referring to what the firm would have spent in purchasing instead of manufacturing the goods. Thus, if the total purchase value is more than the cost of manufacture, a gross profit on manufacture has resulted.

On the other hand, a loss will arise if the manufacturing cost exceeds purchase cost. Therefore, it requires that finished goods are taken out of the factory at the estimated market value (purchase cost) instead of the actual cost of production. Thus, the estimated market value is credited to the manufacturing account and debited to the trading account. A credit balance represents a gross profit on manufacturing while a debit balance represents a loss. The difference is then transferred to the profit and loss account as appropriate.

Example

Let us assume the same data as in the previous example. Let us also assume that the firm likes to ascertain the relative efficiency of its manufacturing operations, and estimates that had it not manufactured the goods, it would have purchased the total volume which it finished during the period at a cost of N150,000.00.

We are required to prepare the manufacturing, trading and profit and loss accounts of TEKI LTD, showing separately, the profit or loss on manufacturing as against selling operations.

Solution

TEKI LTD.
MANUFACTURING, TRADING AND PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 30TH SEPTEMBER, 1993

	N	N	N
Estimated market value of finished goods			150,000
Raw materials:			
Opening stock	12,500		
Purchases	68,200		
Carriage inwards	3,410		
	84,110		
Less: Closing stock	14,480		
Cost of materials consumed	69,630		
Direct Wages	18,390		
PRIME COST		88,020	
Add: Factory overheads			
Rent on factory	4,800		
Supervisors' salaries	8,740		
Insurance of equipment	2,840		
Power and lighting	5,610		
Factory general expenses	8,360		
Depreciation of equipment	16,280	46,630	
COST OF PRODUCTION		134,650	
Add: Opening work-in-progress		8,600	
Less: Closing work-in-progress		10,250	
COST OF GOODS COMPLETED			133,000
Profit on Manufacturing			17,000
Sales		215,000	
Finished goods:			
Opening stock	14,800		
Market value of finished goods	150,000		
Less closing stock	18,390	146,410	
GROSS PROFIT		68,590	

Less:	Administrative, Selling and Distribution Expenses		
	Office and salesmen's salaries	22,570	
	Rent on office space	5,400	
	Power and lighting	3,200	
	Office general expenses	12,930	
	Bad debts	960	
	Depreciation	14,880	59,940
Net Profit			8,650
Add Profit on Manufacture			17,000
NET PROFIT			N25,650

SELF ASSESSMENT EXERCISE 4

1. How do you ascertain the profit or loss on manufacture?
2. On what basis is the profit or loss on manufacture ascertained? Explain the basis.

4.0 CONCLUSION

Apart from the trading and profit and loss account, a manufacturing account is prepared for concerns whose main activity is in the manufacture of goods for sale. The goods, because costs are incurred during the manufacturing process, are valued at costs to the firm. The major distinguishing factor between the trading, profit and loss accounts of a manufacturing business and those of a trading firm lies in the ascertainment of cost of goods manufactured as against the cost of goods purchased for resale.

The manufacturing account, thus, aims at disclosing the total cost of manufacture as well as enabling the firm to determine the relative efficiency of manufacturing in place of buying of goods for resale.

5.0 SUMMARY

The manufacturing firm transforms raw materials into finished goods for sale. Costs are incurred, during the manufacturing process, in order to complete the products. A manufacturing account is prepared for a manufacturing company.

In this unit, we have been able to highlight the objectives of a manufacturing account. We have also classified the manufacturing costs, and distinguished between them (manufacturing costs) and the non-manufacturing costs such as administrative, selling and distribution costs. We discussed, in addition, the valuation of the closing stock of a manufacturing concern, emphasising the principle that relates to each type of inventory, a proportion of the total cost incurred up to the level where the stock accrues.

Finally, we discussed the ascertainment of profit or loss on manufacture relative to purchase of finished goods for resale, using the principle of opportunity cost by considering what the firm would have spent in purchasing in place of manufacturing the goods.

6.0 TUTOR-MARKED ASSIGNMENT

The following is the trial balance of DEDE Manufacturing Ltd. for the year ended 30th September, 2005:

		Dr.	Cr.
		N	N
Bank		31,000	
Debtors		79,000	
Prepaid expenses		1,000	
Inventory at 1/10/2004:			
Raw materials		20,000	
Work-in-progress		42,000	
Finished goods		28,000	
Fixed assets		350,000	
Creditors			35,000
Long term loan			100,000
Share capital			300,000
Accumulated profits, 1/10/2004			55,000
Sales			900,000
Materials purchases:	Direct	240,000	
	Indirect	5,000	
Labour:	Direct	190,000	
	Indirect	33,000	
Other manufacturing overheads		120,000	
Selling expenses		100,000	
Administrative expenses		90,000	
Interest paid		10,000	
Income tax expense		50,000	
Bad debts		1,000	
		1,390,000	1,390,000

The closing inventory balances are:

Raw materials	19,000
Work-in-progress	40,000
Finished goods	30,000

You are required to prepare for DEDE Manufacturing Ltd for the year ended 30th September, 2005:

(i) the manufacturing account;
(ii) the trading and profit and loss account; and
(iii) the balance sheet.

7.0 REFERENCES/FURTHER READINGS

Anao, A.R. (1993). *An Introduction to Financial Accounting*. Ibadan: Longman Nigeria Limited.

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UNIT 2 CONTROL ACCOUNTS

Contents

1.0 INTRODUCTION

The whole process of book-keeping revolves around the idea that the records "balance", that is, every transaction has a credit and a debit, and the total of the debits equals the total of the credits. In other words, if there are no errors in the records, the trial balance will balance.

When a trial balance does not balance, it shows that errors have been made in the accounting entries which may be difficult and time-consuming to trace, especially in a large business organisation. The problem of errors can be solved by having a control account for each ledger that shall act as a check on the accuracy of the entries in that ledger. Most notably of control accounts are the debtors and creditors control accounts. These are ledger accounts which summarise a large number of transactions, and should be free from errors if the trial balance must agree. Sometimes, a ledger that has a control account is referred to as a self-balancing ledger.

In this unit, therefore, apart from looking at the meaning of control account, we shall consider how control accounts are written-up. Also, we shall explain what advantages control accounts have. And lastly, we shall go into the treatment of certain items in the control account.

2.0 OBJECTIVES

At the end of this unit, you will be able to:

- explain the meaning of control accounts
- discuss how control accounts are written-up
- explain the advantages of control accounts
- give accounting treatment to certain items in the control accounts.

