FINANCIAL ACCOUNTING

ACC311

Course Guide

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CONTENT

INTRODUCTION

This is a course guide for ACC311 (Financial Accounting). The purpose of the course guide is to relate to you the basic structure of the course material you are expected to study as a B.Sc. Accounting Student in National Open University of Nigeria. Like the name 'course guide' implies, it is to guide you on what to expect from the course material and at the end of studying the course material.

COURSE CONTENT

The course content consists basically of the treatment of transactions in departmental account, branch account, partnership and company account. Specifically, Company Accounts: Formation, issue and redemption of Shares and debentures, final accounts, merging, amalgamation, absorption, etc.; Advanced Partnership accounts: Admission, retirement, dissolution, change of interest, including the treatment of goodwill on admission/retirement, Conversion of partnerships to Limited companies, amalgamation of partnerships; Departmental and Branch Accounts (Home and Foreign branches) and Introduction to interpretation of accounts and financial statement analysis – Funds flow statements.

COURSE AIM

The aim of the course is to bring to your cognizance the practical treatment and presentation of financial transactions as regards issues in partnership and company accounts appropriate at this level.

COURSE OBJECTIVES

At the end of studying the course material, among other objectives, you should be able to:

1. Explain the accounting treatment of departmental account;
2. Explain accounting principles guiding the preparation of transactions of home and foreign branches;
3. Explain basic concept in partnership account and various treatment of accounting scenarios;
4. Explain issue and redemption of Shares and debentures, final accounts, merging, amalgamation, absorption, etc.
5. Show relevant accounting entries in the books; and
6. Interpretation of accounts and financial statement analysis

COURSE MATERIAL

The course material package is composed of:

The Course Guide
The study units
Self-Assessment Exercises
Tutor Marked Assignment
References/Further Reading

THE STUDY UNITS
The study units are as listed below:

MODULE 1: DEPARTMENTAL ACCOUNT
Unit 1: Unit 1: Basic concepts and treatment of departmental transaction

MODULE 2: BRANCH ACCOUNTS
Unit 1: Accounting Treatment of Home Branches Accounts
Unit 2: Accounting Treatment of Foreign Branches Accounts

MODULE 3: ADVANCED PARTNERSHIP ACCOUNTS
Unit 1: Partnership Arrangement
Unit 2: Changes in the Constitution of Partnership
Unit 3: Conversion of Partnership into Limited Company

MODULE 4: COMPANY ACCOUNTS
Unit 1: Formation of Company
Unit 2: Issue of Shares and Debentures
Unit 3: Forfeiture and Redemption of Shares
Unit 4: Amalgamation and Absorption
Unit 5: Final Account of a Limited Company

MODULE 4: INTRODUCTION TO INTERPRETATION OF ACCOUNTS AND FINANCIAL STATEMENT ANALYSIS
Unit 1: Financial Statement Analysis
Unit 2: Classification of Financial Ratio
Unit 3: Cashflow Statement

ASSIGNMENTS
Each unit of the course has a self assessment exercise. You will be expected to attempt them as this will enable you understand the content of the unit.

TUTOR MARKED ASSIGNMENT

The Tutor Marked Assignments (TMAs) at the end of each unit are designed to test your understanding and application of the concepts learned. Besides the preparatory TMAs in the course material to test what has been learnt, it is important that you know that at the end of the course, you must have done your examinable TMAs as they fall due, which are marked electronically. They make up to 30 percent of the total score for the course.

SUMMARY

This course material was designed to provide you the opportunity of obtaining a B. Sc. degree in Accounting and prepare you for future professional examinations. Therefore, it is very important that you commit adequate effort to the study of the course material for maximum benefit. I wish you good success.

TABLE OF CONTENT

MODULE 1: DEPARTMENTAL ACCOUNT

Unit 1: Basic concepts and treatment of departmental transaction

1.0 INTRODUCTION

In this unit, you will learn treatment of financial transaction under departmental account. In this unit, we shall look at the meaning and type of departmental account. W e shall also look at the ledger accounts involve in departmental account.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Explain departmental accounting.
2. State and explain types of department.
3. State the basis of apportioning expenses.
4. Prepare departmental accounts

3.0 MAIN CONTENT

3.1 Meaning of Departmental Accounting

Departmental accounting is centralized and common in corporations and other types of non-banking businesses. Organizations have various departments which are in charge of the various operations, hence the need for each of the departments to give accounts of their operation. All departments must be able to ascertain there trading results. With departmental accounting, most of the accounting procedures can be performed in-house and might be able to use an individual accountant or a small team that oversees the accounting for all departments.

Departmental accounts gives room for an organization to separate the activities of business organization into controllable units and also enable them to compare results of each departments. Departmental account helps the organization to determine which department is doing well and which one to discontinue. Separating the operation of each business units enables accountability.

3.1.1 Advantages of Departmental Account

1. Easy determination of profitable and unprofitable segments
2. It helps in monitoring the progress of each departments
3. It allows for error detection
4. Managers of each department can be paid based on the result of their operation.
5. The progress of each department can be monitored
6. The gross profit of each department can be ascertained.
7. Policies can be formulated for each department based on their trading result.

SELF ASSESSMENT EXERCISE

Explain departmental accounting and state its advantages.

3.2 Methods of Departmental Accounting

There are two methods of keeping departmental accounts:

1. Accounts of all departments are kept in one book only

To prepare such accounts, it will be necessary first, for the income and expenditure of department to be separately recorded in subsidiary books and then for them to be accumulated under separate heads in a ledger or ledgers. This may be done by having columnar subsidiary books and a columnar ledger. Under this system, the gross profit of individual department can be determined accurately.

2. Separate set of books are kept for each department

A separate set of books may be kept for each department, including complete stock accounts of goods received from or transferred to other departments or as also sales.

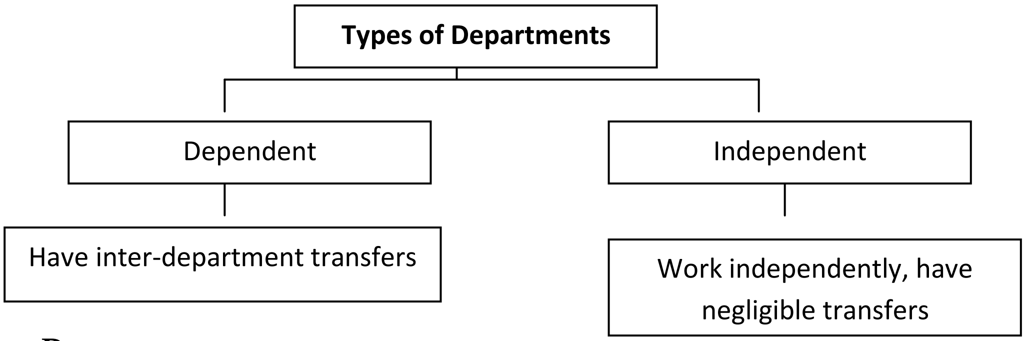
Nevertheless, even when separate sets of books are maintained for different departments, it will also be necessary to devise a basis for allocation of common expenses among the different departments, if an organization is interested in determining the separate departmental net profit in addition to the gross profit.

SELF ASSESSMENT EXERCISE

State and explain two methods of departmental accounting

3. 3 Types of Departments

There are two types of departments



Independent Departments

Departments which work independently of each other and have negligible inter department transfers are called Independent Departments.

Dependent Departments

Departments which transfer goods from one department to another department for further processing are called dependent departments. Here, the output of one department becomes the input for the other departments. These transfers may be done at cost or some pre-decided selling price. The price at which this is done is called a transfer price. In these departments unloading is required if the transfer price is having profit element. The method of eliminating unrealized profit is being discussed in the succeeding paragraph.

Inter-Departmental Transfer

Whenever goods or services are provided by one department to another, their cost should be separately recorded and charged to the department benefiting thereby and credited to that providing it. The totals of such benefits should be disclosed in the departmental Profit and Loss Accounts, to distinguish them from other items of expenditure.

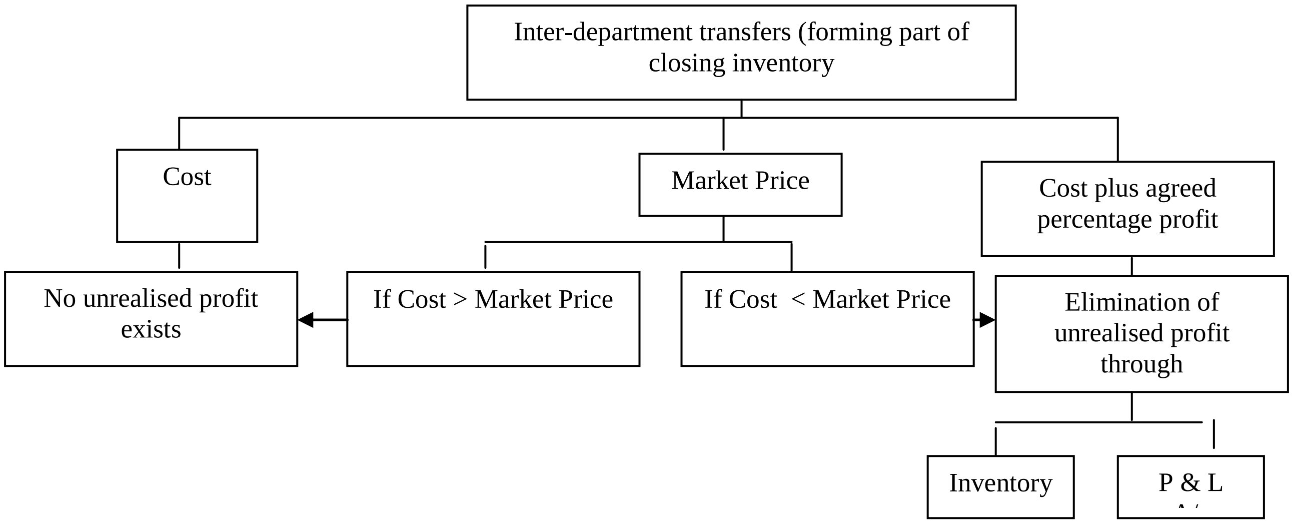
SELF ASSESSMENT EXERCISE

Distinguish between dependent and independent departments.

3.4 Basis of Inter-Departmental Transfers

Goods and services may be charged by one department to another usually on either of the following three bases:

i. Cost
ii. Ruling market price
iii. Cost plus agreed percentage of profit.



SELF ASSESSMENT EXERCISE

Identify three basis of inter-departmental transfer.

