NATIONAL OPEN UNIVERSITY OF NIGERIA

COURSE CODE: BHM 724

COURSE TITLE: FINANCIAL ACCOUNTING

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Course Title Financial Accounting

Course Developer S. O. Israel-Cookey
National Open University of Nigeria
Lagos.

Course Writer S. O. Israel-Cookey
National Open University of Nigeria
Lagos.

Course Editor E. U. Abianga
National Open University of Nigeria
Lagos.

Programme Leader Dr. O.J Onwe
National Open University of Nigeria
Lagos.

Course Coordinator S. O. Israel-Cookey
National Open University of Nigeria
Lagos.

NATIONAL OPEN UNIVERSITY OF NIGERIA

National Open University of Nigeria
Headquarters
14/16 Ahmadu Bello Way
Victoria Island
Lagos

Abuja Annex
245 Samuel Adesujo Ademulegun Street
Central Business District
Opposite Arewa Suites
Abuja

e-mail: centralinfo@nou.edu.ng
URL: www.nou.edu.ng

First Printed 2006

ISBN

Printed by …… ………..
For
National Open University of Nigeria

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MODULE 1

UNIT 1 AN OVERVIEW OF ACCOUNTING

CONTENTS

1.0 INTRODUCTION

Here, we come to the first unit of this course, which is packaged to give an overview of Accounting. This unit will cover the meaning of Accounting, and consider, whether Accounting is a science or an art. Derived from the definition, the accounting cycle will be explained before considering the concepts and conventions which guide in accounts preparation. Lastly, the purpose and uses of accounts will be discussed with emphasis on the categories of user groups of accounting or financial information.

2.0 OBJECTIVES

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

- Explain the meaning of accounting;
- Say whether accounting is a science or an art;
- Enumerate and discuss the accounting concepts and conventions;
- Explain the various uses of accounting information; and
- Discuss the accounting cycle.

3.0 AN OVERVIEW OF ACCOUNTING

3.1 Definition of Accounting

Accounting can be viewed from different perspectives by authors, teachers and practitioners, but can best be thought of as a process of handling information of economic or financial in nature. This information forms the basis for financial reporting. The process could be seen in the light of the following:

- As an activity performed by Accountants and their supporting staff;
- As a system comprising several interrelated and interdependent parts;
- As a technique of management for planning and control purposes, and
- As a discipline of study.

Accounting is basically a service function designed to inform management and other interested parties like analysts, investors, creditors, shareholders, about the financial implications and their effects on the organisation.

From the foregoing, therefore, Accounting can be said to be the language of business; it can be seen as a management tool, as their reports provide the basis for planning, and initiating control measures.

A generally accepted definition of Accounting has it that it is “the art of recording, classifying and summarising in a significant manner and in terms of money, transactions and events which are, in part at best, of a financial character, and interpreting the result thereof”.

At this point, let us mention the two major branches of accounting, which are:

- Financial accounting
- Management accounting.

Details of these would be given in Unit 2.

Self-Assessed Exercise

Explain what Accounting means.

3.2 Accounting: A Science or An Art?

Arguments exist as to whether Accounting is a science or an art. Interestingly, these arguments reveal some features of accounting which may be of benefit, especially, to a new entrant into the discipline, to understand its methodology. Accounting is not a natural science like chemistry or physics, although by the benevolence of more modern definitions of science, it is scientific to the extent that it applies scientific methods of observation, experiment and measurement in the course of processing financial information for use by management.

On the other hand, art stresses the human attributes of imagination and judgement.

Accounting tends to draw from both science and art, but cannot be said to belong to either one. As a science, it is a body of organised knowledge and uses systematic procedures to obtain results. However, it is not an exact science because its results are not conclusive. For example, given the same set of economic data, two Accountants can reach different conclusions. On the other hand, it is not an exact art because it employs a great deal of human skill rather than judgement.

From the foregoing, accounting can be referred to as a management science because it is a tool of management for planning and control. It can be called a social science as well. In conclusion, therefore, accounting is neither science nor art in the strictest sense of it.

Self-Assessed Exercise

Is accounting a science or an art?

3.3 The Accounting Cycle

From the generally accepted definition of accounting in 3.1 above, derives the Accounting Cycle, which refers to series of stages necessary to produce the financial reports. The stages are:

- identifying of transactions
- measuring of economic changes
- recording of transactions in the relevant books
- communicating of financial information associated with economic events.

Please, note that the objective of the Accounting system is to produce financial reports about the organisation.

Self-Assessed Exercise

Explain the Accounting Cycle.

3.4 Accounting Concepts and Conventions

There are seven basic concepts or principles in Accounting, modified by three conventions, which have been adopted as a general guide to practice.

3.4.1 The Business Entity Concept

This concept suggests that the business is separate from the owner. Therefore, all accounts are kept in respect of the business entities which are distinct from persons who own or manage them. It then follows that the personal financial affairs of the owners are never intermingled with those of the business for which the accounting is being performed.

3.4.2 Money as a common unit of Account

This concept speaks to the fact that accounts are expressed in monetary terms which can be added or subtracted. This gives a meaningful financial description. The implication of this concept is that any information that cannot be measured in naira terms, such as the quality and experience of workers, is usually not included in the financial statements.

3.4.3 The Cost Concept

The historical cost concept, as this may be called, says that assets (resources acquired by a business) are reflected at cost, which means that for their subsequent treatment in the measurement of the income of the business, the price paid on such acquisitions form the basis instead of their real or market values.

3.4.4 The Going Concern Concept

This concept assumes that the business will continue operations for the foreseeable future, that is, it has no plans to either liquidate or cut down significantly any major line of its operations in the nearest future.

3.4.5 The Accrual Concept

The concept accommodates all revenues and expenses to be received or charged in a given accounting period irrespective of what is actually received or paid.

3.4.6 The Concept of Duality

The duality concept determines that the financial situation of the enterprise be represented in terms of the basic accounting equation. Thus, it recognises that each transaction involves two entries in the same set of accounts, that is, every credit must have a corresponding debit and vice versa. This will be treated in details under the Double Entry system.

3.4.7 Realization Concept

The realization concept assumes that revenue is earned on the day which it is realised, and that is, when goods are transferred to the customer in exchange for a valuable consideration.

3.4.8 Accounting Conventions

You will recall that we said that there are three conventions which guide the application of the concepts in practice, and they are as follows:

- Conservatism / Prudence

  Here, the profit is understated while all possible losses are anticipated and taken into books, all possible future profits will be ignored.

- Consistency

  There should be consistency in the use of a particular accounting method for a reasonable period of time so that comparisons between accounting periods will be meaningful.

- Materiality

  The size of an amount will influence its treatment in the books of account, depending on individual entities. Therefore, what may be considered material in any circumstance is judgemental.

Self-Assessed Exercise

Name and discuss four accounting concepts and two conventions.

3.5 Purpose / Uses of Accounting

We can categorise the various uses of accounts and their user groups as follows:

- Direct Users

  The direct uses of accounts made by the managers and shareholders are for planning and control purposes. While the managers use accounting information to assess the viability of the business and to make future decisions, shareholders require the information to know whether the business is doing well or not, profit-wise.

- Indirect Users

  Those in this group include financial analysts, creditors, investors, tax authorities, employees and customers. For example, the prospective investor would like to be assured of the security and profitability of his investment; the creditor will determine whether a business will be able to pay its debt as and when due; the employees will even use the information to bargain for a better package; and the tax authorities will be able to calculate the tax liabilities.

Self-Assessed Exercise

Discuss the user groups of accounting information.

4.0 CONCLUSION

Accounting can be regarded as the language of business. The information, when generated, serves both as tool for planning and control, and evidence of financial position. Shareholders, managers, financial analysts, creditors, investors and the tax authorities, use accounting information as of benefit.

5.0 SUMMARY

In this unit, we have defined accounting and classified it into two major branches. We have also explained that Accounting is neither a science nor an art, but can best be regarded as a management science discipline.

Attempts were made to explain the accounting cycle. Also, we discussed the seven accounting concepts and three conventions. Lastly, the uses of accounting information were discussed under the categories of the direct and indirect users.