3.0 Main Content

3.1 Control Accounts

3.1.1 Meaning of Control Accounts

A control account is an account which contains the summary of entries in the individual accounts in each ledger. Put in another way, a control or total account is a replica, in summarised form, of the accounts in the ledger to which it relates. By logic of extension, therefore, the balance on this account, all things being equal, will be equal to the total of all individual balances in the ledger. The principle of control accounts can be applied to all ledgers but it is usually restricted to sales ledger and purchases ledger.

SELF ASSESSMENT EXERCISE 1

What do you understand by a control account?

3.1.2 Writing Control Accounts

From the explanation above, we understand that a control account contains the summary of entries in individual accounts. However, the figures posted to the control account are not obtained from the individual accounts themselves. For example, the figures posted to the debtors' control account are not obtained from the individual debtors' accounts while the figures posted to the creditors' control account are not obtained from the individual creditors' accounts.

Instead, the total credit sales, total returns from customers, and total discounts allowed figures posted to the debtors' control account are obtained from the sales day book, returns inwards day book and discount allowed column of the 3 – column cash book respectively. Similarly, the total credit purchases, total returns to suppliers and total discount received figures posted to the creditors' control account are obtained from the purchases day book, returns outwards day book and the discounts received day book of the 3 – column cash book respectively.

It has to be mentioned that the control accounts are memoranda records which implies that the entries in them are not made on the basis of double entry. The double-entries are the ones made in the individual accounts.

At this point, let us summarise the sources of the entries posted to the control accounts:

DEBTORS' CONTROL ACCOUNT

<u>DebitEntries</u>	<u>Source</u>
Total credit sales	Sales day book
Dishonoured cheques from customers	Cash book
Interest charged to customers	Journal book
Bill receivable dishonoured	Journal book

<u>CreditEntries</u>	<u>Source</u> Cheques
and cash received from customers	Cash book
Discount allowed	Discount allowed column of 3 column-cash book
Bad debt	Journal book
Bills receivable accepted by customers	Journal book
Returns inwards	Returns inwards day book
Purchases ledger contras (set-off)	Journal book

CREDITORS' CONTROL ACCOUNT

<u>DebitEntries</u>	<u>Source</u>
Cheques and cash paid to suppliers	Cash book
Discount received	Discount received column of cash book
Bills payable accepted in favour of suppliers	Journal book
Returns outwards	Returns outwards day book
Sales ledger contras (set-off)	Journal book

<u>CreditEntries</u>	<u>Source</u>
Total credit purchases	Purchases day book
Dishonoured cheques	Cash book
Interest charged by suppliers	Journal book
Bills payable dishonoured	Journal book

SELF ASSESSMENT EXERCISE 2

Discuss how control accounts are written-up. Give specific examples of entries and sources.

3.1.3 Advantages of Control Accounts

From our discussions so far, let us highlight the merits of control accounts as follows:

1. A control account serves as a check on the accuracy of the entries in the ledger to which it relates. Thus, control accounts make it possible to localise errors to specific ledgers so that precious time is not wasted checking ledgers which have no errors.

2. Because control accounts are usually put under the charge of a senior official, they serve as a check against error and fraud by the juniors who keep the ledgers.

3. For management purposes, the balance on the sales ledger control account can be taken to be the total amount owed to creditors. This saves the time and efforts of drawing up the debtors' and creditors' schedules, thereby, aid the timely preparation of draft periodic accounts.

SELF ASSESSMENT EXERCISE 3

Discuss the advantages of control accounts.

3.1.4 Accounting treatment of certain items in Control Accounts

4. Debtors' Control Account

a. Bills receivable – where bills receivable and bills receivable accepted are both given, the later should be used because the obligation of the debtor on a bill arises only when he accepts the bill. However, when only bills receivable is given, it should be interpreted to mean bills receivable accepted.

b. Bills receivable discounted should be disregarded. When a bill is discounted, no entry goes to the debtors' account, and invariably, no entry in respect of that would go to the debtors' control account.
c. Bills receivable honoured should be disregarded. When a debtor honours a bill receivable, no entry is made to the

debtors' account, and therefore, no entry need be made to the debtors' control account.

d. Bad debt recovered should be ignored unless it had earlier been credited to the debtors' control account along with the other sums collected from debtors. In that case, it should be debited to the debtors' control account.

e. Provision for bad/doubtful debt and discount allowable should be disregarded because they do not affect the debtors' account at all. Therefore, no entry need be made to the debtors' control account in respect of these provisions.

f. Cash sales should be disregarded. The entry for cash sale is to debit the cash book and credit the sales account. Since no entry is made to the customer's account, it would not be necessary to make any entry to the debtors' control account in respect of cash sales.

5. Creditors' Control Account

a. Where "bills payable" and "bills payable accepted" are both given, the latter should be used because the right of the creditor on a bill arises only when the debtor accepts the bill. However, where only "bills payable" is given, it should be interpreted to mean "bills payable accepted".

b. Bills payable honoured should be ignored because when a bill payable is honoured, no entry is made to the creditors' account and, of course, no entry need be made to the creditors' control account.

c. Provision for discount receivable should be disregarded because it does not affect the creditors' control account.

d. Cash purchases should be disregarded because the related entries have nothing to do with either the creditors' account or the creditors' control account.

Example

Maduako, a sole trader, keeps his books so that a sales ledger control account and a purchases ledger control account are shown in his general ledger and balanced at the end of the month. From the following details, show how these two control accounts will appear in the general ledger for the month of December, 1997.

At December, 1997:	N
Dr. Balances in the sales ledger	13,500
Dr. Balances in the purchases ledger	415
Cr. Balances in the sales ledger	300
Cr. Balances in the purchases ledger	12,000

For the month of December, 1997:

-	Total credit purchases	17,500
-	Total credit sales	20,000
-	Sales returns and allowances	360
-	Purchase returns and allowances	200
-	Cash received from trade debtors	7,500
-	Cheques received from trade debtors	15,000
-	Discounts received from creditors	120
-	Payments made to trade creditors	16,400
-	Discounts allowed to trade debtors	360
-	Bad debts written-off	50
-	Provision for doubtful debts	200
-	Bills of exchange accepted by trade debtors of Maduako	4,300
-	Sales ledger credit balances transferred to Purchases ledger	80
-	Cash purchases	3,000
-	Dishonoured bills payable	130
-	Dishonoured bills receivable	150
-	Cr. Balances in the sales ledger	195
-	Dr. Balances in the purchases ledger	180