3.5. Basis of apportioning expenses

All expenses should be apportioned to each departments adequately. The expenses are apportioned thus:

a. Expenses incurred for one department: any expenses specifically incurred for a department is charged fully against that particular departments.
b. Expenses incurred on behalf of all the departments: any expenses incurred for the generality of the departments would be treated using any of the following basis:

   a. Turnover   b. Floor area   c. Number of articles sold basis   d. cubic content

   e. Direct analysis basis   f. Average stock held

The following are suggested basis of allocation. Note that the basis of allocating expenses depends on the method specified in the question:

	Expenses	**Suggested basis of allocation**
1.	Rent & Rates	Floor area
2.	Depreciation	Assets employed by each department
3.	Heating & Lighting	Floor Area
4.	Power	Horse power
5.	Salaries & Wages	Number of staff employed

Allocation of Expenses

S/N	Expenses	Basis
1.	Rent, rates and taxes, repairs and maintenance, insurance of building	Floor area occupied by each department (if given) otherwise on time basis
2.	Lighting and Heating expenses (e.g. energy expenses)	Consumption of energy by each department
3.	Selling expenses e.g. discount, bad debts, selling commission, freight outward, travelling sales manager's salary and other costs	Sales of each department
4.	Carriage inward/discount received	Purchases of each department
5.	Wages/Salaries	Time devoted to each department
6.	Depreciation, insurance, repairs and maintenance of capital assets	Value of assets of each department otherwise on time basis
7.	Administrative and other expenses, e.g. salaries of managers, directors, common advertisement expenses, etc	Time basis or equally among all departments
8.	Labour welfare expenses	Number of employees in each department
9.	PF/ESI contributions	Wages and salaries of each department

Note: There are certain expenses and income, most being of financial nature, which cannot be apportioned on a suitable basis, therefore they are recognised in the combined profit and loss account for example – interests on loan, profit/loss on sale of investment etc.

Elimination of Unrealized Profit

When profit is added in the inter-departmental transfer the loading included in the unsold stock at the end of the year is to be excluded before final accounts are prepared so as to eliminate any anticipatory profit included therein.

Stock Reserve

Unrealised profit included in unsold inventory at the end of accounting period is eliminated by creating an appropriate stock reserve by debiting the combined Profit and Loss Account. The amount of stock reserve will be calculated as:

$$\frac{Transfer\ price\ of\ unsold\ stock\ x\ Profit\ included\ inn\ transfer\ price}{Transfer\ price}$$

Journal Entry

At the end of the accounting year, the following journal entry will be passed for elimination of unrealized profit (creation of stock reserve):

Profit and Loss account Dr

To Stock Reserve

(Being a provision made for unrealized profit included in closing inventory)

In the beginning of the next accounting year, the aforesaid journal entry will be reserved as under:

Stock Reserve Dr

To Profit and Loss Account

(Being provision for unrealized profit reversed).

SELF ASSESSMENT EXERCISE

State the basis of allocation of the following expenses: Rent & Rates, depreciation, heating & lighting, power and salaries & wages.

3.6 Disclosure in the Statement of Financial Position

The unsold closing inventory acquired from another department will appear on the assets side of the balance sheet as under:

(An extract of the asset side of the balance sheet)

Current assets	xxx
Inventory	xxx
Less: Stock reserve	xxx

Example 1*:* The purchases of departments are:

X ₦50,000

Y ₦70,000

Z ₦90,000

(a) Carriage Inwards: ₦30,000

(b) Assuming the floor area are X – 2/5; Y – 1/5; Z – 2/5

Rent and rates is ₦20,000

Solution to Example 1

(a) Purchases Basis:

Total Purchases: X + Y + Z = ₦50,000 + ₦70,000 + ₦90,000 = ₦210,000

Department X: $\frac{₦50,000}{₦210,000}$ x ₦30,000 = ₦7,143

Y: $\frac{₦70,000}{₦210,000}$ x ₦30,000 = ₦10,000

Z: $\frac{₦90,000}{₦210,000}$ x N30,000 = ₦12,857

(b) Floor Area Basis

Department X: $\frac{2}{5}$ x ₦20,000 = ₦80,000

Y: $\frac{1}{5}$ x ₦20,000 = ₦4,000

Z: $\frac{2}{5}$ x ₦20,000 = ₦8,000

Format: The usual method is to set the trading, profit and loss accounts using separate columns for each department with an additional column to record the total of all the departments. The format is as below:

Department, Trading, Profit and Loss Account

	A	B	Total		A	B	
Total							
	₦	₦	₦		₦	₦	₦
Opening stock	x	x	x	Sales	x	x	x
Add: Purchases	x	x	x	Less: Return Inwards	x	x	x
Inter-dept transfer	(x)	x	-				
	x	x	xx				
Less: Closing Stock	(x)	(x)	(xx)				
	x	x	x				
Gross Profit	x	x	xx				
	x	x	xx		x	x	xx
Expenses:				Gross Profit b/f	x	x	xx
Rent & Rates	x	x	xx	Discounts received	x	x	xx
Discount allowed	x	x	xx	other income	x	x	xx
Carriage outwards	x	x	xx				
Bad debts	x	x	xx				
Insurance	x	x	xx				
Lighting & heat	x	x	xx				
Net profit	x	x	xx				
	x	x	xx		x	x	xx

Statement of Financial Position

		₦	₦			₦	₦
Capital			x	Fixed Asset:			
Add: Net Profit:	A	x		Land & Building		x	
	B	x	x	Machinery		x	x
			xx	Current Assets:			
Less: Drawings			x	Stock: A	x		
			xx	B	x	x	
Current Liabilities:				Debtors		x	
Creditors		x		Bank		x	

Loan	x		Cash	x	x
Accruals	x	xx			—
		xx			xx

Inter-departmental Transfer: The goods purchased by one department may be transferred to another department. By such, the purchases would be deducted from the original department and added to the receiving department.

Example 2

You are required to prepare the departmental statement of profit and loss and other comprehensive income account for the year ended 31st December, 2012 from the following balances of Top Success Nig. Ltd

		₦	₦
Sales:	Department M		60,000
	Department N		40,000
Opening Stock:	Department M	1,000	
	Department N	800	
Purchases:	Department M	47,200	
	Department N	32,800	
Commission		1,400	
General Office Salaries		2,000	
Insurance		500	
Rates		600	
Repairs		480	
Lighting		1,200	
Cleaning		40	
Internal telephone		240	
Discount received		100	
Discount allowed		120	
Sundry expenses		140	
Stationery		300	
Advertising		460	
Electricity		1,640	
Closing stock:	Department M	1,200	
	Department N	600	

The total floor area occupied by each department was:

Department M: 2/5 Department N: 3/5

The following basis of apportionment should be used for the departments:

a. Commission, Advertising, Discounts Allowed – Proportionate to sales
b. Discount received – Proportionate of purchases
c. Cleaning, electricity, internal telephone, insurance – Total floor rate

All other expenses should be apportioned equally between the departments

Solution to Example 2

Top Success Nig. Ltd
Departmental Statement of Profit & Loss and other Comprehensive Income Account
for the year ended 31st December, 2012

	M ₦	**N** ₦	**Total** ₦		**M** ₦	**N** ₦	**Total** ₦
Opening Stock	1,000	800	1,800	Sales	60,000	40,000	100,000
Purchases	47,200	32,800	80,00				
	48,200	33,600	81,800				
Less: Closing Stock	(1,200)	(600)	(1,800)				
	47,000	33,000	80,000				
Gross profit	13,000	7,000	20,000				
	60,000	40,000	100,000		60,000	40,000	100,000
Expenses:				Gross Profit b/d	13,000	7,000	20,000
Commission (wk1)	840	560	1,400	Discount received (wk 8)	59	41	100
General office salaries (wk12)	1,000	1,000	2,000				
Rate (wk9)	300	300	600				
Insurance (wk7)	200	500	700				
Lighting (wk14)	600	600	1,200				
Repairs (wk13)	240	240	480				
Internal Telephone (wk6)	96	144	240				
Cleaning (wk4)	16	24	40				
Sundry expenses (wk10)	70	70	140				
Advertising (wk2)	276	184	460				
Discount allowed (wk3)	72	48	120				
Stationery (wk11)	150	150	300				
Electricity (wk5)	656	984	1,640				
Net profit	8,543	2,237	10,780				
	13,059	7,041	20,100		13,059	7,041	20,100

Workings

1. Commission – Proportionate to sales

M: $\frac{₦60,000}{₦100,000}$ x ₦1,400 = ₦840

N: $\frac{₦40,000}{₦100,000}$ x ₦1,400 = ₦560

2. Advertising – Proportionate to Sales

M: $\frac{₦60,000}{₦100,000}$ x ₦460 = ₦276

N: $\frac{₦40,000}{₦100,000}$ x ₦460 = ₦184

3. Discounts allowed: Proportionate to sales

M: $\frac{₦60,000}{₦100,000}$ x ₦120 = ₦72

N: $\frac{₦40,000}{₦100,000}$ x ₦120 = ₦48

Basis of floor area:

4. Cleaning

M: $\frac{2}{5}$ x ₦40 = ₦16

N: $\frac{3}{5}$ x ₦40 = ₦24

5. Electricity
M:$\frac{2}{5}$ x ₦1,640 = ₦656
N: $\frac{3}{5}$ x ₦1,640 = ₦984

6. Internal Telephone
M:$\frac{2}{5}$ x ₦240 = ₦96
N: $\frac{3}{5}$ x ₦240 = ₦144

7. Insurance
M:$\frac{2}{5}$ x ₦500 = ₦200
N: $\frac{3}{5}$ x ₦500 = ₦300

8. Discount received: Proportionate to purchases
M:$\frac{₦47,200}{₦80,000}$ x ₦100 = ₦59
N: $\frac{₦32,800}{₦80,000}$ x ₦100 = ₦41

Equality Basis:
9. Rates
M:$\frac{1}{2}$ x ₦600 = ₦300
N: $\frac{1}{2}$ x ₦600 = ₦300

10. Sundry Expenses
M:$\frac{1}{2}$ x ₦140 = ₦70
N: $\frac{1}{2}$ x ₦140 = ₦70

11. Stationery
M:$\frac{1}{2}$ x ₦300 = ₦150
N: $\frac{1}{2}$ x ₦300 = ₦150

12. General Office salaries
M:$\frac{1}{2}$ x ₦2,000 = ₦1,000
N: $\frac{1}{2}$ x ₦2,000 = ₦1,000

13. Repairs
M:$\frac{1}{2}$ x ₦480 = ₦240
N: $\frac{1}{2}$ x ₦480 = ₦240
14. Lighting
M:$\frac{1}{2}$ x ₦1,200 = ₦600

N: $\frac{1}{2}$ x ₦1,200 = ₦600

4.0 CONCLUSION

It can be concluded that the adequate knowledge of accounting treatments of departmental transaction will assist accountant in the preparation of the annual reports of any business. The accounts must be prepared in accordance with relevant accounting standards.