6.0 TUTOR-MARKED ASSIGNMENTS

1. Define accounting and explain its major processes.

2. Identify the major users of accounting information and explain the types of decisions for which each group may require accounting information.

7.0 REFERENCE AND FURTHER READINGS

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UNIT 2 INTRODUCING FINANCIAL ACCOUNTING

CONTENTS

1.0 INTRODUCTION

In Unit 1, we mentioned that there are two major branches of accounting, namely; Financial Accounting and Management Accounting. Unit 2 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 INTRODUCING FINANCIAL ACCOUNTING

3.1 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-Assessed Exercise

What do you mean by Financial Accounting?

3.2 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 weakness 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-Assessed Exercise

Explain the purpose of Financial Accounting.

3.3 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-Assessed Exercise

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

3.4 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-Assessed Exercise

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 ASSIGNMENTS

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

2. Compare financial accounting with Management accounting.

7.0 REFERENCE AND 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 3 BASIC BOOK KEEPING

CONTENTS

1.0 INTRODUCTION

This unit is packaged to deal with preliminary matters relating to recording procedures in Accounting – Basic Book-keeping and the Double Entry System. Here, we shall discuss the meaning and objectives of book-keeping. What are books of account? And how do we explain the Accounting Information Generating Process? These questions would receive answers in this unit. In addition, we would explain and apply the principles of the double entry system in recording business transactions.

2.0 OBJECTIVES

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

- Define book-keeping;
- Discuss the objectives of book-keeping;
- Discuss the books of account;
- Explain the Accounting Information Generating process;
- Describe and apply the principles of double entry system of book-keeping.

3.0 BASIC BOOK-KEEPING

3.1 Definition of Book-Keeping

Book-keeping which resulted from a practical business need, can be said to be a subset of Accounting or a record-making place of the accounting process. It can be defined as “the act of recording all money transactions so that the financial position of an undertaking and its relationship to both its proprietors and to outside persons can be readily ascertained". It is important to note that book-keeping lays emphasis on regular and systematic method of recording, how the records are maintained in the books, the right classification and summarisation so that the users of accounts can find the information contained in the books meaningful. The transactions for which record are maintained and the nature and scope of the records themselves differ from business to business.

Self-Assessed Exercise

What is book-keeping?

3.2 Objectives of Book-Keeping

From the meaning of book-keeping given in 3.1 above, the objectives of book-keeping include the following:

- To provide information about the conduct and position of the business;
- To provide a permanent and systematic record of financial transactions;
- To provide record for the value of various items of transactions;
- To ensure the arithmetical accuracy of financial records;
- To ascertain the financial worth of an undertaking at any given time;
- To provide records of profit or loss at any given time;
- To assist in the detection of fraud and other irregularities;
- To provide financial records for comparative purposes;
- To provide aid to planning and control;
- To provide a basis for taxation.

Self-Assessed Exercise

Discuss the objectives of Book-keeping.

3.3 Books of Account

The Books of account consist of the subsidiary books and the ledger. Recording of transactions start from the subsidiary books to the ledger.

Subsidiary Books

The subsidiary books, the Day books, books of original entry, and the books of prime entry all mean one and the same thing. These books exist to provide periodic totals for posting into the ledger. Please, note that transactions are not normally posted from the source documents (invoices, receipts, etc.) directly to the ledger.

Subsidiary books are books into which transactions are recorded on a daily basis from the source documents and from which postings are made periodically to the relevant accounts in the ledger. This practice prevents the ledger from containing too many details.

The subsidiary books normally used in financial accounting are:

- Sales Day book (or sales journal) for recording credit sales.
- Purchase Day book (or purchases journal) for recording credit purchases.
- Returns Inward Day book (or returns inward journal or sales returns day book) for recording returns from customers.
- Returns Outward Day book (or returns outward journal or purchases returns day book) for recording returns to suppliers.
- Cash book for recording receipt and payment of money.
- Journal proper for recording other transactions like:

  - the purchase and sale of fixed assets on credit;
  - opening entries;
  - correction of errors;
  - transfer from one account to another;
  - taking of goods by the owner from the business for his private use;
  - end-of-period adjustments; and
  - any other transaction which cannot be recorded in any of the other subsidiary books.

Illustration: Purchase of fixed asset on credit

Ndale Systems Limited purchased a motor vehicle on credit at a cost of N1.8 million from Coscharis Motors on 31st October, 2005.

The journal to record this transaction will appear as follows:

	DR	CR
	N	N
Motor Vehicle Account	1,800,000	
Coscharis Account		1,800,000

Being cost of motor vehicle purchased on credit from Coscharis Motors on 31st October, 2005.

Ledger

The ledger is the main or principal book of account where accounts are maintained for income, assets, expenses as well as individuals (or organisations) who may be debtors or creditors to the firm. Entries made or posted into the ledger (usually in summarised form) are expected to be preserved over a reasonable period. As we said earlier, the ledger is written-up periodically, and is the ultimate destination of all entries made in the subsidiary books.

Below is an example of a Ledger Account:

Dr. Motor Vehicle Account Cr..

Date	**Particulars**	**Folio**	**Amount**	**Date**	**Particular**	**Folio**	**Amount**

Self-Assessed Exercise

Discuss the Books of Account with emphasis on the relationship/correlation between the books of original entry and the ledger.

3.4 Accounting Information Generating Process

This process involves a sequence of activities from gathering, sorting and extracting data, from the source documents, to the preparation of financial reports. This process is clerical, fairly routine and at times mechanistic. The figure below says it all about the nature and sequence of the activities involved:

SOURCE DOCUMENTS
(Invoices, Receipts, Bank Tellers, etc.)

|
Recorded in
|

SUBSIDIARY BOOKS

|
Posted to
|

THE LEDGER
(Debtors/Creditors/General Ledger)

|
Checked by trial balance
|

FINANCIAL REPORTS

The Information Generating Process

Self-Assessed Exercise

Explain the Accounting Information Generating Process.

3.5 The Double Entry System

The Double Entry system of book-keeping hinges on the "Duality Concept" which we explained in Unit 1. Recognising that every transaction involves the "receiving" and the "giving" of values, the double entry system (or principle) requires that the dual effect of every transaction should be recorded. For every debit entry, there is a corresponding credit entry and vice versa. Let us note here that credit is given to the giver of the value always while the receiver is debited. Therefore, every transaction has to be recorded twice between accounts in the same set of books to ensure that a complete record is obtained. This principle has its origin from the Italian merchants of the 14th century.

Let us illustrate with the following example:

Olabisi & Company Limited sells a generator to Mrs. A.J. Thompson for N2,000.00 only.

This is a sales transaction where there is a purchaser and a seller. The company is parting with a generator and receiving cash in return; Mrs. Thompson is giving away cash and getting a generator in return. With the double entry rule in mind – "debit the receiver, credit the giver", we shall record the sales transaction as follows:

In Thompson's Books:

Dr. Purchases Account Cr.

Olabisi & Co (Cash) 12,000.00	

Dr. Cash Account Cr.

Olabisi & Co (Purchases) 12,000.00	

In Olabisi's Books:

Dr. Cash Account Cr.

Thompson (Purchases) 12,000.00	

Dr. Purchases Account Cr.

Thompson (Cash) 12,000.00	

In double entry system of recording, it is necessary to analyse the effect of each transaction in respect of "who gives and who receives" to determine who to debit and who to credit. As a guide in posting ledger account, entries on the DEBIT side increases in assets, expenses and losses while entries on the CREDIT side increases in liabilities, income and profits.

Self-Assessed Exercise

Describe the double entry system of book-keeping.

4.0 CONCLUSION

Book-keeping can be seen as a record-making phase of the accounting process, the activity of which, amongst others, provide meaningful information about the conduct and position of the business to users of accounts. The information generating process of accounts involves a sequence of activities from gathering, sorting and extracting data from the source documents to the preparation of financial reports. Necessary entries, made in both the books of original entry and the ledgers, should obey the double entry principle of book-keeping which identifies the "giver" and "receiver" in every transaction and "debits" or "credits" accordingly. The double entry system has the added advantage of maintaining a complete record of transactions both from the viewpoint of the business and those the business deals with.