Solution

Sales Ledger Control Account

Dr.	N		Cr. N
Balance b/d	13,500	Balance b/d	300
Sales	20,000	Sales returns and allowances	360
Purchases ledger control	80	Cash	7,500
Bills receivable dishonoured	150	Bank	15,000
Balance c/d	195	Discounts allowed	360
		Bad debts	50
		Bills receivable	4,300
		Balance c/d	6,055
	33,925		33,925
Balance b/d	6,055	Balance b/d	195

Purchases Ledger Control Account

Dr.	N		Cr. N
Balance b/d	415	Balance b/d	12,000
Purchases returns and alls	200	Purchases	17,500
Discount received	120	Sales ledger control	80
Bank	16,400	Bills payable dishonoured	130
Bills payable	6,600	Balance c/d	180
Balance c/d	6,155		
	29,890		29,890
Balance b/d	180	Balance b/d	6.155

SELF ASSESSMENT EXERCISE 4

Explain the accounting treatment of the following items in the control accounts:

Bills receivable discounted
Bills receivable honoured
Cash sales
Bills payable accepted
Provision for discount receivable
Cash purchases
Total credit sales
Provision for doubtful debts
Discounts received from creditors

4.0 CONCLUSION

Having a control account for each ledger that act as a check on the accuracy of the entries in that ledger is a sure way to solve problems which arise from wrong entries. The notable control accounts are the debtors and creditors control accounts. A control account has the advantage of serving as a check on the accuracy of the entries in the ledger to which it relates.

5.0 SUMMARY

We have seen the control (or total) account as one which contains the summary of entries in the individual accounts in each ledger. We have also observed that the figures posted to the control accounts are not obtained from the individual accounts themselves.

Mention was made that the control accounts are memoranda records which means that the entries in them are not made on the double-entry principle. We have also considered the various advantages which control accounts can offer as well as the accounting treatment given to certain items in the control accounts.

6.0 TUTOR-MARKED ASSIGNMENT

1. (a) Explain the concept of control account.
   (b) What advantages do control accounts offer?

2. Enter the following amounts in the purchases ledger control and sales ledger control accounts in the general ledger, and obtain balances at the end of the period:

		₦
1st Jan.	Purchases ledger control balances	8,650
	Sales ledger control balances	12,390
	Summary of transactions during the period:	
	Purchases journal total	43,270
	Sales journal total	72,680
	Sales returns journal total	1,460
	Purchases returns journal total	1,320
	Cash rebate given	240
	Cash and cheques received from debtors	69,350
	Cash and cheques paid to creditors	45,190
	Discounts allowed	150
	Discounts received	170
	Bad debts written-off	490
	Dishonoured cheque received	2,300

7.0 REFERENCES/FURTHER READINGS

ACCA (2003). *Preparing Financial Statements.* Middlesex: A.T. Foulks Lynch Ltd.

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Igben, R.O. (2004). *Financial Accounting Made Simple (Volume 1)* Lagos: ROI Publishers.

UNIT 3 FUNDS FLOW STATEMENT

CONTENTS

1.0 INTRODUCTION

In our earlier discussions on the "Financial Statements", we concluded that while the Profit and Loss account measures the flow of value in and out of the business highlighting the net profit or loss, the balance sheet gives a static picture of the supposed financial position of the company. None of these two statements deals with liquidity, that is, the ability of the firm to meet its maturing obligations.

The Profit and Loss Account cannot measure this because it is prepared on accrual basis. Therefore, the net 'profit' or 'loss' cannot be equated with the extent of growth or decline in the cash or even working capital position. To address this mater of liquidity, the "Funds Flow Statement" or "The Statement of Sources and Application of Funds" is usually prepared. This will be the focus of this unit – the concept of funds, relevance of funds flow statement, flow of funds in a business, preparing a funds flow statement.

2.0 OBJECTIVES

At the end of this unit, you will be able to:

- explain the concept of funds
- discuss the relevance of funds flow statement
- explain the flow of funds in a business
- prepare a funds flow statement.

3.0 MAIN CONTENT

3.1 Funds Flow Statement

3.1.1 The Concept of Funds

The term “funds” may be defined as the financial resources possessed by a firm and which flows from transactions concluded with third parties. Therefore, “funds” may be identified as the total value that is available to an entity for the pursuit of its objectives.

Funds are represented by cash in the most liquid form, but since all other forms of assets have the ultimate possibility of being converted into cash, they represent part of the total funds of the business. The total funds of a business firm are, therefore, the total value of the assets employed by the firm.

However, in the measurement of liquidity, interest would be in the more liquid forms of fund like cash or near cash, current assets (or working capital).

3.1.2 Relevance of Funds Flow Statement

The funds flow statement is a requirement of the Companies and Allied Matters Decree of 1990. It attempts to show how the funds available to the firm has been managed during the outgoing period, what new funds were generated and how these funds were, together with the existing ones, utilised (Sources and Applications).

The statement supplies the users of financial statements with useful and relevant information. For example, answers to the following questions may be obtained from this statement:

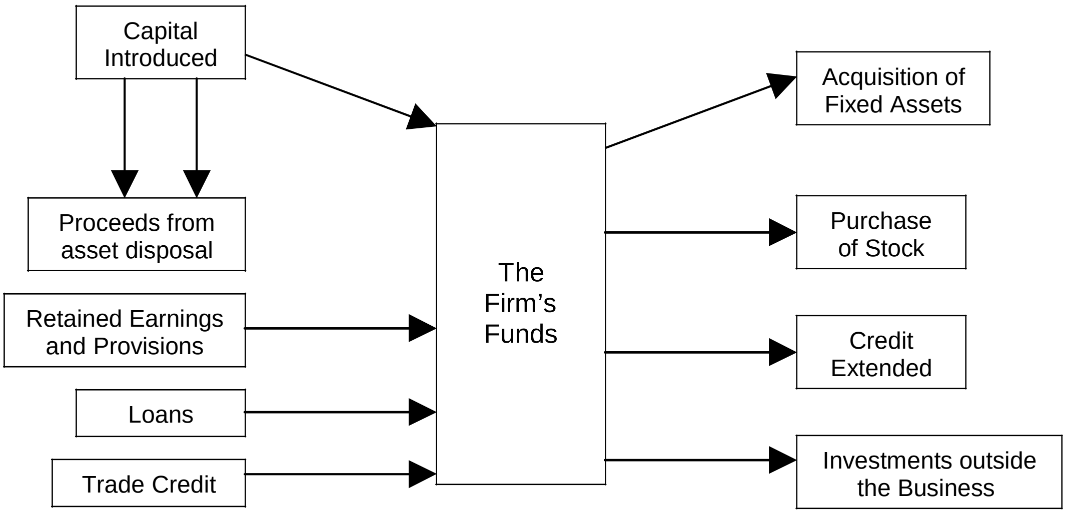
- Was sufficient cash generated from operations to pay the interest charges, dividend and taxation?
- How was expansion funded?
- Is the company a net generator or user of cash?
- Does the company generate sufficient cash from its operations to maintain its present operating capacity?