5.0 SUMMARY

This unit explores the meaning, types and method of departmental account. Basis of apportionment, treatment of unrealised profit and journal entries were clearly examined and simplified.

6.0 TUTOR MARKED ASSIGNMENT

1. The following balances have been extracted from the books of Ajaloleru Enterprises for the year ended 30th September 2009.

			Dr	Cr
			₦	₦
Capital				71,000
Sales:	Hardware			59,000
	Electrical			29,500
Purchases:	Hardware		20,000	
	Electrical		10,000	
Stock 1/10/98:	Hardware		2,320	
	Electrical		2,136	
Salaries and wages:		Hardware	20,560	
		Electrical	15,440	
Advertising			615	
Discounts allowed			600	
Salesmen commission			3,000	
Premises			43,000	
Equipment:	Hardware		18,000	
	Electrical		7,000	
Debtors and creditors			10,200	5,319
Bank			5,600	
Rent and Rates			1,580	
Canteen expenses			875	
Electricity			880	
Insurance			940	
Administrative salaries and wages			2,073	
			164,819	164,819

Additional Information:

1. The following amount were owing as at 30/09/99

		₦
Wages:	Hardware	250
	Electrical	170
Electricity		20

2. The general administrative salaries and rent and rates included prepayments ₦33, and N80 respectively.
3. Stock at 30/9/99 were:-

Electrical	₦2,800
Hardware	₦2,450

4. Depreciation is to be provided on shop fittings and equipment as 10% of the written down value.
5. Managers of both departments are to be paid a commission of 5% of the net profit (prior to the commission payment) of the respective departments.
6. The expenses are apportioned using the following basis.
   Sales: Advertising, discounts allowed, salesmen commission
   Area: Electricity, rent and rates, insurance
   No of workers: Canteen charges, general administrative salaries

	Hardware	Electrical
Number of workers	9	6
Floor area (square meters)	4,000	2,000

You are required to prepare:

a. Departmental Statement of Profit and loss account and other comprehensive income for the year ended 30/9/99.

2. Define departmental accounting. State and explain two types of departments.

7.0 REFERENCES/FURTHER READING

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MODULE 2: BRANCH ACCOUNTS
Unit 1: Accounting Treatment of Home Branches Accounts
Unit 2: Accounting Treatment of Foreign Branches Accounts

Unit 1: Accounting Treatment of Home Branches Accounts

1.0 INTRODUCTION

This unit deals with the meaning, types of branch account and accounting treatment of home branch account.

2.0 OBJECTIVES

After studying this unit, you should be able to:
1. Explain meaning and types of branch account.
2. State and explain accounting treatment of home branches accounts.
3. Explain treatment of item in transit.

3.0 MAIN CONTENT

3.1 Meaning and Type of Branches

3.1.1 Meaning

A branch is segment or unit of business not located within the same premises as the main office or the head office. The branch may be within the same country as the head office or in 2 foreign countries. Many businesses operate through branches. The business will maintain a head office which controls to a varying degree the operations of its branches. In the first instance, the head office procures all the necessary physical resources needed by each branch including the premises, in order to commence operation.

Terminology of Branch Accounts

To have a proper understanding of how to go about preparing appropriate accounting records of the business transactions carried out by a branch of a business entity within an accounting period, one must be mindful of the following basic concepts of branch accounts:

Local Branch

This is a branch located within the same country in which the head office of the business is located.

Foreign Branch

A branch located in a different country from that in which the head office of the business is located.

Dependent Branch

This is a branch that has most of its major business transactions record in the accounting record of the head office and not in separate accounting record of its own. The 'Dependence' of a branch implies that it cannot maintain a bank accounts of its own and cannot prepare its own financial statements. Such a branch has these features:

a. It can maintain basic personal accounts of credit customers and a cash account, but cannot maintain a bank account of its own
b. It cannot grant credit sales without authorization from the head office
c. All it cash proceeds from sales must be promptly remitted to the head office. This could be done a daily or weekly basis
d. It cannot make any purchase of goods on it own
e. It cannot incur any cost in the name of business without being authorized by the head office
f. It cannot prepare its own financial statements

Independent Branch

This is a branch that has all of it own separate accounting records. Features of an independent branch are:

a. It maintains full ledger accounts including a bank accounts of its own

b. It can grant credit sales at the discretion of the branch manager

c. It can make its own purchase of goods at the discretion of the branch manager

d. It can incur cost in the name of the business at the discretion of the bank manager

e. It can extract trial balance and prepare its own financial statements

3.1.2 TYPES OF BRANCHES

There are three types of branches:

- Dependent branches (net maintaining detailed account)
- Independent or Autonomous branches
- Foreign Branches

Dependent - Good supply

- All branch expenses

- Daily collection – cash and Debtors to Bank

- Expenses

- A petty cash book maintained

- A stock register maintained

- At a particular time period, branch details are submitted and suggestions given.

SELF ASSESSMENT EXERCISE

State and explain three types of branches

3.2 ACCOUNTING ARRANGEMENT

There are two main methods of account for branch transactions. These are:

1. Where head office maintains accounts of its branches
2. Where branches maintain their own accounts.

3.2.1 Method One: Where Head Office Maintain Branch Account

This is divided into two categories

A. Where Head Office maintain account of its branches and also sends goods to the branches at cost price, the following ledger account would be opened to record the branch transactions.

i. Branch Stock Account: This serves the purpose of a trading account

ii. Good sent to branch account

iii. Branch Debtors account (where there is a credit sale)

iv. Branch Bank Account

v. Branch Expenses account

vi. Branch profit and loss account.

ACCOUNTING ENTRIES

1.	DR	Branch stock a/c	
	CR	Goods send to branch a/c	with the cost of goods sent to branch
2.	DR	Branch Debtors/Bank a/c	
	CR	Branch Stock a/c	with the branch sales
3.	DR	Bank Stock a/c	with the value of goods returned to branch by credit
	CR	Branch Debtors a/c	customer (RI)
4.	DR	Goods send to branch a/c	
	CR	Branch Stock a/c	with the cost of goods returned to H/O by branch
5.	DR	Bank Stock a/c	
	CR	P & L a/c	with the gross profit of the Branch
6.	DR	Branch P & L a/c	
	CR	Branch Debtors a/c	with Bad Debt and Discount allowed
7.	DR	Branch Bank a/c	
	CR	Branch Debtors a/c	with amount received from debtors by the branch
8.	DR	Branch Expenses a/c	
	CR	Branch Bank a/c	with the amount paid for expenses by Branch
9.	DR	Branch P & L a/c	
	CR	Branch Expenses a/c	with the expenses incurred by the Branch
10.	DR	Branch P & L a/c	
	CR	H/O P & L a/c	with the Net profit of the Branch
11.	DR	Goods sent to Branch a/c	
	CR	H/O Trading a/c	with the balance of goods to Branch

B. Where goods are sent to Branch at a price other than at cost price but Head Office

In this case, two methods can be employed to account for the branch stock transactions i.e. Goods sent to branch account or good returned to head office.

These methods are:

1. Memorandum Column Method
2. Adjustment Account Method

1. **Memorandum Column Method:** Under this method, the branch stock account contains on each side, an extra column known as the memorandum column, which does not form part of the double entry system. The normal double entry column contains figures which are stated at cost while the memorandum column contains figures which are stated at the transfer price.

Dr Memorandum branch stock account Cr

	Invoiced Price	**Cost Price**		**Invoiced Price**	**Cost Price**
Balance b/d	x	x	Returns to head office	x	x
Good sent to branch	x	x	Cash sales	x	x
Gross profit	-	x	Credit sales	x	x
			Reduction in selling price	x	-
			Stock deficiency	x	x
			Cash stolen	x	x
			Goods stolen	x	x
			Normal loss	x	-
			Balance c/d	x	x
	xx	xx		xx	xx

NB: It should be noted that all other accounts (Goods sent to branch, debtors account, profit and loss account) will remain the same as in Branch adjustment method.

Illustration: Temilade Limited operate a branch at Ikeja. All purchases are made by the head office in Ikoyi and goods are invoiced at selling price, being cost plus 50%. The following information was given for the year ended 30th September 2000.

	₦
Cash sales	98,550
Credit sales	315,000
Goods sent to branch at invoiced price	562,500
Returns to head office at invoiced price	5,625
Stock at close at invoiced price	140,625
Goods stolen at invoiced price	450
Cash stolen at invoiced price	1,350
Allowance off selling price	900

You are required to prepare the necessary accounts in the books of the head office using memorandum method.

Dr	Memorandum branch stock account			Cr	
	Invoiced Price	**Cost price**		**Invoiced price**	**Cost price**
	₦	₦		₦	₦
Goods sent to branch	562,500	375,000	Cash sales	98,550	98,550
Gross profit		137,700	Credit sales	315,000	315,000
			Returns to head office	5,625	3,750
			Cash stolen	1,350	1,350
			Goods stolen	450	300
			Allowance selling price	900	-
	562,500	512,700		562,500	512,700
			Balance c/d	140,625	93,750

Workings: Convert mark-up to margin

Profit = $\frac{50}{100}$ = $\frac{50}{100+50}$ = $\frac{50}{150}$ = $\frac{1}{3}$

Cost price = $\frac{1}{3}$ - 1 = $\frac{2}{3}$

Goods sent to branch: Cost price = $\frac{2}{3}$ x 562,500 = ₦375,000

Returns to head office: Cost price = $\frac{2}{3}$ x 5,625 = ₦3,750

Good stolen: Cost price = $\frac{2}{3}$ x 450 = ₦300

Closing stock: Cost price = $\frac{2}{3}$ x 140,625 = ₦93,750

Dr	Goods sent to branch account (cost price)		Cr
	₦		₦
Returns to head office	3,750	Branch stock	375,000
Trading account	371,250		
	375,000		375,000

Dr	Profit and Loss account		Cr
	₦		₦
Cash stolen	1,350	Gross profit b/d	137,700
Cost of goods stolen	300		
Net profit	136,050		
	137,700		137,700

2. **Adjustment Account Method:** Under thus method, the goods sent to branch and the branch stock account are maintained at the transfer price. The profit elements contained in these figures are transferred from the goods sent to branch account into the branch stock adjustment account. The gross profit is disclosed by the branch stock adjustment account while the closing balance which represents unrealized profits is deducted from the stock in the balance sheet. The following accounts will be prepared.

i. Branch stock account

ii. Branch mark-up or adjustment account

iii. Good sent to branch account

iv. Branch debtors account

v. Profit and loss account

1. Branch Stock account: The items here are recorded in selling price. It is used to determine the value of stocks of good at close.