5.0 SUMMARY

We have seen book-keeping as laying emphasis on the regular and systematic method of recording that provide information to users of accounts. We also considered the objectives of book-keeping in details. In addition, we were able to explain the accounting information generating process as well as answer that the books of account consist of the subsidiary books and the ledger. Finally, the principle of double entry has told us that for every debit, there must be a corresponding credit entry, and this forms the basis of recording economic transactions to show the effect which is either an increase or a decrease in the particular account concerned.

6.0 TUTOR-MARKED ASSIGNMENTS

1. Define book-keeping and discuss its objectives.

2. (a) Explain the double entry system of recording transactions.
   (b) Indicate which account should be debited or credited in the following transactions:

      (i) Cash paid into business by owner;
      (ii) Rent paid by owner of business;
      (iii) Purchase of goods for cash;

(iv) Sale of goods on credit to OKC;
(v) Purchase of motor vehicle on credit from OMOBA Motors Ltd;
(vi) Payment of electricity expenses;
(vii) Cash withdrawn from business by owner;
(viii) Receipt of loan from Benevolent Bank;
(ix) Cash received from OKC (Credit customer); and
(x) Remittance to OMOBA Motors Ltd. (Creditor).

7.0 REFERENCE AND FURTHER READINGS

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UNIT 4 THE CASH BOOK, PETTY CASH BOOK AND THE IMPREST SYSTEM

CONTENTS

1.0 INTRODUCTION

In Unit 3, we listed the cash book as one of the books of prime entry. It is also a ledger. The existence of the cash book in any organisation, be it profit-making or non-profit making, needs not be overstressed because of dealings with money (cash-in-hand or cash-at-bank). And the recording procedures for cash using the cash book become very essential. This unit will deal with the nature and uses of the cash book as well as the treatment of items in the cash book. Columnar cash books will be explained and demonstrated also. Furthermore, the petty cash book and the imprest system will not be left out.

2.0 OBJECTIVES

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

- Discuss the nature and uses of the cash book;
- Distinguish between the treatments given to various items in the cash book;
- Demonstrate the columnar cash books;
- Define a petty cash book and the imprest system;
- Effect posting in the petty cash book using the petty cash vouchers.

3.0 THE CASH BOOK, PETTY CASH BOOK AND THE IMPREST SYSTEM

3.1 Nature and Uses of the Cash Book

One of the main books of account is the cash book. Kindly recall that we had said earlier that the cash book is both a subsidiary book and a ledger. It is a book of prime entry where cash receipts and payments are recorded immediately after transactions have taken place and on daily basis, and a ledger where the daily recorded transactions are summarised periodically and transferred to the final accounts. From the foregoing, please note that the cash book is not posted into the ledger but balanced and the relevant figures carried to the balance sheet. Usually, the cashier maintains the cash book. The operation of a cash book is very important in accounting because it provides a means of controlling the amount held at all times. The dual use of the cash book in an organisation becomes clear when we consider or take cognisance of the fact that cash constitutes the most fluid form of asset of the organisation which is easily prone to losses or abuses.

Self-Assessed Exercise

Explain the dual use of the cash book.

3.2 Treatment of items in the Cash Book

Contra Entry:

Contra entry is when the double entry for a transaction appears on both sides of the cash book. Therefore, contra entries do not require recording in another account because entry has taken place within the cash book. These entries are made when surplus cash is transferred to the bank or the withdrawal of cash from the bank for use. The entries here will be to credit cash and debit bank or debit cash and credit bank in the columnar cash book which we shall consider in 3.3.

Cash

Cash receipts are debited in the cash column while payments are credited in the cash column.

Cheques

Cheques received from customers are debited in the bank column while cheques issued to suppliers are credited.

Cash Discounts

Cash discounts are rebates granted to a buyer or debtor for making cash payments within a shorter time period than the normal credit period. This implies that the seller accepts an amount smaller than the invoice value in full settlement of the account. If it is a two – column cash book (to be considered shortly), they are posted directly to the ledger but if it is 3 three – column cash book, they will be recorded in the cash book.

Self-Assessed Exercise

Explain the treatment of any two items in the cash book.

3.3 Columnar Cash Books

Single – Column Cash Book

Dr. Cash Account Cr

Date	**Particulars**	**Folio**	**Amount (₦)**	**Date**	**Particular**	**Folio**	**Amount (₦)**

The above is a format for the single – column cash book, which is like a ledger account with one column each for debit and credit; thus, making provision for cash transaction only. This is used to record the receipts and payments of cash, typical of small businesses whose transactions do not involve cheques/bank.

Two – Column Cash Book

This is the commonest form of cash book. As the name implies, the two – column cash book makes provision for two columns, one each for cash and bank transactions. The format is shown as follows:

Dr. Cash Account Cr.

Date	Particulars	Folio	Cash	Bank	Date	Particular	Folio	Cash	Bank

Here, all cash and cheque receipts are debited in the appropriate column while payments by cash and cheque are credited accordingly. The cash book is usually balanced at the end of the month.

Example:

Bello Trading Company brought forward balances of N2,000.00 and N13,200.00 for cash and bank respectively, from June, 2004 account. The following transactions took place:

		N
July 2	Cheque received	11,500.00
July 3	Cash sales	8,200.00
July 6	Paid rent by cash	3,500.00
July 7	Banked part of cash	5,000.00
July 14	Cash sales (paid through the Bank)	4,000.00
July 23	Paid by cheque	17,700.00
July 29	Cash withdrawal for use	12,000.00
July 31	Wages paid in cash	11,800.00

You are required to write-up a two-column cash book for this company and balance off at the end of July, 2004.

n:

Bello Trading Company

Cash Account Cr.

iculars	**Folio**	**Cash**	**Bank**	**Date**	**Particular**	**Folio**	**Cash**	**Bank**
ance b/f		2,000.00	13,000.00	6/7/04	Rent		3,500.00	
que			11,500.00	7/7/04	Bank			
s		8,200.00		23/7/04	Cheque		5,000.00	17,700.00
n			5,000.00	29/7/04	Cash			12,000.00
s			4,000.00	31/7/04	Wages			
k		12,000.00		31/7/04	Balance c/d		11,800.00	4,000.00
		22,200.00	**33,700.00**				1,900.00	**33,700.00**
ance b/d		1,900.00					**22,200.00**	
			4,000.00					

Three – Column Cash Book

A three-column cash book, as the name suggests, makes provision for a third column (in addition to the two columns for cash and bank) for recording cash discounts allowed to customers and received from suppliers. Discounts allowed to debtors are listed as debits while those received from credits are credited.

The discount columns save time although they are not part of the double entry system because they are not expected to balance each and also in posting out. Total debits, at the end of the period, are debited to the Discount Allowed account while the total credits are transferred to the Discount Received account. The corresponding entries are usually made in the various personal ledger accounts of debtors and creditors. We shall illustrate the three-column cash book now.

Example:

Mike started a small business with N80,000.00 on January 2, 2005 which he paid into a bank account for the business on the same date. His transactions for the rest of the month were as follows:

5/1/05 Purchases by cheque N27,300.00
6/1/05 Credit purchases N25,200.00
Electricity paid by cheque N500.00; Rent N700.00 by cheque
7/1/05 Drew cash for office use N1,200.00
Sales by cheque N42,520.00
Sales by cash N480.00
Sales on credit N50,000.00
8/1/05 Paid creditors by cheque N15,100.00 and received discount of N300.00
9/1/05 Cash sales N17,115.00; cash wages paid N500.00
10/1/05 Paid into bank the sales made on 9/1/05; Stationery bought by cash N50.00
12/1/05 Received from customers cheques for N39,200.00 and allowed discount of N800.00
15/1/05 Drew cash from bank for office use N200.00
16/1/05 Servicing and repairs by cash N120.00
Purchases by cash N20,000.00
Purchases by cheque N5,000.00
Purchases on credit N45,000.00
20/1/05 Sales by cash N37,500.00
Sales by cheques N17,000.00
22/1/05 Paid creditors N27,900.00 by cheque and received discount of N100.00

Cash sales N2,000.00 which was immediately lodged into the bank.