SELF ASSESSMENT EXERCISE 1

Assess the relevance of the funds flow statement.

3.1.3 Flow of Funds in a Business

A business operation comprises a continuous flow of funds in and out of the firm. At the start, funds are received from the owners of business and long-term creditors such as debentures or loan stock holders. Funds flow out when fixed assets are acquired. Subsequently, funds flow in and out of the firm as it buys and sells its wares. The following figure shows sources and application of business funds:



SOURCESANDAPPLICATIONOFBUSINESSFUNDS

3.1.4 Preparing a Funds Flow Statement

Interest in liquidity is because of the importance of cash for the continued existence of the business organisation (solvency). A certain minimum amount of cash is required for the continued operation of the business and for meeting the normal obligations as well as extraordinary items as they fall due.

Basically, there are two ways of preparing a funds flow statement:

- Cash basis (funds in the most liquid state)
- Working capital basis (cash plus all near-liquid assets)

Whichever basis is adopted, however, the basic structure of the report is the same. The approach is to take the balance sheets prepared as at two dates and determine, by comparing the individual items appearing therein, which items have generated funds and which have applied funds. The sources and applications would then be summed separately, the difference in the totals would represent the "net change" in the cash or working capital position.

The basic principle for determining sources and application of funds from two balance sheets can be stated as follows:

an increase in an asset is an application while a decrease is a source;
an increase in a liability is a source while a decrease is an application.

The usual "sources" and "applications" may be summarized:

S/N	Sources	S/N	Applications
1.	Profit for the year	1.	Acquisition of fixed assets
2.	Depreciation and other write-offs not associated with immediate cash outlay	2.	New investments outside the business
3.	Increase in liabilities	3.	Increase in assets
4.	Decrease in fixed assets	4.	Decrease in liabilities
5.	New capital injections	5.	Redemption of capital

An Example

Boyus Company Ltd.
Balance Sheet as at 31 December, 2006

	2005	**2006**		**2005**	**2006**
Equity			**Fixed Assets** (net)		
Issued capital	200,000	300,000	Land & Building	60,000	83,000
Capital reserve	-	23,000	Plant & Machinery	160,000	240,000
General reserve	50,000	60,000	Motor Vehicles	40,000	40,000
Profit and Loss	18,000	42,000		268,000	425,000
				260,000	363,000
10% Mortgage loan	100,000	80,000			
Current Liabilities			**Current Assets**		
Creditors	60,000	45,000	Work-in-progress	46,000	67,000
Bank overdraft	26,000	52,000	Stock	70,000	90,000
Dividend payable	20,000	30,000	Debtors	80,000	110,000
Taxation	12,000	18,000	Bank cash	30,000	20,000
	118,000	145,000		226,000	287,000
	486,000	**650,000**		**486,000**	**650,000**

Other information

1. The net profit for the year amounting to ₦82,000 was appropriated as follows:

	₦
Transfer to general reserve	10,000
Provision for the year's taxation	18,000
Provision for the year's dividend	30,000
Retained	24,000
	82,000

2. The taxation and dividend provisions brought forward from 2005 were paid during the year.
3. Additional capital of ₦100,000 was obtained during the year by the issue of new shares.
4. Land and buildings were revalued during the year and this resulted in a surplus of ₦23,000 which was taken to capital reserves.
5. The increase in plant and machinery during the year resulted as follows – depreciation ₦20,000, additions ₦100,000.
6. Motor vehicles amounting to ₦10,000 at net book value were sold during the year for the same amount. Depreciation amounting to ₦10,000 was also written off.

Prepare a funds flow statement for 2006 on cash basis.

Solution:

Boyus Company Ltd.
Balance Sheet as at 31 December, 2006

	2005	**2006**	**Sources**	**Applications**	
	₦	₦	₦	₦	
Fixed Assets:					
Lands and buildings	60,000	83,000		23,000	
Plant and machinery	160,000	240,000		80,000	
Motor vehicles	40,000	40,000		-	
Current Assets:					
Work in progress	46,000	67,000		21,000	
Stock	70,000	90,000		20,000	
Debtors	80,000	110,000		30,000	
Bank cash	30,000	20,000	10,000		
Total Assets	**486,000**	**650,000**			
Equity:					
Issued share capital	200,000	300,000	100,000		
Capital reserve	-	23,000	23,000		
General reserve	50,000	60,000	10,000		
Profit and loss	18,000	42,000	24,000		
10% Mortgage loan	100,000	80,000			20,000

Current Liabilities:			
Creditors	60,000	45,000	
Bank overdraft	26,000	52,000	26,000
Dividend payable	20,000	30,000	10,000

Total sources/applications	**209,000**	**209,000**

Change in cash position:

BOYUS Co. Ltd.
Funds Flow Statement 31 December, 2006

	₦	₦
Sources of Funds:		
Net profit for the year		82,000
Add Depreciation:		
Motor vehicles	10,000	
Plant and machinery	20,000	30,000
Sale of fixed assets		10,000
Decrease in working capital;		
Bank overdraft (increase)		26,000
Increase in equity:		
Issue of shares	100,000	
Revaluation surplus on land and buildings	23,000	123,000
		271,000
Application of Funds:		
Fixed Assets:		
Land and buildings (revaluation)	23,000	
Plant and machinery acquired	100,000	
Motor vehicles purchased	20,000	143,000
Repayment of mortgage loan		
Increase in working capital:		
Work in progress (increase)	21,000	
Stock (increase)	20,000	
Debtors (increase)	30,000	
Creditors (decrease)	15,000	86,000
Payments:		
Taxation	12,000	
Dividend paid	20,000	32,000
		281,000
Excess of applications over sources		**10,000**
Movement in cash		
Balance as at 31/12/2005		30,000
Balance as at 31/12/2006		20,000
Net decrease		**10,000**

From the above example, while BOYUS earned a net profit of ₦82,000 during the year, the cash position declined by ₦10,000, but the company would be relieved to learn from the funds flow statement that the profit had helped to pay for increase in stock and debtors while additional funds had been obtained from shareholders to pay for the acquisition of additional fixed assets.

SELF ASSESSMENT EXERCISE 2

What specific purpose is fulfilled by the preparation of a funds flow statement along with the other financial reports?