Dr Branch stock account (invoiced price) Cr

	₦		₦
Balance b/d	x	Returns to head office	x
Goods sent to branch	x	Transfer to other branch	x
Returns to branch by customer	x	Sales: Cash	x
		Credit	x
		Allowance off selling price	x
		Goods lost in transit	x
		Goods in transit	x
		Good stolen	x
		Any expenses paid	x
		Normal loss	x
		Cash stolen	x
		Cash in hand	x
		Deficiencies	x
		Balance c/d	x
	xx		xx

2. Branch mark-up or Adjustment account: This is the account which is used to ascertain the gross profit of the branch. All the items posted to this account represent the profit loading i.e. percentage added to the items.

Dr Branch mark-up or Adjustment account Cr

	₦		₦
Unrealised profit on returns to Head office by branch	x	Unrealised profit on opening stock	x
Unrealised profit on returns to Head office by customer	x	Unrealised profit on good sent	x
Unrealized profit on good in transit	x		
Unrealized profit on goods stolen	x		
Allowance off selling price	x		
Selling price of normal loss	x		
Unrealised profit on transfer to Other branch	x		
Unrealized profit on closing stock	x		
Gross profit	x		
	xx		xx

Dr	Profit and loss account		Cr
	₦		₦
Discount allowed	x	Gross profit	x
Bad debts	x		
Cost of goods stolen	x		
Cost of goods lost in transit	x		
Money stolen	x		
Sundry expenses	x		
Net profit	x		
	xx		xx

Dr	Branch debtor account		Cr
	₦		₦
Balance b/d	x	Discounts allowed	x
Credit sales	x	Returns	x
		Bad debts	x
		Cheque from debtors	x
		Cash from debtors	x
		Balance c/d	x
	xx		xx

Dr	Goods sent to branch account (cost price)		Cr
	₦		₦
Branch returns to head office	x	Branch stock account	x
Returns to head office from Customer	x		
Transfer to other branch	x		
Purchases	x		
	xx		xx

3.2.2 METHOD TWO: BRANCH ACCOUNTS MAINTAINED IN BRANCH LEDGERS (Where the Branch Keep their accounts)

Under this method, the branch maintains a record of its transactions. Periodically, the branch sends records of its transactions, assets and liabilities to the head office for amalgamation with those of the other branches and that of the head office so that the result of the business as a single unit can be ascertained

OTHER IMPORTANT ACCOUNT

1. **Head Office Current Account:** The branch will maintain a current account for the head office in its books to record all resources received from the Head Office and

with all remittance sent to the Head Office. The net profit or loss of the branch for the period will also be recorded in the current account.

2. **Branch Current Account:** The Head Office will in turn maintain a current account for each branch. All the resources sent to the branches will be recorded in the current account and also, all the remittance received from the branches will be recorded in the current account. The net profit loss of the branches for the period will also be recorded in the current account.
3. **Inter-branch Current Account:** Where a branch maintains its separate sets of account and the branch has dealings with other branches, it becomes necessary to open inter branch current account to record transactions affecting the other branch

Format of current account: In the book of the head office

Dr	Branch current account		Cr
	₦		₦
Cash to branch	x	Returns to head office	x
Goods sent to branch	x	Remmitance to head office	x
Profit	x	Cash in transit	x
		Goods in transit	x
		Balance c/d	x
	xx		xx

SELF ASSESSMENT EXERCISE

Name and explain two main methods of account for branch transactions.

3.3 ITEMS IN TRANSIT

A minor source of difficulty at year end is the treatment of items in transit either from the Head Office to branch and/or vice versa. Postings to branch current account in Head Office books are made when goods are sent or remittance received from the branch. On the other hand, postings to Head Office current account in branch books are made when goods are received or remittance sent to the Head office. It follows therefore that some items in transit at the end of the year would not have passed through the current account. Difference would therefore occur between the current account. There are two ways of accounting for such items in transit. These are:

1. Where the ledger of the recipient accounting unit is adjusted i.e. Head Office ledger is adjusted for cash in transit while branch ledger is adjusted for goods in transit.
2. Where all the adjustments are made in the ledger of the head office.

NOTE: The latter alternative is more favoured and therefore recommended for exam purposes.

When goods or cash are in transit, the adjustment should be made in the books of the head office.

Procedures:

a. Goods in transit

Dr Goods in transit account

Cr Branch current account

b. Cash in transit

Dr Cash in transit account

Cr Branch current account

SELF ASSESSMENT EXERCISE

Briefly explain the procedure for accounting for goods and cash in transit.

3.4 UNREALISED PROFITS

Where goods are sent to branch at a price other than at cost price from the head office and part of the goods remain unsold at the year ends, the provision must be made for unrealized profit on the unsold stock or else, the combined profit figure will be overstated.

ACCOUNTING TREATMENT FOR UNREALISED PROFIT IN THE HEAD OFFICE BOOK

DR Head Office P & L a/c

CR Provision for unrealized profit a/c

NOTE: For balance sheet purposes, provision for unrealized profit will be treated as a current liability item.

Stock shortages at Branch Office

Where stock taking at branch office reveals shortage of stock; the cost of the stock shortage will have to be deducted before arriving at the branch cost of sales. This treatment is necessary in order to have a uniform rate of gross profit.

Treatment of Branch Trading Results

If the trading result of the branch is a profit:

a. In the Head Office books:

DR Branch Current a/c

CR Head Office P & L a/c

b. In Branch books

DR Branch P & L a/c

CR Head Office Current a/c

If the trading result of a branch is a loss

a. In the Head Office Books:

DR Head Office P & L a/c

CR Branch P&L a/c

b. In Branch Books
DR Head Office Current a/c
CR Branch P & L a/c

TRADING, PROFIT AND LOSS ACCOUNT FORMAT

	H/O		BRANCH		COMBINED	
	₦	₦	₦	₦	₦	₦
Sales		x		x		
Add: Goods sent to branch		x				
		x				
Cost of Sales:						
Opening Stock	x		x		x	
Add: Purchases	x		x		_	
Goods received from Head Office	-		x		x	
Less: Cost of Stock Shortage	x		x		x	
	x		x		x	
Less: Closing stock	x		x		x	
Cost of sales		(x)		(x)		(x)
Gross Profit		x		x		x
Less Provision for unrealized profit	x				x	
Stock shortage	-		x		x	
Admin expenses	x		x		x	
Selling and Distribution expenses	x		x		x	
Depreciation of Fixed Assets	x		x		x	
Other expenses	x		x		x	
Head Office charges	(x)	x	(x)	x	_	x
Net Profit for the year		x		x		x
Branch/ Head Office current a/c		x		(x)		__
		x		-		x

NOTES:

1. Goods sent to Branch

Where goods are sent to branch at cost price to the Head office, the cost of goods sent to branch will be subtracted from the purchases of the Head Office in the Trading a/c. However, where goods are sent to branch at a price other than at cost price the Head Office, the transfer price of the goods sent to the branch will be added to the sales of the Head Office in the Trading a/c.

2. Combined Opening/Closing Stock:

	₦	₦
Head office		x
Branch	x	
Less: Unrealised profit	x	x

Goods in transit	x	
Less: Unrealised profit	x	x
		xx

TRANSFER PRIZES OF GOOD FROM HEAD OFFICE TO BRANCH

Good sent to the branch at a transfer price may be any of the following

i. Cost
ii. Cost plus mark-up or
iii. Selling price

The transfer price can also be referred to as INOVICE PRICE because the goods are normally sent to the branch along with a pro-forma invoice selling out the quantity sent and price at which they are rent

i. COST PRICE

This denotes the actual cost of purchasing or producing goods and it is used as a transfer price of sending goods to a branch in a situation where the branch manager is authorized to determine the price at which the goods are to be sold by the branch. The pricing method is used mostly in sending goods to independent branches, but it is sometimes used in sending goods to dependent branches, if the goods being rent are of perishable nature.

ii. COST PRICE PLUS MARK-UP

This implies that the transfer price of the goods will be the sum of the cost price of the goods and a certain percentage of the cost price of the goods. This percentage (which is the profit loading) is known as the mark-up. When goods are charged to the branch at cost plus mark-up, it serves as a guide to the branch i.e the branch may sell at any price provided it is not below the transfer price. For instance, if goods with cost price of ₦50,000 are sent at a transfer price of cost plus 40%, then, the branch will sell at a minimum of ₦70,000 derived this way:

₦5,0000 +(40% X ₦5,0000)= ₦5,0000 +₦20,000= ₦70,000

Where the transfer price is also the selling price of the branch and circumstances warrant that the branch sells at a price below the normal selling price; the reduction (i.e. allowance of selling price), must be approved by the head office.

iii. SELLING PRICE

In this case, the transfer price of the good will be the price of which the goods are sold by the head office. However, unlike the cost plus mark-up method, the mark-up of the goods will not be made known to the branch. This pricing method is mainly used in securing goods to dependent branches.

Cost Method (Accounting Required)

The following accounts shall be maintained for the branch transactions

1. Branch Inventory A/C: all entries in this account, except branch sales, are at cost and the branch gross profit will also be ascertained on this account

2. Good & Sent to Branch A/C: this account shows the cost of the goods sent to the branch less cost of good returned to the head office and all entries here are at cost.

3. Branch Receivable A/C: for branch credit sales

4. Branch Expenses A/C: shows the expenses incurred by or on behalf of the branch

5. Branch Port A/C: shows the net profit or loss of the branch

Cost Plus Mark-Ups Method (Accounting Required)

1. Branch Inventory A/C: all entries on this account, except branch sales and allowance off selling price, are at transfer price, this account also records the movement of inventory at the branch, thereby indicating inventory deficiency or surplus where such exist at the branch.

2. Good Sent to Branch Account: performs the same role as in cost method

3. Branch Mark-up Account: record the profit loading on (the) goods; the opening (also known as Branch inventory) and closing balances on this account respectively. (Adjustment account) represent the unrealized profit on the opening and closing inventory at the branch and the balancing figure (after allowing for the profit loading) on the good returned to head office by branch customers, profit-loading on goods stolen and allowance off selling price) represent the branch gross profit.

4. Branch Receivable Account: serves the same purpose as in cost methods

5. Branch Expenses Account- performs the same role as in cost method.

6. Branch Profit Loss Account: performs the same roles as in cost method

SELF ASSESSMENT EXERCISE
State transfer pricing methods by which good can be sent to the branch by the head office.