24/1/05 Payments by cheque:

Rent N1,200.00

Rates N300.00

Wages N2,000.00

28/1/05 Salaries by cheque N3,600.00

30/1/05 Cash lodged into bank N10,000.00

31/1/05 Drew cheque for petty cash N200.00

Required:

Three – column cash book of Mike for the month of January, 2005.

n:

Mike Trading Company

Cash Book

ticulars	Disc. All'd	Cash	Bank	Date	Particular	Disc. Rec'd	Cash	Bank
ital			80,000.00	5/1/05	Purchases			27,300.00
t (contra)		1,200.00		6/1/05	Electricity			500.0 0
.		480.00	42,520.00	6/1/05	Rent			700.0 0
.		17,115.00		7/1/05	Cash (contra)			1,200.00
(contra)			17,115.00	8/1/05	Trade Creditors	32 0.00		15,100.00
e Debtors	800 .00		39,200.00	9/1/05	Wages		500.00	
t (contra)		200.00		10 /1/05	Bank (contra)		17 ,115.00	
.		37,500.00	17,000.00	10 /1/05	Stationery		50.00	
.			2,000.00	15 /1/05	Cash (contra)			200.0 0
(contra)			10,000.00	16 /1/05	Rep airs		120.00	
t (contra)		200.00		16 /1/05	Purchases		20 ,000.00	5,000.00
				22 /1/05	Trade Creditors	10 0.00		27,900.00
				24 /1/05	Rent			1,200.00
				24 /1/05	Rates			300.00
				24 /1/05	Wages			2,000.00
				28 /1/05	Salaries		10 ,000.00	3,600.00
				30 /1/05	Bank (contra)			200.00
				31 /1/05	Cash (contra)		8,910.00	12 2,635.00
	800 .00	**56,695.00**	**207 ,835.00**	31 /1/05	Balance c/d	**42 0.00**	**56 ,695.00**	**20 7,835.00**
nce b/d		8,910.00	122 ,635.00					

Self-Assessed Exercise

Discuss the columnar cash books, pointing out their major differences.

3.4 The Petty Cash Book and Voucher

It is certain that in almost every organisation, there will be a great deal of small cash payments to be made. Records of these payments could be kept separate from the main cash book. The petty cash book is a record, in columnar format, of small cash payments made on a day-to-day basis. The columnar ruling of the petty cash books is designed to enable small payments to be analysed according to expenditure head and posted in totals to the ledger periodically. This book is maintained by the petty cashier under the supervision of the main cashier.

The petty cash voucher shows the amount of money required the purpose and nature of expenditure involved, and the account to be charged. The petty cash voucher is required before making any payment. It must be duly authorised before payment is made out of the petty cash float. The format of the voucher varies from organisation to organisation. However, it is the instrument from which posting is done to the petty cash book.

Self-Assessed Exercise

Explain the petty cash book and the petty cash voucher.

3.5 The Imprest System

This is basically a system of funding petty cash which reimburses the petty cashier with the total amount expended. By this, the total amount which the petty cashier has is restored to the float (fixed amount) with which he started. Therefore, total payments added to the imprest balance will, at all times, remain equal to the float.

Self-Assessed Exercise

What is the Imprest System?

3.6 Posting the Petty Cash Book

We shall use the following exercise to illustrate posting into the petty cash book:

The following is a summary of petty cash transactions of a business organisation for the month of June, 2004. The business maintains a petty cash float of N5,000.00.

June 1 Petty cash float given to petty cashier

June 3	Postages	200
June 5	Transport fare	450
June 8	Cleaning materials	350
June 9	Stationery	170
June 14	Petrol for delivery van	880
June 16	Taxi fare	390
June 20	Postages	180
June 21	Disinfectant for cleaning toilet	280
June 23	Petrol for general manager s car	660
June 24	Service of delivery van	400
June 28	Writing materials	310
June 30	Transport fare	120

You are required to rule up a petty cash book with columns for Postages, Transport, Travelling, Cleaning, Stationery and Motor Expenses and enter the month s transactions, entering the re-imbursement on 30th June, 2004 necessary to restore the imprest.

Petty Cash Book Cr.

s	Date	Details	Payments					
			Total	**Postages**	**Transport & Travel**	**Cleaning**	**Stationery**	**Motor Expenses**
	1/6/04	Cash float						
	3/6/04	Postages	200	200				
	5/6/04	Transport fare	450		450			
	8/6/04	Cleaning materials	350			350		
	9/6/04	Stationery	170				170	
	14/6/04	Petrol for delivery van	880					880
	16/6/04	Taxi fare	390		390			
	20/6/04	Postages	180	180				
	21/6/04	Disinfectant	280			280		
	23/6/04	Petrol for GM s car	660					660
	24/6/04	Service of delivery van	400					400
	28/6/04	Writing materials	310				310	
	30/6/04	Transport fare	120		120			
	30/6/04	Balance c/d						
			4,390	**380**	**960**	**630**	**480**	**1,940**
	1/7/04	Balance b/d	610					
	1/7/04	Reimbursed	**5,000**					

The double entry for the disbursements during June, 2004 will be completed by posting the total of each of the payments columns to the debit of the appropriate ledger accounts. For example, N380.00 will be debited to postages account, N960.00 debited to transport and travelling account and so on.

Self-Assessed Exercise

Explain how posting is made in the petty cash book.

4.0 CONCLUSION

The cash book is both a book of original entry and a ledger. Entries into the cash book must obey the double entry principle. The cash book provides a means of controlling cash. To take care of sundry small day-to-day cash payments in an organisation, the petty cash book becomes relevant. It plays the role of a subsidiary book. The funding of petty cash is through the imprest system.

5.0 SUMMARY

We have discussed the nature and uses of the cash book as well as distinguished between the treatments given to various items in the cash book. Also, we explained and demonstrated the use of the columnar cash books. Furthermore, we considered the usefulness of the petty cash book and voucher, as well as the imprest system. Amongst other advantages, the imprest system enables control to be kept over the series of frequent small expenditure of the organisation because all petty cash disbursements must be duly authorised/approved.

6.0 TUTOR-MARKED ASSIGNMENTS

1. Discuss the advantages of the imprest system.

2. Adekoye Nigeria Ltd. operates its petty cash account on the imprest system. It maintains its imprest at a figure of N56,000 on the first day of each month. At 31 May, 2002, the petty cashier had a balance of N3,100 at hand.

   During the month of June, 2002, the following petty cash transactions arose:

1st	Paid bus fares	900
2nd	Bought stationery	4,800
7th	Bought trade journals	2,400
8th	Bus fare	1,280

11th	Bought stationery items	2,320
12th	Bought printer ribbon	740
14th	Postage	1,160
15th	Paid for newspapers	1,800
16th	Repair of giant stapling machine	700
18th	Bought postage stamps	4,000
20th	Bought wrapping paper	1,100
22nd	Biro pens	3,600
25th	Paper clips	1,440
28th	Repair of computer printer	1,200
29th	Transport fare	2,300

You are required to draw up a petty cash book with analysis columns for transport and travelling, stationery, journals, and newspapers, postage, and general expenses.

7.0 REFERENCE AND FURTHER READINGS

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UNIT 5 FINANCIAL STATEMENTS

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1.0 INTRODUCTION

In Unit 1, we learnt that 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 are the accounting information presented?

This will be the focus of Unit 5. We shall find out that accounting information are 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 accounts payable.

3.0 FINANCIAL STATEMENTS

3.1 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-Assessed Exercise

Discuss the objectives and structure of financial reports.

3.2 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

3.3 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 into 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: Cost of goods sold			
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: Other incomes			
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	N	N	
	Cost	Acc. Depn.	NBV	
Fixed Assets				
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	
Current Assets				
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			
Current Liabilities				
Creditors	57,100			
Accruals (1,800 + 80)	1,880			
Interest received in advance	200	59,180		
WORKING CAPITAL		24,879		
Net Assets		78,179		

Financed By

Owner s Equity		
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:

Additional information No.	Nature of adjustment
(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-Assessed Exercise

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 percent for depreciation on plant and machinery for the current year.
(vi) Provide 5 percent for depreciation on furniture and fittings for the current year.