4.0 CONCLUSION

Funds flow statement addresses the matter of liquidity – ability of the firm to meet its maturing obligations – which information is hard to find in the presented Profit and Loss Account and the Balance Sheet. Funds flow statement could be prepared either on cash basis or on the basis of working capital. It guards against overtrading (a point of acute illiquidity) or maintaining a high cash balance that may threaten the future profitability of the business.

5.0 SUMMARY

In this unit, we have considered the preparation of funds flow statement or the Statement of Source and Application of Funds in order to address the liquidity information deficiencies of the Profit and Loss Account and the Balance Sheet. The statement assists companies to strike a balance between liquidity and profitability relative to the business operations.

6.0 TUTOR-MARKED ASSIGNMENT

From the example of BOYUS COMPANY LTD above, prepare a Funds Flow Statement for the year, 2006 on the basis of working capital, and comment on the statement.

7.0 REFERENCES/FURTHER READINGS

Anao, A.R. (1989). *An Introduction to Financial Accounting*. Ibadan: Longman Nigeria Limited.

Flynn, David, *et al.* (2000). *Fundamental Accounting*, (4th Edition). Kenwyn: Juta and Co. Ltd.

UNIT 4 INTRODUCING ANALYSIS OF FINANCIAL STATEMENTS

CONTENTS

1.0 INTRODUCTION

In Unit 2, we considered the financial statements where we discussed the objectives and structure of the basic financial reports such as the Trading and Profit and Loss accounts, and the Balance Sheet. We established that these reports assist the management and other interested users like the investors, analysts, creditors, to take appropriate financial decisions.

Therefore, financial statements are prepared not as an end in themselves but in order that users can make decisions. To be very useful in this regard, financial statements need to be analysed and interpreted, so that the relationships between different parts of the reports will be more clearly seen.

In the analysis of financial statements, we have to recognise that the different users of financial information have different needs, for example:

1. Management needs information for control of costs and improved profitability;
2. Lenders need information for borrowing and credit purposes;
3. Shareholders and investment analysts require financial information to make investment decisions – buying and selling of shares, etc.

Bearing in mind that the relevance of financial analysis cannot be overemphasised, this unit will attempt to answer the following questions:

1. What is the usefulness of financial analysis?

2. What are the ways in which accounting reports can be analysed and made more meaningful to the users?

As managers and would-be managers, we need to have adequate information to be guided or aided in taking appropriate financial decisions.

2.0 OBJECTIVES

At the end of this unit, you will be able to:

- discuss the usefulness of financial analysis
- discuss the various ways of analysing financial statements.

3.0 MAIN CONTENT

3.1 Introducing Analysis of Financial Statements

3.1.1 Usefulness of Financial Analysis

Financial analysis may be simply defined as knowing what to look for and how to interpret it. The information gathered by calculating ratios will allow comparisons with:

- the performance of the business in previous years;
- the budgeted or planned performance in the current year;
- the performance of similar businesses.

More specifically, financial analysis will be useful to the users in the light of the following:

- Since the shareholders and potential shareholders will be interested in its profitability, it will aid them in measuring the returns on their investment in equity;
- It will also aid the shareholders to establish the financial stability of the company in order to assess the risk attached to their investment;
- Financial analysis will aid the suppliers of short-term credit (bank overdraft or supply of goods on credit) to assess the ability of the company to pay its debt promptly;
- Suppliers of long-term credit (such as mortgage bonds and debentures) will be better guided in assessing the company's ability to meet its annual interest obligations as well as its ability to repay the debt;

Management is assisted in taking decisions that make for efficient and effective operations in order to maximise the wealth of the shareholders and ensure continued operations.

Apart from the ratios, it is essential that the following factors about the organisation's environment should be analysed:

- Markets in which the concern functions;
- General economic conditions;
- Size of business in relation to competitors.

SELF ASSESSMENT EXERCISE 1

How useful is the analysis of financial statements?

3.1.2 Various Ways of Financial Analysis

The various ways of financial analysis are:

Trend analysis
Percentage analysis
Ratio analysis

3.1.2.1 Trend Analysis

One of the easiest ways of making accounting information more meaningful is to build up a trend with them, which means developing a time series analysis of important accounting factors for a number of years. It is easy to see whether over time the company has done better or worse if the major highlights of the financial statements (relative to funds employed, employment of funds and turnover/profit) are compiled for three, four or five years.

This type of analysis is a legal requirement for firms presenting corporate accounts and is essentially an inter-period comparison of the results of one firm. Although trend analysis is useful, it also has limitations. Majorly, in concentrating only on one firm, it fails to meet the requirement of most users of accounting information to be able to compare their potential well-being as a result of investing in two or more alternative companies.

3.1.2.2 Percentage Analysis

The limitations of the trend analysis calls for the use of other ways of analysis to supplement them. In percentage analysis, the items appearing in the Trading, Profit and Loss Account and Balance Sheet are expressed as percentage of total sales and total assets respectively.

If this is done for several years, the changes in the relative proportions of total sales or total assets contributed, or accounted for, by individual items from your to year can be highlighted. Thus, one would not only see a trend but also even isolate the items on which performance appears to have improved or deteriorated. This can be useful aid of control since performance could be optimised if efforts were then concentrated on remedying those items in which things seem to be going wrong. The direction of future changes could also be detected early, rationalised or influenced.

3.2.2 Ratio Analysis

Undoubtedly, ratio analysis is the most popular of all analytical techniques. It may be defined as the selection of two line items which have a meaningful relationship and expressing that relationship as a ratio.

In ratio analysis, the principle of factor relationship covers a wide range of items which could be of possible interest to the different users of accounting information. Thus, ratio analysis yields percentage or other coefficients of the relationships between any two accounting factors once some closeness is exhibited by the two factors. For example, profit may be related to turnover or equity funds or total long-term funds (capital employed); turnover may be related to inventory or trade debtors; fixed assets may be related to long-term funds; current assets related to current liabilities, etc. This will be treated in details in Unit 15.

SELF ASSESSMENT EXERCISE 2

Discuss the Trend Analysis relative to its meaning and limitations.

4.0 CONCLUSION

Financial statements need to be analysed and interpreted for them to be useful in taking financial decisions. The trend, percentage and ratio analyses can be employed although they have their usefulness and limitations.

5.0 SUMMARY

In this unit, we have been able to introduce the analysis of financial statements. So far, we have attempted to provide answers to the following questions:

What is the usefulness of financial analysis?
What are the ways in which accounting reports can be analysed and made more meaningful to the users?

6.0 TUTOR-MARKED ASSIGNMENT

1. How would you develop a percentage analysis in accounting evaluation?
2. What advantages, if any, would such analysis have over a trend statement compiled on the basis of absolute values?