Example 1

Gold Standard Plc send goods to its branch at cost plus mark-up of 33 $^1/_3$%. The company has its head office in Lagos, Nigeria and one of its branches in Abuja, Nigeria. The following are details of the Abuja branch transactions for the year ended 30th November, 2016

	₦
Opening inventory at branch selling price	40,000
Goods sent to branch at selling price	400.000
Goods returned to head office by branch at selling price	30,000
Goods returned to head office by branch customer	10,000
Credit Sales	290,000
Cash Sales	9,700
Authorized allowance off selling price	3,000
Goods returned to branch by branch customers at selling price	15,000
Cheques/ cash received from branch customer	190,000
Cash discount allowed to branch customer	11,000
Branch bad debts in ten off	7,500
Branch sundry expenses paid by head office	15,000
Cash stolen at branch	10,000
Goods stolen at branch at selling price	4,000
Closing inventory at branch at selling price	60,000

Goods invoiced to the branch at ₦8,000 on 19th November was not received by the branch until 3rd December and had not been included in the figures.

Required: Prepare the necessary ledger accounts using

a. Cost method

b. Cost plus mark up method

Solution to Example 1

a. Cost method

Dr Branch Inventory Account Cr

	₦		₦
Balance b/d ($^{3}/_{4}$ x 40000)	30,000	Goods sent to Branch ($^{3}/_{4}$ x 30000)	22,500
Good sent to Branch ($^{3}/_{4}$ x 40000)	300,000	Branch Receivable (sales)	290,000
Branch Receivable ($^{1}/_{4}$ x 10000) – profit	2,500	Cash Book (sales)	97,000
Branch Receivable (Returns)	15,000	Branch statement of Por (cash stolen)	10,000
Branch Gross Profit	126,000	Branch statement of Por L ($^{3}/_{4}$ x 4000)	3,000
		Good-in-transit ($^{3}/_{4}$ x 8000)	6,000
		Balance c/d ($^{3}/_{4}$ x 60000)	45,000
	473,500		473,500
Balance b/d	45,000		

Dr Good Sent to Branch Account Cr

	₦		₦
Balance b/d ($^{3}/_{4}$ x 30000)	22,500	Branch inventory ($^{3}/_{4}$ x 400, 000)	300,000
Branch Receivable ($^{3}/_{4}$ x 10000)	7,500		
Purchases	270,000		
	300,000		300,000

Dr Branch Receivable Account Cr

	₦		₦
Balance inventory (sales)	290,000	Goods sent to Branch ($^{3}/_{4}$ x 10000)	7, 500
		Branch inventory ($^{1}/_{4}$ x 1 0000)	2,500
		Branch inventory (returns)	15,000
		Cash Book	190,000
		Discount allowed	11,000
		Bad debts	7,500
	290,000	Balance c/d	565,000
Balance b/d	56,500		290,000

Dr Branch Statement of Profit or Loss Cr

	₦		₦
Discount allowed	11,000	Branch Gross Profit	126,000
Bad debt	7,500		
Sundry expenses	15,000		

Branch inventory (cash stolen)	10,000		
Branch inventory (Good stolen) ($^3/_4$ x 40000)	3,000		
Branch Net profit	79,500		
	126,000		126,000

b. Cost plus mark-up method

Dr Branch Inventory Account Cr

	₦		₦
Balance b/d	40,000	Goods sent to Branch ($^3/_4$ x 30000)	22, 500
Good sent to Branch ($^3/_4$ x 40000)	300,000	Branch Inventory Adjustment($^1/_4$ x 40000)	7,500
Branch Inventory Adjustment($^1/_4$ x 40000)	100,000	Branch Receivable (sales)	290,000
Branch Receivable (Returns)	15,000	Cash Bank (Sales)	97,000
Inventory Surplus (bal. fig)	47,000	Branch Invt. Adj. (Allowance of selling profit)	3,000
		Branch statement of Por L (Cash stolen)	10,000
		Branch statement of Por L (Good stolen) ($^3/_4$ x 4000)	3,000
		Branch inventory Adjustment ($^1/_4$ x 40000)	1,000
		Good-in-term ($^3/_4$ x 8000)	6,000
		Branch inventory Adjustment ($^1/_4$ x 40000)	2,000
		Balance c/d	60,000
	502,000		502,000

Dr Good Sent to Branch Account Cr

	₦		₦
Balance b/d ($^3/_4$ x 30000)	22,500	Branch inventory ($^3/_4$ x 400, 000)	300,000
Branch Receivable ($^3/_4$ x 10000)	7,500		
Purchases	270,000		
	300,000		300,000

Dr Branch Inventory Adjustment Account Cr

	₦		₦
Branch inventory ($^1/_4$ x 30000)	7,500	Balance b/d ($^1/_4$ x 4000)	10,000
Branch Recievable ($^1/_4$ x 10000)	2,500	Branch inventory(($^1/_4$ x 4000)	100,000
Branch Invt. Adj. (Allowance of selling profit)	3,000	Branch inventory (inventory surplus)	47,000
Branch inventory (good stolen) ($^1/_4$ x 4000)	1,000		
Branch inventory (good in transit) ($^1/_4$ x 4000)	2,000		
Branch Gross Profit (bal fig)	126,000		
Balance c/d ($^1/_4$ x 60000)	15,000		
	157,000		157,000

Dr	Branch Receivables Account		Cr
	₦		₦
Balance inventory (sales)	290,000	Goods sent to Branch $(\frac{3}{4}$ x 10000)	7,500
		Branch inventory $(\frac{1}{4}$ x 1 0000)	2,500
		Branch inventory (returns)	15,000
		Cash Book	190,000
		Discount allowed	11,000
		Bad debts	7,500
		Balance c/d	56,500
	290,000		290,000
Balance b/d	56,500		

NOTE: The statement of profit or loss remains the same as in Cost Method

4.0 CONCLUSION

It can be concluded that the adequate knowledge of accounting treatments of home branch transaction will assist accountant in the preparation of the annual reports of head office account. The accounts must be prepared in accordance with relevant accounting standards.

5.0 SUMMARY

This unit explores the meaning of home branch account and statutory framework guiding its accounting treatment. Basic terminology, items in transit, treatment of unrealised profit and issue of transfer prices from head office were clearly examined and simplified.

6.0 TUTOR MARKED ASSIGNMENT

Question 1

Nationwide Inc. opened a branch in Barisonville. The head office in Monrovia maintains all records and charge goods to branch at cost. The following information were extracted from Nationwide Inc. Records.

	₦
Goods sent to branch by head office at cost	360,000
Returns from branch to head office at cost	16,000
Branch credit sales	300,000
Cash sales sent to head office	84,000
Cash sales stolen	1,200
Goods stolen	400
Branch expenses paid by head office	12,800
Closing inventory at branch at cost	100,000
Cash received from debtors	232,000
Discounts allowed to branch receivables	12,000
Head office	
Opening inventory October 1, 2013	480,000
Purchases	2,800,000
Sales	3,600,000
Closing inventory September 30, 2014	280,000
Expenses	160,000

You are required to:
Prepare the necessary ledger accounts for the branch for the year ended September 30, 2014 and show the head office trading account.

2. Briefly explain the procedure for accounting for goods and cash in transit.

3. State and explain transfer pricing methods by which good can be sent to the branch by the head office.

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UNIT 2: ACCOUNTING TREATMENT OF FOREIGN BRANCHES ACCOUNTS

1.0 INTRODUCTION
This unit deals with the accounting treatment of foreign branch account.

2.0 OBJECTIVES
After studying this unit, you should be able to:
1. Explain meaning of foreign branch account.
2. State and explain accounting treatment of foreign branch account.

3.0 MAIN CONTENT
3.1 Introduction

It is quite common for a business in one country to conduct operations in other countries whose currencies are different from the currency of the country of the head office. The books of the overseas branches are usually maintained in the foreign currencies. Therefore in order to prepare a combined financial statement, the trial balance of the foreign branch must be translated from the foreign currency into the local currency of the parent coy.

Two main methods can be employed to translate the trial balance of a foreign branch these are:

(1) The historic rate or temporal method.

(2) Closing rate or net investment method.

(1) TEMPORAL METHOD: This method is employed where the investing company views its investment in the individual assets and liabilities of the overseas operations. In this case the overseas branches considered as a direct extension of the investing company such that the impact of cash flows on the overseas company has a direct influence on the cash flows of the investing coy.

(2) THE CLOSING RATE METHOD: This method is suitable where the investing coy views of foreign branch as a semi independent or independent operations and views its investment in the shared capital of the foreign operations rather than investment in the individual assets and liabilities. The method recognizes that the investing company is interested in the net worth of its foreign enterprise rather than in the individual assets and liabilities.

NOTE: From the foregoing, the temporal method should be used for foreign branch while the closing rate method should be used for foreign subsidiaries.

SELF ASSESSMENT EXERCISE

State two methods that can be employed to translate the trial balance of a foreign branch.

3.2. EXCHANGE TRANSLATION RATE UNDER THE TEMPORAL METHOD:

Description	Exchange rate
(a) Trading profit and loss items	
1. Sales and sales returns	Average rate
2. Purchases and purchases returns	Average rate
3. Opening stock	Opening rate/closing rate of previous period
4. Closing stock	
- for Bal. sheet purpose	Closing rate
- for trading a/c purpose	Average rate
5. Carriage inwards and outwards	Average rate
6. Expenses	Average rate
7. Discount received and allowed	Average rate
8. Bad debt and provision for bad debt	Closing rate or rate used for debtors
9. Depreciation of Non-Current Asset s	Average rate
10. Prepaid expenses – for INCOME STATEMENT	Average rate
purpose	Closing rate
- for bal sheet	Average rate
11. Accrued expenses – for INCOME STATEMENT	Closing rate
purpose	
- for bal sheet	Historic rate
(b) Statement of Financial Position items	Historic rate
1. Non-Current Asset s	Closing rate
2. Accum. Dep	Closing rate
3. Debtors/ creditors	Closing rate
4. Bank cash balances	
5. Bank overdraft	Actual sum realized
6. Remittances to H/O	Actual amount realized after YIE will be added to the bal. in h/o trial bal. and the total taken as
(a) If there are no cash in transit	the conversion
(b) if there are cash in transit	Actual of trial bal fig real after
	Actual bal. in H/O books
	The value of goods in transit and the amount realized from C.T. after YIE will be subtracted fro
7. H/o current a/c:-	the balance in H/o books the different taken as the conversion. H/O Balance – (GIT + CIT)
(a) if there are not items in transit	
(b) if there are goods and cash on transit	

3.1.2 EXCHANGE DIFFERENCE

This is the difference between the debit and credit side of the translated trial balance of the foreign branch. If the difference is a credit balance it will be regarded as an exchange gain. On the other hand, if the difference is a debit balance it will be regarded as an ex loss.