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

3.4 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 differ in the books of account. It is also necessary in the determination of profit made by the enterprises and explain why certain items go to the Trading and Profit and Loss account and others go to the Balance Sheet.

Capital and Revenue Receipts

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.

Capital and Revenue E xpenditure

"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 expenditure 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-Assessed Exercise

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

3.5 Treatment of Account 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 an omission that will lead to an overstatement of profit. Credit purchase transactions are recorded in the purchase journal.

Self-Assessed Exercise

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 ASSIGNMENTS

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

		Dr. N	Cr. 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.

Required:

(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 REFERENCE AND FURTHER READINGS

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UNIT 6: BANK RECONCILIATION STATEMENTS

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1.0 INTRODUCTION

In Unit 4, we considered the Two-Column Cash Book which provides two columns, one each for cash and bank transactions. Therefore, this cash book brings together the cash and bank accounts maintained by an organisation. Usually, the business transacts with the bank while the bank transacts with the business. The cash book records al the business transactions with the bank, and for al the bank s transactions with the business, a bank statement records the proceedings. However, the balance on the cash book is rarely if ever the same as the balanc e on the bank statement. Therefore, in this unit, we shall examine the need to agree our bank balance obtained from the cash book to the bank statement balance issued by the bank. Also, we shall consider the factors that are responsible for the differences in both balances, how they are treated and how reconciliation statements are prepared.

2.0 OBJECTIVES

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

- Explain why the bank balance obtained from the cash book differs from the bank statement;
- Discuss the need for bank reconciliation statements;
- Prepare the bank reconciliation statements to agree with the two balances.

3.0 BANK RECONCILIATIONSTATEMENTS

3.1 Bank Statements and Bank Reconciliation

Banks send monthly or periodical statements to their customers – individuals, associations, corporate entities, etc. A bank statement shows details of bank s transactions (deposits, withdrawals and charges) with their customers during a given period. At the end of the period to which the statement relates, it would indicate the balance in the account taking note of the credits (deposits) and debits (withdrawals and charges).

Earlier in the introduction, we noted that it is difficult for the cash book balance to agree with the balance on the bank statement, why?

One reason can be attributed to timing differences. For example, a cheque payment may be recorded in the cash book when it is issued. The bank only records such a cheque when it is paid by the bank, which may be several days or even weeks later (unpresented cheque). Other examples are outstanding deposits and uncredited lodgements.

Secondly, some items may appear in the bank statement but yet to be entered in the cash book, and these include bank charges, bank interest paid (on overdrafts) or received (on deposits), standing orders and direct debts, credit transfers (where a receipt has been paid direct into the organisation s bank account), cheques returned unpaid, and unauthorised debits due to genuine mistakes or fraud.

Therefore, bank reconciliation is the process of investigating the difference in both balances and attempt to agree them.

Self-Assessed Exercise

Explain why the cash book is rarely if ever the same as the balance on the bank statement.

3.2 The Bank Reconciliation Statement

This is a statement prepared to agree the balances of both the bank statement and the cash book. Apart from this function, the bank reconciliation statement helps to ensure that:

All deposits and withdrawals have been entered correctly.
No unauthorised debits have been made in the account.
Frauds and errors are detected early and corrected.

The reconciliation process is to verify the entries by ticking the credit side of the bank statement to the debit side of the cash book and vice versa. Any unticked entries in either the statement or the cash book represents items given as examples in explaining the reasons why balances in the statement and the cash book don t agree. The items could be treated as follows:

- Unpresented Cheques have been deducted in the cash book already but not in the bank statement. Either we add it back to cash book balance or deduct from bank statement balance.
- Direct debits are either added to cash book balance or deducted from bank statement balance.
- Uncredited lodgements are either added to the statement balance or deducted from cash book balance.
- Frauds and errors should be investigated and corrected.

Self-Assessed Exercise

1. Define the bank reconciliation statement.
2. Discuss the bank reconciliation process.

3.3 Methods of Bank Reconciliation

There are two methods of bank reconciliation:

- Update the cash book by recording items in the bank statement not in it, and then, reconcile the adjusted cash book balance to the statement balance.
- Do straight reconciliation.

We shall demonstrate both methods in the following illustration:

On 31 July, 2004, Adekunle Ajani received a bank statement which showed a balance of N198,000 whereas the bank column of the cash book showed a balance of N140,000. After comparing the entries in both, the following items were revealed as accounting for the difference:

29 July 2004 Dividend received from ABC Ltd. credited by bank not yet recorded in the cash book amounts to N16,000.

30 July 2004 Payment of N10,000 by standing order not yet recorded in the cash book.

30 July 2004 Transfer charges (N300) and bank commission (N700) not yet recorded in the cash book.

31 July 2004 Interest of N24,000 credited by bank not yet entered into the cash book.

31 July 2004 Cheque Nos. 311, 316 and 317 in favour S. Kasali, John Dans and Dennis Kay for N6,000, N16,000 and N7,000 respectively, have not been presented for payment.

You are required to prepare a bank reconciliation statement.

Method I:

Adekunle Ajani

Dr. Adjusted Cash Account (Bank Column) Cr.

Date	Particulars	Folio	Amount	Date	Particular	Folio	Amount
	Balance as given		140,000.00		Payment by order		1
29/7/04	Dividend (ABC Ltd.)		16,000.00		Transfer Charges		
31/7/04	Interest (bank)		24,000.00		Bank Commission		
					Balance c/d		169
			180,000.00				180
	Balance b/d		169,000.00				

Bank Reconciliation Statement

N N

Balance as per Bank Statement 198,000.00

Less: Unpresented cheques:

S. Kasali (311) 6,000.00

John Dans (316) 16,000.00

Dennis Kay (317) 7,000.00 29,000.00

Balance as per adjusted Cash Book N169,000.00

Method II: A Straight Reconciliation

N N

Balance as per Bank Statement 198,000.00

Add: Direct Debits:

Transfer charges 300.00

Bank Commission	700.00		
Payment by order	10,000.00	11,000.00	
			209,000.00
Less: Unpresented cheques			29,000.00
Less: Direct Credits:			
ABC Ltd. Dividend	16,000.00		
Bank Interest	24,000.00	69,000.00	
Balance as per Cash Book			**N140,000.00**

Self-Assessed Exercise

Prepare a bank reconciliation statement using the following particulars:

30 April 2002	Bank statement balance	N780,000
	Cash book balance	N680,000
	Cheques drawn not presented for payment	N300,000
	Cheques paid into bank not yet credited	N200,000

4.0 CONCLUSION

We wish to conclude that usually, the balance on the cash book and the bank statement do rarely agree with each other, due to timing differences as well as the fact that some items may appear in the bank statement but yet to be recorded in the cash book. A process of bank reconciliation which involves investigating the differences in both balances is employed to agree the balances. This leads to the generation of a bank reconciliation statement.

5.0 SUMMARY

In this unit, we have examined the need to agree our cash book balance to the bank statement balance. We considered, also, reasons for the differences in both balances, and how they could be reconciled. Two methods were employed to illustrate/demonstrate how bank reconciliation statements are drawn.

6.0 TUTOR MARKED ASSIGNMENTS

1. Discuss the need for bank reconciliation.

2. The following cash book and bank statement relates to the firm of Onyeka Enterprises for the month of June 2002.

Dr. CASH BOOK Cr.