7.0 REFERENCES/FURTHER READINGS

ACCA (2003). *Preparing Financial Statements*. Middlesex: A. T. Foulks Lynch Ltd.

Anao, A.R. (1993). *An Introduction to Financial Accounting*. Ibadan: Longman Nigeria Limited.

Flynn, David *et. al.* (2000). *Fundamental Accounting* (4th Edition), Kenwyn: Juta & Co. Limited.

UNIT 5 ANALYSIS OF FINANCIAL STATEMENTS II

CONTENTS

1.0 INTRODUCTION

In this unit, we shall move further in our consideration of the analysis of financial statements by treating “Ratio Analysis” in great details since it appears to be most popular and result yield technique of analysis.

2.0 OBJECTIVES

At the end of this unit, you will be able to demonstrate the use of ratios in the analysis of financial statements.

3.0 MAIN CONTENT

3.1 Analysis of Financial Statements II

3.1.1 Ratio Analysis

Ratio analysis attempts to determine some notion of the standard relationship which ought to exist between any two factors, and to interpret the specific relationship in anyone form in terms of the extent to which the firm attains to that standard. The attainment of that standard would be interpreted as good performance or healthy financial condition or otherwise.

The following considerations, therefore, can be made in the analysis of ratio:

If a ratio has been computed over a number of time periods, does it show a worsening or an improving situation?

Can the ratio be compared to an objective standard? That is, can it be compared with an ‘ideal’ ratio?

Do all the ratios when taken together support the conclusions drawn from each individual ratio?

Ratios can be classified variously, but we shall adopt the following:

Profitability Ratios

i. Gross profit and net profit margin
ii Returns on assets managed
iii Returns on capital employed (ROCE)
iv Returns on equity (ROE)

Liquidity Ratios

i. Current ratio
ii. Quick (or acid test) ratio

Leverage Ratios

i. Debt ratio
ii. Capital gearing
iii. Times interest covered

Activity Ratios

i. Total assets turnover
ii. Stock turnover
iii. Sales to debtors
iv. Average collection period

Investment Ratios

i. Earnings yield
ii. Dividend yield
iii. Price – earning multiple

We shall explain all the ratios with examples:

1. <u>GrossProfitandNetProfitmargin</u>:

The <u>grossprofit</u> margin is the ratio of gross profit to sales while the <u>net profit</u> margin is the ratio of net profit to sales. The former seeks to highlight the aggregate impact of the firm's mark-up or pricing policy, and the latter aims to evaluate the overall efficiency of the firm in its buying and selling operations. They are calculated as follows:

a. Gross profit margin $= \dfrac{\underline{\text{Grossprofit}}}{\text{Sales}}$

b. Net profit margin $= \dfrac{\underline{\text{Netprofit}}}{\text{Sales}}$

2. <u>ReturnonAssetsManaged(ROAM)</u>:

$$\text{ROAM} = \frac{\underline{\text{Netprofitbeforeinterest}}}{\text{Total sales}}$$

Here, profit is seen as a function of the size of total assets at the disposal of management for operating the business. A large amount of assets is expected to generate more profits than a smaller volume of assets.

3. <u>ReturnonCapitalEmployed</u>:

$$\text{ROCE} = \frac{\underline{\text{Netprofit+Interestonlong-termloan}}}{\text{Total long-term funds}}$$

Capital employed means all the long-term funds invested in the business – equity (share capital, reserves, profit balance), preference capital and debentures or loan stock.

4. <u>ReturnonEquity</u>: ROE $= \dfrac{\underline{\text{Netprofitaftertax}}}{\text{Total equity funds}}$

The equity funds in a business represent the book value of the total investment by the shareholders. The net profit after tax, on the other hand, represents to the shareholders, the total surplus generated by their investment. For equity holders, the efficiency with which their funds are employed is reflected by the ratio of net profit after tax to the total equity funds.

5. <u>CurrentRatio</u>: CR $= \dfrac{\underline{\text{Currentassets}}}{\text{Current liabilities}}$

Current ratio is a relationship between total assets and total liabilities. It is also a relationship between funds due and funds owed. It indicates the ability of the firm to meet its short-term obligations as at when due. A low ratio indicates the inability of a firm to pay its bills as at when due. A high ratio, on the other hand, may indicate an excessive amount of current assets and the inability of management to effectively utilize the firm's resources. Depending on the business of the firm, a ratio of 2:1 is recommended.

6. $\underline{\text{Quick(orAcidtest)Ratio}}$: $= \dfrac{\text{Totalcurrentassets–Inventory}}{\text{Total current liabilities}}$
QR

This is a more stringent measure of a firm's liquidity position because the least liquid current assets (inventory) is excluded in the computation. A lower quick ratio is an indication of the inability of the firm to meet its short-term obligations while a higher ratio represents ineffectiveness in the management of the firm's resources. A ratio of 1:1 is normal.

7. $\underline{\text{DebtRatio}}$: $= \dfrac{\text{Totaldebts}}{\text{Total assets}}$
Debt Ratio

This ratio measures the proportion of the firm's total assets that are paid for by debt. Long-term lenders use this ratio to assess the extent to which their funds are exposed to risk. A debt ratio of 50% would imply that creditors have financed half of the assets, and this can be the limit to which lenders would be prepared to lend money to the firm without charging a risk premium.

8. $\underline{\text{CapitalGearingRatio}}$: = Long term loan: Total Equity funds
CGR

This ratio helps to measure the degree of financing risk. Generally, equity holders gear their investment in the business, that is, employ long-term loans to support their own funds.

A gearing of 1:1 means that long-term lenders have provided one naira for every one naira equity funds.

9. $\underline{\text{TimesInterestCovered}}$: $= \dfrac{\text{Netprofit+Interest}}{\text{Interest}}$
TIC

This means the number of times that the total interest burden is covered by the total net profit before interest and taxes. This ratio measures the likelihood of default in interest payment. A high ratio is an evidence of financial strength and is preferred.

10. $\underline{\text{TotalAssetsTurnover}}$: $= \dfrac{\text{Sales}}{\text{Total assets}}$
TAT

This is a ratio of sales to total assets. The number of times that total sales are turned over is a measure of the effectiveness in the use of the firm's assets. A high turnover is a measure of success.

11. $\underline{\text{StockTurnover}}$: $= \dfrac{\text{CostofSales}}{\text{Average stock}}$
ST

This is the ratio of cost of sales to average stock.