3.3 TREATMENT OF EXCHANGE DIFFEREMCE

(1) In H/o books

Exchange gain - Dr. Branch current account

- Cr. H/o INCOME STATEMENT account

Exchange loss - Dr. H/o P & L account

- Cr. Branch current account

In branch books -

Exchange gain - Cr H/O Current account

Exchange loss – Dr H/O Current account

Example 1

HOLINESS COMPANY LIMITED

On 1st March 2003, Holiness Company Limited resolved to open a branch in Paris to sell its new range of bi-lingual dolls. The manager was authorised to purchase local French toys for resale but it was expected that the major proportion of the sales would be of the bi-lingual dolls supplied by Head Office in Kaduna. The manager was to be allowed a commission of 1% on the sales of the dolls supplied by Head Office. No commission was to be allowed on locally purchased products.

On 28 February 2004, the trial balance was as follows:

	Kaduna	Head Office	Paris	Branch Office
	₦	₦	France	France
Share capital		400,000		
Reserves		50,800		
Profit and loss accounts		35,800		123,312
Creditors		44,250		
Premises at cost	225,000			
Fixtures and fittings at cost	147,000		840,000	
Provision for depreciation of Fixtures	58,000			
Stock at March	143,000			
Debtors	125,941		351,024	
Bank balance	101,938		270,792	
Cash in hand	9,821		86,004	
Sales		1,010,786		2,661,345
Purchases	586,535		2,065,005	
Goods sent to branch		135,000		
Goods sent to branch	169,000			1,565,000

Branch stocks adjustments account		33,800		
Remittances from branch		110,000	1,293,500	
Advance to branch	100,000			1,040,000
Administrative expenses	187,128		285,173	
Distribution expenses	82,487		198,159	
	1,878,636	1,878,63	5,389,657	5,389,657

You have the following additional information:
As at February 2004, 12 France to the ₦1 Stock on hand at 28 February, 2004 was

Kaduna	141,600
Paris- ex-Kaduna	263,000 Frances
Local purchases	82,000

2 Goods were invoiced by Kaduna to Paris at accost plus 25%.Paris sold the goods at invoiced price plus 50%.The value of goods sent to Paris was based on a fixed conversation rate of 10 France to the ₦.
3 There were goods in transit that had been recorded in the Kaduna books at 12,500 but had not been received or recorded by Paris at February 28, 2004.

4 Paris had remittance at 58,000 France on 27 February 2004 .It was received in 5 March and converted to ₦4,375

5 The advance of ₦100,000 was remitted to Paris when the exchange rate was 10.4 France to the ₦. The fixtures and fittings were acquired when the exchange rate was 10.5 France to the ₦, on June 2003.

6 Depreciation of the Kaduna and Paris fixtures and fittings is to be provided at the rate of 10% per annun on cost.

7 Rate of exchanged at other dates were:

As at 1 March 2003	10 France to
Average for financial year	11 Frances to ₦

8 The company' policy on the transaction of the branch balances at 28 February 2004 was to use the following exchange rates:

Non-Current Assets- Rate of exchange at date of acquisition, current assets rate of exchange at 28th February 2004

Current liabilities – rate of exchange at 28 February 2004 sales, local purchases and expenses – average rate for the year. Goods sent from Kaduna – fixed rate of 10 francs to ₦

Required:
(a) Prepare a Statement of Profit and Loss & other comprehensive Income account in columnar form for the head office, the Paris branch and the whole business for the year.
(b) Prepare a Statement of Financial Position as at 28th February 2004 for the whole business. **Show all relevant workings.**

Solution to Example 1

Sofowora Company Limited

Translation of the trial balance of Paris branch as at 28/2/04

		Frances Dr	Cr	Exchange Rate	Naira Dr	Cr
Creditors			123312	12		10276
F & F		840000		10.5	80000	
Debtors		351024		12	29250	
Bank balance		270,792		12	22566	
Cash in hand		86004		12	7167	
Sales		661345		11		241940
Purchases - from H/o		1565000		10	156500	
- locally		500005		11	45455	
Goods sent to branch		1565000		10		156500
Remittances from branch		1293500			114375	
Advance to branch			1040000	10.4		100000
Admin- expenses		285173		11	25925	
Distribution expenses		198159		11	18014	
Closing stock:-						
From H/o - for trading a/c			263000	10		26300
- for bal. sheet		263000		10	26300	
Local -for trading			82000	11		7455
- for bal sheet		82000		12	6833	
Depn of F & F						
- forIncome Statement			63000	11		5727
- for Bal. sheet		63000		10.5	6000	
Manager's commission						
- for P & L a/c		19530		11	1775	
- for bal. sheet			19530	12		1628
Exchange loss					10210	
		5817187	5817187		550099	550099
Combined stocks						
H/Office				141600		
Branch	33133					
Less unreal profit	5260		27873			
Work lids in transit	12500					
Less unreal profit	2500		10000			
			179473			

Sofowora Company Limited
Statement of Profit and Loss & other comprehensive Income account for the YIE 28/2/04

	Head office		Branch		Combined	
	₦	₦	₦	₦	₦	₦
Sales		1010786		241940		1252726
Add Gds sent to branch		169000				
		1179786				
Cost of sales:-						
Openings stock	143786				143786	
Add purchases	586535		45455		631990	
Goods record from H/o			156500			
	730321		201955		775776	
Less closing stock	141600		33755		180095	
Cost of Sales		(588721)		(168200)		(595681)
Gross Profit		591865		73740		657045
Less:						
Admin. Expenses	187128		25925		213055	
Distribution Expenses	82487		18014		100501	
Depn of F & F	14700		5727		20427	
Exchange loss	10201		-		10210	
Managers commission	-		1775		1775	
Prov. For unreal profit	7760		-		-	
		302285		51441		345966
Net profit		288780		22299		311079
Branch/ H/o current a/c		22299		(22299)		-
		311079		-		311079
Add P & L a/c b/f		35800				35800
P & L a/c c/f		346879				346879

Dr Branch Current a/c Cr

	₦			₦
Goods sent to branch	169000	Remittance from branch		110000
Advance to Branch	100000	Bal. c/d		159000
	269000			269000
Bal. b/d	159000	Goods in transit		12500
H/o P & L	22299	Cash in transit	4375	
		Exchange loss	10210	
		Bal. c/d		154214
	181299			181299

Dr H/O Current Account Cr

	₦		₦
Remittances to H/O	114375	Gds record from H/o	156500
Bal. c/d	142125	Adv. From H/o	100000
	256500		256500
Exchange loss	10210	Bal. b/d	142125
Bal. c/d	154214	Branch P & L	22299
	164424		164424

1. **Calculation of Managers Commission**

	Frances
Goods record from H/o	1565000
Less closing stock	263000
Invoice price of goods sold	1302000
Add mark-up of 50%	651000
Sales of Dolls from H/o	1953000
∴ Commission = 1% of 1953000	19530

2. **Combined Closing stock**

	₦	₦
H/O		141600
Branch	33755	
Less unrealized profit =25/125	5260	28495
(25/125 x 26300)		
Goods in transit	12500	
Less unrealized profit = (25/125 x 12500) =	2500	10000
		180095

3. **Branch Closing Stock**

	₦
Goods from H/o	26300
Goods purchased locally	6833
	33133

Statement of Financial Position as at 28/2/04

	Head Office		Branch		Combined	
Non-Current Assets	₦	₦	₦	₦	₦	₦
Premises		22500		-		22500
Fix and Fittings	147000		80000		227000	
Less Acc. Depn	73500		6000		79500	
		73500		74000		147500
		298500		74000		372500
Branch current a/c		154214		-		-
Current Assets						
Stock (w4)	141600		33133		179473	
Goods in transit	12500		-		-	
Debtors	125941		29252		155193	
Bank Bal.	101938		22566		124504	
Cash in transit	4375		-		4375	
Cash bal.	9821		7167		16988	
	396175		92118		480533	
Current liabilities						
Creditors	44250		10276		54526	
Mgr's commission	-		1628		1628	
Prov. for unreal Profit	7760		-		-	
	52010		11904		56154	
		344165		80214		424379
		796879		154214		796879
Financed by:						
Share capital		400000		-		400000
Reserves		50000		-		50000
Retained profit		346879		-		346879
H/o current a/c	-		154214		-	
		796879		154214		796879

4.0 CONCLUSION

It can be concluded that the adequate knowledge of accounting treatments of foreign branch transaction will assist accountant in the preparation of the annual reports of head office account. The accounts must be prepared in accordance with relevant accounting standards.

5.0 SUMMARY

This unit explores the meaning of foreign branch account and statutory framework guiding its accounting treatment. Basic terminologies and issue of transfer prices from head office were clearly examined and simplified.

6.0 TUTOR MARKED ASSIGNMENT

1. The draft financial statement of Zuba Plc, a Nigerian company and its Subsidiary, Mensa Ltd are set out below.

Statement of Financial Position as at 31 December 2003

	Zuba Plc	Mensa Ltd
	₦'000	₦'000
Tangible Non-Current Assets	8,480	52,400
Investment in Mensa Ltd	1,960	
Stocks	2,980	84,640
Trade debtors	3,240	47,280
Cash in hand	480	20,600
Creditors	(6,500)	(45,860)
Bank overdraft	(3,900)	
	6,740	**6,740**

Profit and loss accounts for the year ended 31 December 2003

	₦'000	₦'000
Turnover	80,850	981,250
Cost of sales	(65,000)	(769,500)
Gross profit	15,850	211,750
Admin expenses	(10,760)	(59,200)
Investment income	614	
Profit before tax	5,704	152,550
Taxation	(2,404)	(46,950)
Profit after tax	3,300	105,600
Dividends	(1,500)	(38,200)
Retained profit	1,800	67,080

Additional information:

i. Zuba Plc acquired 80% of the equity shares in Mensa Ltd for ₦1,960,000 on 30 March, 1998 when Mensa Ltd reserves stood at ₦29,240,000.

ii. Mensa Ltd. Paid an interim dividend of ₦14,980,000 on 18 June, 2003 and proposed to pay a final dividend of ₦23,540,000. Zuba Plc has not yet accounted for the dividend receivable. The amount of the proposed dividend is included in the creditors of Mensa Ltd.

iii. Zuba Plc's accounting policy is to translate the financial statements of its foreign subsidiaries using the closing rate method and to deal with exchange differences as a movement on reserve.

iv. Exchange rates to naira.