Date	Particulars	Folio	Amount	Date	Particular	Folio	Amount
1/6/02	Balance b/fwd		12,000 .00	2/6/02	Cheq ue – Oweh		800.00
3/6/02	Cash		1,00 0.00	2/6/02	Cheq ue – Peter		300.00
5/6/02	Cheq ue - Ko nb e		170.00	6/6/02	Cheq ue – Bello		210.00
7/6/02	Cheq ue – Ladi		440.00	8/6/02	Cheq ue – Smart		730.00
9/6/02	Cheq ue – Michael		310.00	10/6/02	Cheq ue – Thomas		2,240.00
11/6/02	Cheq ue - Nwafa		720.00	12/6/02	Balance c/d		13,360.00
			14,640 .00				14,640.00
	Balance b/d		169,000 .00				

ONYEKA ENTERPRISES
Bank Statement as at 12th June 2002

		Dr.	Cr.	Balance
1/6	Balance			12,000.00 Cr.
2/6	Cheque No. 5554	800.00		11,200.00 Cr
3/6	Cash		1,000.00	12,200.00 Cr.
4/6	COT	40.00		12,160.00 Cr.
5/6	Cheque deposits		170.00	12,330.00 Cr.
6/6	Cheque No. 5555	300.00		12,030.00 Cr.
7/6	Cheque deposit		440.00	12,470.00 Cr.
8/6	Cheque deposit (by Yinka)		1,200.00	13,670.00 Cr.
9/6	Cheque dishonoured	170.00		13,500.00 Cr.
11/6	Standing Order (Insurance Prem)	1,120.00		12,380.00 Cr.
12/6	Cheque No. 5556	210.00		12,170.00 Cr.

You are required to:

(a) Adjust the Cash Book

(b) Prepare a Bank Reconciliation Statement.

7.0 REFERENCE AND FURTHER READINGS

ACCA (2004). Preparing Financial Statements. Middlesex: A. T. Foulks Lynch Limited.

Akplu, H.F. (1985). Introduction to Accounting. London: Macmillan Publishers Limited.

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

UNIT 7: 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 5 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 ACCOUNTS OF SOLE PROPRIETORSHIPS

3.1 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 Assessed Exercise

Discuss the characteristics of a sole proprietorship business.

3.2 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:

			N
Capital b/f			XX
Add: Amount introduced during the year	X		
Profit earned during the year	X		
			XX
Less: Drawings during the year	X		
Capital c/f			XX

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 is 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 Assessed Exercise

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

3.3 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-Assessed Exercise

Explain the features of drawings.

3.4 Nature of Tax

A business which has a legal entity normally pays tax on its income just as any natural person does. 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-Assessed Exercise

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 ASSIGNMENTS

1. What do you understand by sole proprietorship?

2. The following trial balance is extracted from the books of Cornerstone 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	
	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.

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

(e) 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 Cornerstone Enterprises as at December 31, 2004, and show the up-to-date capital position.

7.0 REFERENCE AND FURTHER READINGS

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.

Oyekanmi, Abiodun (2003). Introductory Financial Accounting for Professionals. Calabar: NOOKIA Ventures Ltd.

UNIT 8: 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:

- the association must be engaged in a business which may be a trade or a profession;
- the trade or the profession must be carried on together, jointly, for the benefit of all the partners; and
- 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 reduced to writing as this will tend to lead to fewer possibilities of misunderstandings and disagreements between partners), will govern the relationships between the partners, including:

- name of organisation, the type of business, and duration;
- capital to be introduced by partners;
- 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;
- drawings by partners;

arrangements for dissolution, or on the death or retirement of partners;
settling of disputes;
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 backgrounder, 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 ACCOUNTS OF PARTNERSHIP I

3.1 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	4.	The rights of partners themselves are governed by

	the Articles of Association and can be varied by passing a special resolution of the company in a general meeting.		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-Assessed Exercise

Distinguish between limited liability companies and partnerships.

3.2 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 very beginning when 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.

An 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.
- 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. (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-Assessed Exercise

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?

3.3 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.

An Example:

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-Assessed Exercise

If Kay and Ker 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?

3.4 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-Assessed Exercise

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 ASSIGNMENTS

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 ratio 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.

7.0 REFERENCE AND FURTHER READINGS

ACCA (2004). Preparing Financial Statements. Middlesex: A.T. Foulks Lynch Ltd.

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UNIT 9: 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:

all assets are realised in full;
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 ACCOUNTS OF PARTNERSHIPS II

3.1 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 pertinent 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 re sidual 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:

(i) The equipment was sold for N72,000;
(ii) The land and buildings were sold to Zaki Ltd. For N60,000;
(iii) All stocks were sold for N24,800;
(iv) The insurance were surrendered for the premium of N400;
(v) All creditors and taxes payable were paid;
(vi) N16,600 was collected from debtors and the balance written-off;
(vii) N10,400 representing the face value of the note and interest due to maturity was deposited in a special account with Chartered Bank;
(viii) 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:

Dr. Oluwole, Osuji and Bamidele 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-Assessed Exercise

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

3.2 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 1/06/2001	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**	**50%**	**20%**	**30%**
	N	**Oluwole**	**Osuji**	**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-Assessed Exercise

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 ASSIGNMENTS

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	
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 information 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 REFERENCE AND FURTHER READINGS

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UNIT 10: ACCOUNTS OF PARTNERSHIP III

CONTENTS

1.0 INTRODUCTION

We shall conclude our discussion on Accounts of Partnerships in this unit. Earlier in units 8 and 9, 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 ACCOUNTS OF PARTNERSHIPS III

3.1 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's Account Cr.

Date	Particulars	N	Date	Particulars	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
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

The New Balance Sheet after T s Retirement:

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

Self-Assessed Exercise

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.

3.2 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.

Required: 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

Dr. Profit and Loss Account for the period of Six months ended 31/3/1999 Cr.

		N		N
Partners Salaries			Profit for 6 months to-date (N11,600 ÷ 2)	5,800
O:	500			
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

Dr. Profit and Loss Account for the period of Six months ended 30/9/1999 Cr.

	N		N
A s salary	500	Profits for 6 months to-date (N11,600 ÷ 2)	5,800
Interest: O (5% per annum of N15,900 – Balance of capital account And current account – 16,000 + 1200 + 500 – 1800)	398		
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

Dr. Current Account of O Cr.

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

Dr. O's Capital Account 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

3.2.1 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).

<u>Example</u>:

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:

Dr. Balance Sheet of ABC Cr.

	N		N
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:

Dr. Reconstructed Balance Sheet Cr.

	N		N
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-Assessed Exercise

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 ASSIGNMENTS

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 REFERENCE AND FURTHER READINGS

Beckett, D.W. (1980). Spicer and Pegler s Book-Keeping and Accounts. London: HFL Publishers Limited.

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UNIT 11: 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.

Therefore, 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 ACCOUNTS OF NON-PROFIT ORGANISATIONS

3.1 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 therefrom, 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-Assessed Exercise

Discuss the features of non-profit organisations.

3.2 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 basis 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-Assessed Exercise

What are the accounting requirements of non-profit organisations?

3.3 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:

Dr. Receipts and Payments Account 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

	N	N
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-Assessed Exercise

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.

3.4 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.

Required:

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

	N	N	N
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

	N	N
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-Assessed Exercise

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

4.0 CONCLUSION

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 – summarises all cash transactions carried out during the period. Their major limitation lies on 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 better preferred.

6.0 TUTOR-MARKED ASSIGNMENTS

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 Salaries and wages 19,600
Year: Rent and rates 3,800
At bank 6,300 Printing and stationery 1,800
In hand 1,000 Affiliation fees 1,200
Subscriptions: Captain s and treasurer s
exps. 3,700
Supporters 15,000 Refreshments for
visiting teams 6,100
Supporters – 1998 season 2,000 Annual social fund 10,200
Share of gate takings 32,000 Equipment purchased 2,600
Annual social 13,400 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 percent 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 REFERENCE AND FURTHER READINGS

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

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UNIT 12: MANUFACTURING ACCOUNTS

Table of 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 MANUFACTURING ACCOUNTS

3.1 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-Assessed Exercise

Explain the objectives of a manufacturing account.

3.2 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-Assessed Exercise

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

3.3 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.

<u>Example:</u>

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-Assessed Exercise

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

3.4 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-Assessed Exercise

How do you ascertain the profit or loss on manufacture?
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 ASSIGNMENTS

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

	Dr. N	Cr. 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 REFERENCE AND FURTHER READINGS

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.

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UNIT 13: CONTROL ACCOUNTS

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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 CONTROL ACCOUNTS

3.1 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 Assessed Exercise

What do you understand by a control account?