12. $\text{Sales to Debtors: } = \dfrac{\text{Sales}}{\text{Debtors}}$

Sales to Debtors

This ratio measures the extent to which the credit sales policy may have contributed to the total sales of the firm. A high sale-to-debtors ratio suggests an effective credit control policy.

13. $\text{Average Collection Period: } = \dfrac{\text{Debtors}}{\text{Average sales per day}}$

ACP days

Here, average sales per day are the year's turnover divided by 360 days. This ratio measures the effectiveness of the firm's credit control function. A preferred ratio should represent a smaller number of days' sales.

14. $\text{Earnings Yield: } = \dfrac{\text{Earnings per share}}{\text{Market price of share}} \times \dfrac{100}{1}$

EY

Where $\text{EPS} = \dfrac{\text{Net profit after tax}}{\text{Number of shares outstanding}}$

This ratio is a measure of the company's efficiency in the use of shareholders' capital.

15 $\text{Dividend Yield: } = \dfrac{\text{Dividend per share}}{\text{Market price of share}}$

DY

Where $\text{DPS} = \dfrac{\text{Dividend for the year}}{\text{No. of shares outstanding}}$

Dividend is significant to shareholders because it is the portion of total earnings which they actually receive, the remainder being retained within the business. It is believed that DYR provides a realistic alternative to Earnings Yield as basis for comparing the potential return from alternative investments.

16. $\text{Price–Earnings Multiple: } = \dfrac{\text{Market price per share}}{\text{Earnings per share}}$

P – E M

This ratio is the mechanism through which a certain measure of standardisation or equilibrium is introduced among the prices of shares of similar risk-return characteristics.

Example

Below are the financial statements of UJAH Trading Company Limited.

You are required to compute the financial ratios, tabulate and compare them. Assume that the shares in question have a nominal value of N1.00 each and that the shares are currently quoted in the stock market at a price of N1.50. The same share was sold at a price of N1.45 just after the accounts were published the previous year.

UJAH Trading Company Limited
Trading and Profit and Loss Account for the Year Ended 31 December, 1996

	1996		1995	
	N000	N000	N000	N000
Sales		1,840		1,444
Less cost of sales:				
Opening stock	116		90	
Purchases	1,388		1,061	
Warehouses exps	64		48	
	1,568		1,199	
Closing stock	157		116	
		1,411		1,083
Gross profit		429		
361				
Less expenses:				
Salaries and				
Expenses on selling	78		72	
Salaries and wages	56		50	
Rent and rates	25		24	
B & D debts	6		8	
Depreciation	44		32	
Interest on Mortgage				
Loan	8		10	
Power and lighting	17		15	
General expenses	72		61	
Directors' fees	34		24	
Audit fees	7	347	7	303
Net profit		82		58

Appropriations

Provision for taxation	18	12
Transfer to general reserves	10	8
Dividend payable	30	20
	58	40
Retained in the profit and loss account	24	18

Balance Sheet as at 31 December, 1996

Fixed Assets (less depreciation)			
Land and buildings		83	60
Plant and machinery		240	160
Motor vehicles		40	40
Total fixed assets		363	260
Current Assets			
Work in progress	67		46
Stock (finished goods)	90		70
Debtors (less doubtful debts)	110		80
Bank cash	20		30
	287		226
Less:			
Current Liabilities			
Creditors	45		60
Bank overdraft	52		26
Dividend payable	30		20
Taxation	18		12
	145		118
Net working capital		142	108
Net assets		505	368
Financed by equity funds:			
Issued / paid up capital	300		200
Capital reserves	23		-
General reserves	60		50
Profit and loss	42		18
	425		268
10 per cent mortgage loan	80		100
	505		368

(1) ProfitabilityRatios:

(a) Gross profit margin = $\frac{\text{Grossprofit}}{\text{Sales}}$

1996 = $\frac{429,000}{1,840,000}$ = 23.3%

1995 = $\frac{361,000}{1,444,000}$ = 25.0%

(b) Net profit margin = $\frac{\text{Netprofit}}{\text{Sales}}$

1996 = $\frac{82,000}{1,840,000}$ = 4.5%

1995 = $\frac{58,000}{1,444,000}$ = 4.0%

This ratio can also be computed with the net profit after tax figure.

(c) Return on assets managed = $\frac{\text{Netprofitbeforeinterest}}{\text{Total assets}}$ *

1996 = $\frac{82,000+8,000}{363,000 + 287,000}$

= $\frac{90,000}{650,000}$ = 13.8%

1995 = $\frac{58,000+10,000}{260,000 + 226,000}$

= $\frac{68,000}{486,000}$ = 14.0%

a. In the absence of information about the interest cost paid on bank overdraft, the item is excluded from this computation.

(d) Return on capital employed=$\frac{\text{Netprofit+interestonlong-termloan}}{\text{Total long-term funds}}$

1996 = $\frac{82,000+8,000}{505,000}$ = 17.8%

1995 = $\frac{58,000+10,000}{368,000}$ = 18.5%

(e) Return on equity = $\frac{\text{Netprofitaftertax}}{\text{Total equity funds}}$

1996 = $\frac{82,000–18,000}{425,000}$ = 15%

1995 = $\frac{58,000–12,000}{268,000}$ = 17.2%

(2) **LiquidityRatios:**

(a) Current Ratio = $\frac{\text{currentassets}}{\text{current liabilities}}$

1996 = $\frac{287,000}{145,000}$ = 1.98: 1

1995 = $\frac{226,000}{118,000}$ = 1.91: 1

(b) Quick asset ratio = $\frac{\text{currentassets–stocks}}{\text{current liabilities}}$