30 March, 1998	22 cedi
31 December, 2002	20 cedi
18 June, 2003	19.5 cedi
31 December 2003	18 cedi

Average for 2003 19 cedi

Required:

(a) Prepare the translated Statement of Financial Position and Income Statement of Mensa Ltd.

(b) Prepare the consolidated Income Statement for the year ended 31 December, 2003.

(c) Calculate the exchange gain or loss.

(d) Calculate the goodwill on acquisition

Show all relevant workings

2. State and explain two methods that can be employed to translate the trial balance of a foreign branch.

7.0 REFERENCES/FURTHER READING

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MODULE 3: ADVANCED PARTNERSHIP ACCOUNTS

Unit 1: Partnership Arrangement

1.0 INTRODUCTION

This unit deals with the meaning, partnership agreement and act, types of partners, partners' account and appropriation account.

2.0 OBJECTIVES

After studying this unit, you should be able to:
1. Explain the meaning of partnership, partnership agreement and act.
2. State and explain types of partners' personal accounts.
3. Explain appropriation account.

3.0 MAIN CONTENT

3.1 Meaning of Partnership

The Partnership Act, 1890 defines a partnership as "the relationship which subsists between persons carrying on a business in common with a view of profit". Partnerships are those businesses which are being carried on by two or more persons with a view of profit. A partnership business can come into existence due to the following circumstances:

a. Where two or more persons with none of them possess an existing business decide to create a business.
b. Where one person is in business and decided to partner with another person.

c. Where two sole traders decide to combine their business and form a partnership

The minimum number of persons that can form a partnership business is two while the maximum number of twenty. No limit now applies to the number of partners in firms belonging to the following professions: accountants, solicitors, patent agents, surveyors, etc

SELF ASSESSMENT EXERCISE

Define partnership in accordance with Partnership Act, 1890.

3.2 THE PARTNERSHIP AGREEMENT: A partnership agreement is a document which set out the arrangements which have been agreed upon between partners in order to achieve its objectives. It is also called partnership deeds.

To form a partnership, it is desirable for the partners to come to some understanding as to the conditions upon which the business is to be carried on, and as to their respective rights and powers. The areas that would be covered by the agreements are stated below:

(1) Name and type of Business
(2) Amount of capital to be introduced by each partner
(3) Proportion in which profits & losses are to be shared
(4) Partners 'Salaries
(5) Partners 'Drawings
(6) Circumstances in which partnership should be dissolved
(7) Keeping of books & records
(8) Restrictions if any on the powers of any or all the partners
(9) Provision as to the basis of valuation of assets in the event of dissolution

The Act lays down certain rules to be observed in the absence of agreement. They are:

(a) All the partners are entitled to share equally in the capital and profits of the business, and must contribute equally towards the losses, whether of capital or otherwise, sustained by the firm.

(b) The firm must indemnify every partner in respect of payments made and personal liabilities incurred by him:

(i) in the ordinary and proper conduct of the business of the firm; or

(ii) in anything necessarily done for the preservation of the business or property of the firm.

(c) A partner making, for the purpose of the partnership, any payment or advance beyond the amount of capital which he has agreed to subscribe, is entitled to interest at the rate of 5 percent, per annum from the date of the payment or advance.

(d) Every partner may take part in the management of the partnership business.

(e) No partner shall be entitled to remuneration for acting in the partnership business

(f) No person any be introduced as a partner without the consent of all existing partners.

(g) The partnership books are to be kept at the place of business of the partnership and every partner may, when he thinks fit, have access to and inspect and copy any of them.

SELF ASSESSMENT EXERCISE

Outline the areas that should be covered by the partnership agreements

3.3 THE PARTNERSHIP ACT, 1890: In the absence of any partnership agreement, the preparer of the financial statements of a partnership business must be guided by the Partnership Act of 1890. The Partnership Act of 1890 is a law governing a partnership business that has no agreement. That is, the Act will be applied only in the absence of any agreement, express or implied, between the partners. The Act provides for the following:

i. there should be no interest on capital
ii. there should be no interest on drawings
iii. there should be no salary for any partner
iv. profits or losses should be shared equally.
v. There should be 5% interest on loan.

SELF ASSESSMENT EXERCISE

In the absence of any partnership agreement, the preparer of the financial statements of a partnership business must be guided by the Partnership Act of 1890. State these provision in the Act.

3.4 TYPES OF PARTNERS

1. General Partners: This is a partner who is entitled to take full share in the administration and management of the firm. He has power to participate in the conduct and management of the business. A general partner is a partner whose liability in respect of the liabilities of the partnership in unlimited.

2. **Active partner:** This is a partner who participates actively and positively in the daily activities of the firm. He will be remunerated according to agreement. Any action taken is binding on the partners.

3. **Limited Partner:** This is a partner who has contributed in the financing of the business but cannot take active part in the management of the firm. The liability of a limited partner is limited to the total amount he has contributed and it will not extend to his private properties. In short, he has limited liability.

4. **Dormant (sleeping):** This is a partner who contributes capital but does not participate actively in the running of the business; he has contributed financially but takes no part in the administration and management of the firm. A sleeping partner stays at the background and has the same duties, rights and liabilities as the other partners. He is liable for the actions of other partners.

5. **Nominal partner (Quasi):** A nominal partner allows his name to be used by the firm for prestige and reputation purpose. He is a partner who does not contribute capital or engage in the day to day running of the business. He is a person of high standing or reputation who can increase the goodwill of the firm in order to ensure more benefits to the organization. The law will hold him responsible for liabilities of the firm.

Number of partners: The number of partners in a partnership is limited to Twenty, with the exception that member within each of the under mentioned groups may form partnerships of more than twenty persons:

(a) Practicing solicitors provided each partner is a solicitor of the supreme court;
(b) Practicing accountants where each of the partners is qualified for appointment as auditor of a company;
(c) Member of a recognized stock exchange provided each partner is a member of that exchange.

The duties of a partner: The act also points out what the duties of a partner should be

They are-;

(a) To act with the utmost good faith in his relations with his co-partners.

(b) To render true account and full information of any partner his legal representatives

(c) To account to the firm for any benefit derived by him without the partners from any transaction concerning the partnership, or from any use by him of the partnership property, name or business connection.

(d) To refrain from competing with the firm. Where a partner, without the consent of his co-partners, carries on a competing business, he must account for and pay over to the firm all profits made by him in that business.

Liability of partners: The liability of each member for debts of the firm is unlimited.

SELF ASSESSMENT EXERCISE

Enumerate and explain types of partners.

3.5 PARTNERS' PERSONAL ACCOUNTS

When dealing with partnership account, a personal account must be opened for each partner in order to ascertain the personal stake of an individual partner in the business. The personal account of each partner is usually contained in two accounts.

a. Capital accounts
b. Current accounts

3.5.1 CAPITAL ACCOUNT: The capital accounts of the partners can either be kept at fixed or at floating. Therefore there are two types of capital accounts: Fixed Capital Accounts and Floating Capital Accounts.

3.5.2 FIXED CAPITAL ACCOUNTS: The partnership agreement is that the amount of capital introduced by each partner shall remain fixed and that nothing is either added to or subtracted from it. The balance on this account does not change very often (ICAN, 201). It is clear that an additional account must be opened to deal with any appropriation incomes and expenses, such as drawings, salaries, interests and shares of profits. In a fixed capital account, a current account is necessary where all the appropriation incomes and expenses are recorded. It should be noted however that any additional capital can be recorded in a fixed capital account.

3.5.3 FLOATING CAPITAL ACCOUNT: This account records capital balances at the beginning of the year and corresponding entries of all the appropriation incomes and expenses from the appropriation accounts.

3.5.4 CURRENT ACCOUNTS: This account records all the transactions that take place between the partners and the partnership. The entries in the appropriation account are taken to be opposite sides of the current accounts to complete the corresponding entries. The appropriation incomes are debited to this account while the appropriation expenses are credited to its account.

SELF ASSESSMENT EXERCISE

Distinguish between fixed and floating capital account

3.6 APPROPRIATION ACCOUNTS

This account is used to appropriate the net profit for the year calculated from the statement of profit or loss. In this account, profit for the year shall be divided into the shares to which the respective partners are entitled. Before the profit is divided between the partners, however, it is necessary to take into consideration both the appropriation incomes and the appropriation expenses. Appropriation incomes is interest on drawings while appropriation expenses are interest on capital accounts, interest on current accounts, salary paid to partner, commission paid to partner etc.

3.6.1 INTEREST ON LOAN: Interest paid on loan received from a partner is being credited to the capital account of the partner who advanced the money and debited in the appropriation account. There is other school of thought who believe that interest on loan should be debited to profit and loss account as a charge against profit for the year, whichever way it is dealt with, the distributable profits will remain the same.

Interest on partners' loan at the agreed rate (or in the absence of agreement, at 5percent, per annum) should be credited to his current account or (fluctuating) capital a/c and debited to profit and Loss Account. Interest on partners loan is debited to PROFIT AND LOSS A/C and NOT Appropriation Account, because such a loan could come from outside (i.e. outside the partnership) but for convenience, it may be given to the partnership by one of her members hence it's not regarded as an internal transaction between the partners and the partnership, it is viewed as an external transaction. The loan received is credited to a loan account and debited to cash/bank account.

3.6.2 PARTNERS' SALARIES: As already stated, in the absence of agreement no partner is entitled, before arriving at the amount of divisible profits, to remuneration for his services to the firm. This is based on the presumption that each partner will take part in the management of the partnership. However, it may be desirable for the partnership agreement to provide for the payment of salaries to the partners.

(1) Where some of the partners take a greater or more effective part in the conduct and management of the business than others.

(2) Where there are junior partners, whom it is desired to remunerate by way of a fixed salary, plus, perhaps, a small percentage of this profit.

(3) Where the partnership business is really managed by the partners, and it is desired to ascertain the true profit, after such a charge for managerial services has been made as would have been incurred had the business not been managed by the proprietors.

Where the agreement provides for payment of salaries to partners, it must be realized that such payments, although designated salaries are, like interest on capital, merely in the nature of preferential shares of the divisible profit. The amounts of such salaries should therefore be debited to profit and Loss Appropriation Account, and credited to the partners' current or capital Accounts.

Example I

Daniel, Deborah & David carried on a retail business in partnership. The partnership agreement provides that the partners are to be credited at the end of each year with salaries of 200 to Daniel and 300 each to Deborah and David. Show the entries for the above, in the Partners books and the appropriation account.

P & L APPROCIATION A/C

Salaries	Net Profit X
Daniel 200	
Deborah 300	
David 300	

Partners current /Capital Account

Daniel ₦	Deborah ₦	David ₦	Salaries	Daniel ₦	Deborah ₦	David ₦
				200	300	300

NB: It should be noted that where there is no Current Accounts, salary (partner) should be credited to a capital a/c.