3.2 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

Debit Entries	Source
Total credit sales	Sales day book
Dishonoured cheques from customers	Cash book
Interest charged to customers	Journal book
Bill receivable dishonoured	Journal book

Credit Entries	Source
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

Debit Entries	Source
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

Credit Entries	Source
Total credit purchases	Purchases day book
Dishonoured cheques	Cash book
Interest charged by suppliers	Journal book
Bills payable dishonoured	Journal book

Self-Assessed Exercise

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

3.3 Advantages of Control Accounts

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

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.

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.

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-Assessed Exercise

Discuss the advantages of control accounts.

3.4 Accounting treatment of certain items in Control Accounts

Debtors Control Account

- 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.
- 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.
- 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.
- 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.

- o 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.
- o 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.

Creditors Control Account

- o 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".
- o 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.
- o Provision for discount receivable should be disregarded because it does not affect the creditors control account.
- o 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:

Dr. Sales Ledger Control Account Cr.

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

Dr. Purchases Ledger Control Account Cr.

	N		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 Assessed Exercise

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 ASSIGNMENTS

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 REFERENCE AND FURTHER READINGS

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

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UNIT 14: ACCOUNTS FROM INCOMPLETE RECORDS

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1.0 INTRODUCTION

"Incomplete accounting records" refers to a situation where the accounting system do not apply the principles of double entry, thus, making it difficult or impossible to draw up the normal trading and profit and loss account as well as produce a trial balance. Two distinguishable situations of this are where no records are kept at all and where partial records are maintained usually in the form of real accounts (cash or fixed assets) but personal and expense accounts are omitted.

This unit will concentrate on the above situations. The essence, if not the quintessence, is to explore the possibility or feasibility of creating something out of nothing – having some idea of the trading results with scanty accounting information.

2.0 OBJECTIVES

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

- Give meaning to the term „incomplete records ;
- Compute the trading results where no records are kept;
- Compute the trading results and net investments in the business where partial records are kept.

3.0 ACCOUNTS FROM INCOMPLETE RECORDS

3.1 Meaning of Incomplete Records

From our introduction above, we can say that "incomplete records" denotes varying degrees of deviation from the standard accounting records which are kept on the „complete principle of double entry. In other words, it describes records which the trader has not fully completed or where no records at all have been kept of transactions. However, it may still be possible to prepare periodic financial statements if the relevant basic documents are made available from which the required additional information can be obtained. The matter of incomplete accounting records is more often associated with the sole proprietorships.

Self-Assessed Exercise

Explain what you understand by the term „incomplete records under two distinct situations.

3.2 Situation of No Records

Where no records have been kept, the accountant will fall back to a great extent on basic source documents such as receipts, invoices, and bank tellers/statements as well as the entity s transaction files. Some information relating to opening/closing stocks, cash balances, fixed assets, debtors, creditors and the opening capital position can be gotten from the proprietor through interviews.

Also, where there are no reliable records to lay hands on, further interviews with the proprietor may reveal the extent and frequency of cash withdrawals from the business to meet personal obligations as well as cash or assets introduced into the business during the year, to enable the accountant make appropriate estimates.

A „statement of affairs may be prepared as at the start of the period and another as at the close of period if the aim is just to let the proprietor have some approximate idea of the period s trading results and the closing net worth. A „statement of affairs , which is the name given to what would have been called a „balance sheet if it had been drawn from a set of records, is a summary of an entity s assets, liabilities and capital at a particular date. It contains approximate values rather than values disclosed by books of account which have been kept systematically.

A comparison of the net asset position on the two dates (start and close of periods) will show the amount by which the proprietor s capital had increased/decreased during the intervening period. If there were no withdrawals and no new capital introduced during the period, this difference must be of the nature of profit or loss.

To calculate the amount of profit (or loss) realised between the intervening periods from the relevant statements of affairs would require, firstly, that we find the net increase in the net asset and then add back drawings (if any)and deduct new capital introduced (if any).

Example:

The statement of affairs of Ryzma, a sole proprietor, disc losed capital as at 31st December, 2001 and 2002 as N450,000 and N600,000 respectively. During the year, Ryzma introduced an old delivery van valued at N100,000 but total drawings in cash and goods amounted to N200,000. Compute the net profit for the year.

Solution:

Net change in net worth (capital):	N
Closing balance	600,000
Opening balance	450,000
Difference	150,000
Add: Drawings	200,000
Less: Capital introduced	100,000
Net profit for the year	250,000

Let us look at another example:

The following information is disclosed in respect of Rodro & Co., who did not maintain a set of accounting records during the year 1st July, 1992 to 30th June, 1993. You are required to prepare a set of accounts, highlighting the company s profit for the year as well as the closing networth.

	Estimated Values	
	As at 1/7/92	As at 30/6/93
	N	N
Land and Buildings	25,000	24,000
Plant and machinery	34,000	30,000
Office furniture	6,000	7,000
Motor vehicles	-	4,000
Stocks	12,000	15,000
Sundry Debtors	8,000	12,000
Sundry Creditors	13,000	15,000
Cash	2,000	3,000

During the year, Rodro withdrew cash and goods amounting to N4,500 for his personal use. He, however, brought in sundry assets valued at N3,000. Prepare statement of affairs for Rodro & Co. highlighting the trading results and the financial position of the firm.

Solution:

Dr. Statement of Affairs as at 1st July, 1992 Cr.

Date	Particulars	Folio	Amount (₦)	Date	Particular	Folio	Amount (₦)
	Networth (capital)		74,000.00		Land and Buildings		245000.00
	Creditors		13,000.00		Plant and Machinery		34,000.00
					Office Furniture		6,000.00
					Stocks		12,000.00
					Debtors		8,000.00
					Cash		2,000.00
			87,000.00				87,000.00

Dr. Statement of Affairs as at 30th June, 1993 Cr.

Date	Particulars	Folio	Amount (₦)	Date	Particular	Folio	Amount (₦)
	Networth (capital)		80,000.00		Land and Buildings		24,000.00
	Creditors		15,000.00		Plant and Machinery		30,000.00
					Motor Vehicles		4,000.00
					Office Furniture		7,000.00
					Stocks		15,000.00
					Debtors		12,000.00
					Cash		3,000.00
			95,000.00				95,000.00

Computation of Net Profit

		N
Net worth at 30/6/93		80,000
Less:	Networth at 1/7/92	74,000
Net increase		6,000
Add:	Drawings	4,500
Less:	New capital introduced	3,000
Net profit for the year		7,500

Self-Assessed Exercise

Explain the difference between „statement of affairs and „balance sheet relative to accounts from incomplete records.

Explain the computation of trading results in a situation of „No records .

3.3 Situation of Partial Records

Where partial records are kept (which may be referred to as single entry accounts), some concerns are able to keep a cash book for much of their transactions that are carried out in cash or through the bank. However, cash book entries are usually not posted as few or no ledger accounts are kept. In this circumstance, the accountant will have to fall back on basic documents relating to sales, purchases, cash transactions, etc. which may be filed, as well as the management for additional information. It is important to obtain information relating to fixed assets inventory, inventory values, accruals and prepayments. Also, the accountant may have to convert the entire system into a double entry system first before embarking on the preparation of the final accounts.

When the books are kept on the single entry principle, a common problem which arises is the determination of purchases and sales figures in the absence of accounts maintained for these items. However, the total amounts of sales and purchases for a period can be derived once information is given in respect of the outstanding debtors and creditors at the beginning and close of the period, and also, on the total cash movement during the period between the firm and its customers and suppliers.

Example:

Derive the total sales figure from the following information extracted from a firm s cash book and other relevant records:

Total debtors b/f	5,600	
Total cash receipts from debtors and cash sales		153,000
Total debtors c/f	6,800	

Dr. Total Debtors Account Cr.

Date	Particulars	Fol.	Amount (₦)	Date	Particular	Fol.	Amount (₦)
	Balance b/f		5,600.00		Cash receipts		153,000.00
	Sales (balancing figure		154,200.00		Balance c/f		6,800.00
			159,800.00				159,800.00
	Balance b/f		6,800.00				

Dr. Sales Account Cr.