1996 = $\frac{287,000–67,000–90,000}{145,000}$

= $\frac{130,000}{145,000}$ = 0.9: 1

1995 = $\frac{226,000–46,000–70,000}{118,000}$

= $\frac{110,000}{118,000}$ = 0.93: 1

(3) **LeverageRatios:**

(a) Debt Ratio = $\frac{\text{totaldebts}}{\text{total assets}}$

or

$\frac{\text{currentliabilities+long-termloan}}{\text{total assets}}$

1996 = $\frac{145,000+80,000}{650,000}$ = 34.6%

1995 = $\frac{118,000+100,000}{586,000}$ = 37.2%

(b) Capital gearing ratio = long-term loan : total equity funds

1996 = 80,000: 425,000 = 0.20: 1

1995 = 100,000: 268,000 = 0.37: 1

(c) Times interest covered = $\frac{\text{netprofit+interest}}{\text{interest}}$

1996 = $\frac{82,000+8000}{8,000}$

= $\frac{90,000}{8,000}$ = 11.25 times

1995 = $\frac{58,000+10000}{10,000}$

= $\frac{68,000}{10,000}$ = 6.8 times

(4) **ActivityRatios:**

(a) Total asset turnover = $\frac{\text{sales}}{\text{total assets}}$

1996 = $\frac{1,840,000}{650,000}$ = 2.83 times

1995 = $\frac{1,444,000}{486,000}$ = 2.97 times

(b) Stock turnover = $\frac{\text{costofsales}}{\text{average stock}}$

1996 = $\frac{1,411,000}{\frac{116,000+157,000}{2}}$

$$= \frac{1,411,000}{136,500} = 10.3 \text{ times}$$

$$1995 = \frac{1,083,000}{\frac{90,000+116,000}{2}}$$

$$= \frac{1,083,000}{103,000} = 10.5 \text{ times}$$

(c) Sales to debtors $= \frac{\text{sales}}{\text{debtors}}$

$$1996 = \frac{1,840,000}{110,000} = 16.7 \text{ times}$$

$$1995 = \frac{1,444,000}{80,000} = 18 \text{ times}$$

(d) Average collection period $= \frac{\text{debtors}}{\text{average sales per day}}$

$$1996 = \frac{110,000}{\frac{1,840,000}{365}}$$

$$= \frac{110,000}{5,041} = 22 \text{ days}$$

$$1995 = \frac{80,000}{\frac{1,444,000}{365}}$$

$$= \frac{80,000}{3,956} = 21 \text{ days}$$

(5) **InvestmentRatios:**

(a) Earnings yield $= \frac{\text{earningspershare}}{\text{market price of share}} \times \frac{100}{1}$

where earnings per share (EPS) $= \frac{\text{netprofitaftertax}}{\text{number of shares outstanding}}$

1996: EPS $= \underline{64,000} = 21.3$ k

$$\text{Earnings yield} = \frac{21.3k}{N1.50} \times 100\%$$

$$= 14.2\%$$

$$1995\text{: EPS} = \frac{40,000}{200,000} = 20\text{ k}$$

$$\text{Earnings yield} = \frac{20k}{N1.45} \times 100\%$$

$$= 13.8\%$$

(b) Dividend yield = $\dfrac{\text{dividend per share}}{\text{market price of share}}$

where dividend per share = $\dfrac{\text{dividend for the year}}{\text{number of shares outstanding}}$

$$1996\text{ Dividend per share} = \frac{30,000}{300,000} = 10k$$

$$\text{Earnings yield} = \frac{10k}{N1.50} \times 100\%$$

$$= 6.7\%$$

$$1995\text{ Dividend per share} = \frac{20,000}{200,000} = 10k$$

$$\text{Earnings yield} = \frac{10k}{N1.45} \times 100\%$$

$$= 7\%$$

(c) Price earnings multiple = $\dfrac{\text{market price per share}}{\text{earnings per share}}$

$$1996 = \frac{N1.50}{21.3k} = 7\text{ times}$$

$$1995 = \frac{N1.45}{20k} = 7.25\text{ times}$$

Summary of Financial Ratios
Computed from the Accounts of UJAH Trading Company Limited

			1996	**1995**
1.	(a)	Gross profit margin	23.3%	25%
	(b)	Net profit margin	4.5%	4.0%
	(c)	Return on assets managed	13.8%	14%
	(d)	Return on capital employed	17.8%	18.5%
	(e)	Return on equity	15%	17%
2.	(a)	Current ratio	1.98 : 1	1.91 : 1
	(b)	Quick asset ratio	0.9: 1	0.93: 1
3.	(a)	Debt ratio	34.6%	37.2%
	(b)	Capital gearing	0.2: 1	0.37: 1
	(c)	Times interest covered	11.25 times	6.8 times
4.	(a)	Total assets turnover	2.83 times	2.97 times
	(b)	Stock turnover	10.3 times	10.5 times
	(c)	Sales to debtors	16.7 times	18 times
	(d)	Average collection period	22 days	21 days
5.	(a)	Earnings yield	14.2%	13.8%
	(b)	Dividend yield	6.7%	7%
	(c)	Price earnings multiple	7 times	7.25 times

SELF ASSESSMENT EXERCISE

1. Differentiate between Return on equity and Equity yield ratios.

2. Name two each of the following ratios, state their formula for computation and explain what they measure:

   (a) Activity ratios
   (b) Leverage ratios
   (c) Profitability ratios
   (d) Liquidity ratios

4.0 CONCLUSION

Since financial statements are prepared in order that users can make decisions, they have to be analysed and interpreted so that they can be useful in this regard. Ratio analysis appears to be the most popular of all analytical tools. It selects two accounting items which have a meaningful relationship and expresses that relationship as a ratio. Ratio analysis is used to assess the overall performance of the firm.

5.0 SUMMARY

In this unit, we have dealt with ratio analysis extensively because of its relevance.

6.0 TUTOR-MARKED ASSIGNMENT

The balance sheets and income statements of two companies are presented below. Both companies are in the same industry.

BALANCE SHEET AS AT 28 FEBRUARY 2002

	KOLA LTD.		MEDE LTD.	
	N		N	
ASSETS				
Non-current assets				
Fixed assets at carrying value		469,200		523,200
Current Assets		234,600		130,800
Cash and cash equivalents	31,730		5,450	
Trade and other debtors	62,110		43,600	
Inventory	140,760		81,750	
Total Assets		**703,800**		**654,000**
EQUITY AND LIABILITIES				
Capital and reserves		481,751		390,438
Issued capital	445,740		218,000	
Accumulated profit	36,011		172,438	
Non-current liabilities				
10% debentures		117,300		218,000
Current liabilities		104,749		45,562
Trade and other creditors	67,096		18,748	
Income tax payable	37,653		26,814	
Total equity and liabilities		**703,800**		**654,000**

INCOME STATEMENTS FOR THE YEAR ENDED 28 FEBRUARY 2002

Revenue	504,390	327,000
Cost of sales	328,440	152,600
Gross profit	175,950	174,400
Selling and administrative expenses	38,709	63,220
Net operating profit	137,241`	111,180
Interest	11,730	21,800
Net profit before taxation	125,511	89,380
Taxation	37,653	26,814
Net profit for the period	87,858	62,566

You are required to:

On the basis of the information supplied, which company is:

(1) More profitable?
(2) More liquid?
(3) More efficient?
(4) More secure in respect of long-term solvency?

Use financial ratios, as appropriate, in your analysis. Assume that the balances on the asset and equity accounts at the year end approximate the average balances during the period and that all sales are on credit. Show your workings.

7.0 REFERENCES/FURTHER READINGS

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