Date	Particulars	Folio	Amount (₦)	Date	Particular	Folio	Amount (₦)
					Total Debtors account		154,200

Self Assessed Exercise

From the following information relating to a company, you are required to determine the year s purchases:

Total creditors b/f	7,200
Total cash paid to suppliers	98,800
Total creditors c/f	8,400

4.0 CONCLUSION

The concept of "Incomplete accounting records" describes two distinct situations where either no records have been kept at all or where partial records are being maintained. In either case, there is a deviation from the double entry principle. The situations make it difficult or impossible to produce a trial balance or draw up the final accounts at the end of a period. The task of the accountant, given the situations, is to explore all possible avenues to obtain information in order to create something out of nothing.

5.0 SUMMARY

In this unit, we have discussed "Accounts from incomplete records" that denotes deviation from the accounting records which are kept on the complete principle of double entry. We have considered situations where no records are kept and where partial records are maintained with emphasis on the job of the account to attempt to make good the situations.

6.0 TUTOR MARKED ASSIGNMENTS

Ms Clark, a shop owner, keeps a cash book and a ledger containing personal accounts for debtors and creditors. At 31st December, 1999 and 31st December, 2000, her assets and liabilities were as follows:

	1999	2000
Petty cash balance	100	125
Bank balance	2,000	5,000
Debtors	10,000	12,000
Creditors	15,000	13,000
Inventory	5,000	6,000
Equipment at carrying value	5,000	7,500

The following additional information are ascertained:

(i) Drawings during the year amounted to N2,500.

(ii) During the year, a legacy of N3,000 had been paid into the bank as additional capital.

(iii) N50,000 had been paid to creditors for purchases.
(iv) Receipts from debtors amounted to N75,000. All sales were on credit.
(v) An amount of N1,000 must be written-off as bad debts.
(vi) Depreciation is to be provided for at 10% on carrying value.
(vii) Additional equipment was purchased on 1st July, 1999.

You are REQUIRED to prepare in respect of Ms Clark s shop:

(a) The Trading and Profit and Loss account for the year ended 31st December, 2000 to show the gross profit as well as the net profit.
(b) The balance sheet as at 31st December, 2000.

7.0 REFERENCE AND FURTHER READINGS

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

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UNIT 15: ANALYSIS OF FINANCIAL STATEMENTS

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1.0 INTRODUCTION

In Unit 5, 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:

Management needs information for control of costs and improved profitability;
Lenders need information for borrowing and credit purposes;
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:

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?

As managers at different levels and areas of calling, 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;
- Demonstrate the use of ratios in the analysis of financial statements.

3.0 ANALYSIS OF FINANCIAL STATEMENTS

3.1 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-Assessed Exercise

How useful is the analysis of financial statements?

3.2 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.

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 below:

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

v. Current ratio
vi. Quick (or acid test) ratio

Leverage Ratios

vii. Debt ratio
viii. Capital gearing
ix. Times interest covered

Activity Ratios

x. Total assets turnover
xi. Stock turnover
xii. Sales to debtors
xiii. Average collection period

Investment Ratios

xiv. Earnings yield
xv. Dividend yield
xvi. Price – earning multiple

We shall explain all the ratios with examples:

1. Gross Profit and Net Profit margin:

The gross profit margin is the ratio of gross profit to sales while the net profit 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:

- Gross profit margin $= \dfrac{\text{Gross profit}}{\text{Sales}}$

- Net profit margin $= \dfrac{\text{Net profit}}{\text{Sales}}$

2. Return on Assets Managed (ROAM):

$$ROAM = \frac{\text{Net profit before interest}}{\text{Total sales}}$$

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. Return on Capital Employed:

$$ROCE = \frac{\text{Net profit + Interest on long-term loan}}{\text{Total long-term funds}}$$

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. Return on Equity:

$$ROE = \frac{\text{Net profit after tax}}{\text{Total equity funds}}$$

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. Current Ratio:

$$CR = \frac{\text{Current assets}}{\text{Current liabilities}}$$

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. Quick (or Acid test) Ratio:

$$QR = \frac{\text{Total current assets – Inventory}}{\text{Total current liabilities}}$$

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. Debt Ratio:

$$\text{Debt Ratio} = \frac{\text{Total debts}}{\text{Total assets}}$$

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. Capital Gearing Ratio:

CGR = Long term loan : Total Equity funds

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. Times Interest Covered:

$$TIC = \frac{\text{Net profit + Interest}}{\text{Interest}}$$

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. Total Assets Turnover:

$$TAT = \frac{Sales}{Total\ assets}$$

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. Stock Turnover:

$$ST = \frac{Cost\ of\ Sales}{Average\ stock}$$

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

12. Sales to Debtors:

$$Sales\ to\ Debtors = \frac{Sales}{Debtors}$$

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. Average Collection Period:

$$ACP = \frac{Debtors}{Average\ sales\ per\ day}\ days$$

Here, average sales per day is 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. Earnings Yield:

$$EY = \frac{Earnings\ per\ share}{Market\ price\ of\ share} \times \frac{100}{1}$$

Where EPS = Net profit after tax

Number of shares outstanding

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

15. Dividend Yield:

$$DY = \frac{\text{Dividend per share}}{\text{Market price of share}}$$

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

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. Price – Earnings Multiple:

$$P - E\ M = \frac{\text{Market price per share}}{\text{Earnings per share}}$$

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

	1996	1995
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 percent mortgage loan	80	100
	505	368

(1) <u>Profitability Ratios:</u>

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

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

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

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

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 = $\frac{\text{Net profit before interest *}}{\text{Total assets}}$

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%

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 = $\frac{\text{Net profit + interest on long-term loan}}{\text{Total long-term funds}}$

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

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

(e) Return on equity = $\frac{\text{Net profit after tax}}{\text{Total equity funds}}$

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

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

(2) Liquidity Ratios:

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

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

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

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

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) Leverage Ratios:

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

or

$\frac{\text{current liabilities + long-term loan}}{\text{total assets}}$

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 = 0.2 : 1

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

(c) Times interest covered $= \dfrac{\text{net profit + interest}}{\text{interest}}$

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

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

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

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

(4) <u>Activity Ratios:</u>

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

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

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

(b) Stock turnover $= \dfrac{\text{cost of sales}}{\text{average stock}}$

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

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

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

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

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

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

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

(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) Investment Ratios:

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

where earnings per share (EPS) = $\frac{\text{net profit after tax}}{\text{number of shares outstanding}}$

$$1996 : \text{EPS} = \frac{64,000}{300,000} = 21.3 \text{ k}$$

$$\text{Earnings yield} = \frac{21.3\text{k}}{\text{N}1.50} \times 100\%$$

$$= 14.2\%$$

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

$$\text{Earnings yield} = \frac{20\text{k}}{\text{N}1.45} \times 100\%$$

$$= 13.8\%$$

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

where dividend per share = $\frac{\text{dividend for the year}}{\text{number of shares outstanding}}$

1996 Dividend per share = $\frac{30{,}000}{300{,}000}$ = 10k

Earnings yield = $\frac{10\text{k}}{\text{N}1.50} \times 100\%$

= 6.7%

1995 Dividend per share = $\frac{20{,}000}{200{,}000}$ = 10k

Earnings yield = $\frac{10\text{k}}{\text{N}1.45} \times 100\%$

= 7%

(c) Price earnings multiple = $\frac{\text{market price per share}}{\text{earnings per share}}$

1996 = $\frac{\text{N}1.50}{21.3\text{k}}$ = 7 times

1995 = $\frac{\text{N}1.45}{20\text{k}}$ = 7.25 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-Assessed 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 considered the usefulness of financial statements analysis as well as the ways in which accounting reports can be analysed and made more meaningful to the users. Ratio analysis has been dealt with extensively.

6.0 TUTOR-MARKED ASSIGNMENTS

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. N		MEDE LTD.	
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

	KOLA LTD.	MEDE LTD.
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**

REQUIRED:

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 REFERENCE AND FURTHER READINGS

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