3.5.3 INTEREST ON PARTNERS' CAPITAL: These are credited to the respective partners' current accounts and debited to the appropriation account. When interest is paid on capital, the partner's capital or current Accounts will be credited with the amount of interest, and the profit and Loss Appropriation Account debited. Interest on capital should be calculated for the period during which the business has had the use of the capital.

Example 2

Segun, Ade, Ojo have capitals of ₦8000, ₦600 and ₦4000 respectively, on which they are entitled to interest at 5 per cent.

Show how the interest on capital will be dealt with in the partners' account (The profits for the year, before charging interest in capital, amounted to ₦2000.

Dr APPROPRIATION ACCOUNT Cr

Dr		Cr	
Interest on capital		B/f	₦200
Segun	₦400		
Ade:	₦300		
Ojo:	₦200		

Partners' Current Accounts

Segun	Ade	Ojo		Segun	Ade	Ojo
			Interest on capital	₦ 400	₦ 300	₦ 200
		i.e. Dr Appropriation a/c XX Cr current a/c (with int. on capital)				

NB: It should be noted that where there is no current Accounts, interest on capital (partner) should be credited to a capital a/c.

INTEREST ON DRAWING: Interest is sometimes charged against partners in respect of the amount taken out of the business. The interest on drawing shall be debited to current account of the partner concerned and credited in the profit and loss appropriation account.

Example 3

Osun and Omoluabi are in partnership sharing profit and loss equally. The following was taken from their books for the year ended 31st December, 2014.

		₦
Capital Accounts:	Osun	18,375
	Omoluabi	105,350

Current Accounts:	Osun	10,500(DR)
	Omoluabi	12,600
Drawing Accounts	Osun	21,000
	Omoluabi	3,850
Profit for the year (Income Statement)		**123,000**

The agreement of the partnership are:

a. Omoluabi shall be entitled to ₦2,100 monthly salary.

b. Interest on current accounts and drawing shall be 15% and 10% respectively.

c. 5% interest is allowed on their capital accounts

d. Omoluabi is also entitled to a 5% commission on profit after such commission had been deducted.

Required: i. Prepare the appropriation account

ii. Prepare the partner's current and capital accounts

Solution to Example 3

Dr		**Appropriation Account**		**Cr**
		₦		₦
Salary (Omoluabi)(w1)		25,200	Profit for the year	123,000
Commision (Omoluabi) (w2)		5,857	Interest on Drawings:	
Interest on Capital:			Osun ($\frac{10}{100}$ x 21000)	2,100
Osun ($\frac{5}{100}$ x 18375)		919	Omoluabi ($\frac{10}{100}$ x 3850)	385
Omoluabi ($\frac{5}{100}$ x 105350)		5,268		
Interest on Current Account:				
Omoluabi ($\frac{5}{100}$ x 12600)		1890		
Share of profit				
Osun	43,175.50			
Omoluabi	43,175.50	86,351		
		125,485		125,485

Workings:

(i) Monthly salary is ₦2,100. 12 months make a year, therefore

Annual Salary = (₦2,100 x 12) = ₦25,200

(ii) 5% is on the profit after the commission had been deducted. Therefore the following formula is needed:

$$\frac{\%}{100+\%} \; x \; profit\ for\ the\ year\ (Net\ profit)$$

$$= \frac{5}{100+5} \text{ x } 123,000$$

= ₦5,857

Capital Account

	Osun	**Omoluabi**		**Osun**	**Omoluabi**
	₦	₦		₦	₦
Balance c/d	18,375	105,350	Balance b/f	18,375	105,350
			Balance b/d	18,375	105,350

NB: Final Capital Account

Dr		Current Account			Cr
	Osun	**Omoluabi**		**Osun**	**Omoluabi**
	₦	**₦**		**₦**	**₦**
Balance c/d	10,500	-	Balance b/f	-	12,600
Drawing	21,000	3,850	Salary	-	25,200
Interest on Drawing	2,100	385	Commission	-	5,857
Balance c/d	10,494.50	89,755.50	Int. on capital	919	5,268
			Int. on current a/c	-	1,890
			Share of profit	43,175.50	43,175.50
	44,094.50	93,990.50		44,094.50	93,990.50
			Balance b/d	10,494.50	89,755.50

Example 4

Ayo, Femi and Kunle are in partnership sharing profit and loss in a proportion 3: 2: 1. By the terms of the partnership agreement, interest on capital is 5% per anum and Kunle entitles to a salary of ₦300 per annum. On 31st Dec 1970, the following credit balances appear in partnership books.

Ayo's capita account ₦5,000
Femi's " " ₦4,000
Kunle's " ₦2,000
Ayo's current account ₦1000
Femi's " " ₦400
Kunle's " " ₦100
Femi's loan account ₦500

The net profit for the year before changing interest on capital, interest on Femi's loan and Kunle's salary amounted to ₦2075.

Drawing for the year amounted to:

Ayo - ₦1200
Femi - ₦1000 and Kunle ₦750

You are required to show the entry in the appropriation account and balance up the current Account of the partners.

Solution to Example 4

Dr		Partners' Capital Account				Cr
Ayo	Femi	Kunle		Ayo	Femi	Kunle
₦ 5000	₦ 4000	₦ 2000		₦ 5000	₦ 4000	₦ 2000
5000	4000	2000	b/f	5000	4000	2000
			Balance b/f	5000	4000	2000

Dr				Partners Current Account			Cr
	Ayo	Femi	Kunle		Ayo	Femi	Kunle
	₦	₦	₦		₦	₦	₦
	1200	1000	750	Bal b/f Int	1000	4000	100
Drawing				on Capital			1000
				Salary Int	250	200	300
(Cash)				on loan			
				share of		25	200
	650	25	-	profits	600		50
Balance				Bal. c/f	-	400	
c/f						-	
	1850	1025	750		1850	1025	750
Balance b/f	-	-	50	Balance b/f	650	25	

Dr	Profit Loss Account		Cr
Interest	₦	Trading	₦
on loan-Femi	25	Profits b/f	2075
Balance c/f	2050		
	2075		2075
		Balance b/f	2050

Dr	P & L Appropriation account		Cr
Interest on Capital:		Net Profit	₦2050
	₦	For the year	
Ayo	250		
Femi	200		
Kunle	100		
	550		
Salary-Kunle	300		
Share of Profit:			
Ayo	600		
Femi	400		
Kunle	200		
	2050		2050

SELF ASSESSMENT EXERCISE

Explain clearly how interest on loan, interest on capital, drawing and salaries of partners will be treated in the appropriation account.

4.0 CONCLUSION

It can be concluded that the adequate knowledge of accounting treatments of partnership transaction will assist accountant in the preparation of the annual reports of partnership business. The accounts must be prepared in accordance with relevant accounting standards.

5.0 SUMMARY

This unit explores the meaning of partnership and statutory framework guiding the formation of partnership. Partnership act, deed, goodwill, appropriation account and partners' personal account were clearly examined and simplified.

6.0 TUTOR MARKED ASSIGNMENT

1. Define the term 'partnership' and enumerate the conditions which must be fulfilled for an association of persons to be legally accepted as a partnership.

2. Write short notes on the following:
   a. The general partner
   b. The Limited partner
   c. The sleeping or dormant partner
   d. Implied agency of partners

3. What is meant by 'Partnership Deed or Partnership Agreement? Enumerate at least ten matters which would be dealt with in a partnership agreement.

4. State at least six matters on which reliance would be placed on the provisions of the partnership law in the absence of any specific provisions in the partnership agreement.
5. Olagunju and Atolagbe are in partnership with capitals of ₦12,000 and ₦6,000 respectively. Profit and losses are shared in proportion of their capitals after charging interest on capital at 5% per annum and a partnership salary of ₦4,200 to Atolagbe. Olagunju desires to retire from full active work in the firm as from 1st January 2008. It was accordingly agreed on 1st January 2007 that:

i. Atolagbe shall in future be entitled to a partnership salary of ₦5,400 per annum.
ii. Interest is to be allowed on capital 5% per annum.
iii. Famakinwa, a manager shall be introduced as a partner without capitals as from 1st January 2007 with a salary of ₦5,250 per annum, the excess over ₦4,200 (his former salary as a Manager) being chargeable against Olagunju and not against the firm's profit before divisions.
iv. Famakinwa shall be entitled to 5% of the profit after charging interest on capital and partnership salaries.
v. The balance of profits is to be divided as to 3/5 to Olagunju and 2/5 to Atolagbe. The profit for the year ended 31st December 2007 was ₦39,600 before charging interest on capital or partnership salaries.

You are required to show the division between the partners through:

a. The use of a profit and loss appropriation account and
b. Summary of total appropriation to the individual partners.

6. In the absence of any partnership agreement, the preparer of the financial statements of a partnership business must be guided by the Partnership Act of 1890. State these provisions in the Act.

7.0 REFERENCES/FURTHER READING

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UNIT 2: CHANGES IN THE CONSTITUTION OF PARTNERSHIP

1.0 INTRODUCTION

This unit discusses the admission of a new partner, death or retirement of a partner, amalgamation of a partnership with another business, and dissolution of partnership.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Explain revaluation and goodwill.
2. Explain accounting treatment of admission of new partner or death of a partner.
3. Explain accounting treatment of amalgamation of partnership and dissolution of a partnership.

3.0 MAIN CONTENT

3.1 Introduction

A change in partnership may be physical changes in the composition of the partnership or a conservative change whereby the original partners remain the same but there is a change in the agreed profit and loss sharing ratio. Physical change may be due to one of the following:

(i) Admission of a new partner

(ii) Death or retirement of a partner

(iii)Amalgamation of a partnership with another business.

The ultimate change is when the partnership is dissolved (Dissolution of partnership) or partnership is converted into a Limited Company.

Combinations of the circumstances above changes in the profit sharing ratio of the partnerships as stated above calls for revaluation of partnership net assets and the net surplus or deficit must be apportioned between the partners.

Whenever there is a change in partnership, net assets must be revalued and the net surplus or deficit must be shared between the partners. Goodwill must also be recognized. Goodwill is the difference between the value of the firm and the net assets of the firm.

3.1 REVALUATION OF ASSETS

When there is a change in partnership, it may becomes necessary for the assets of the firm to be revalued and its will entails certain adjustments being made to show the true value of the assets as at the date of the revaluation. When a new partner is to be admitted to the firm or on the death or retirement of one of the partners, there may be a need for revaluation of the partnership assets.

SELF ASSESSMENT EXERCISE

What is revaluation? State the reasons that can warrant revaluation of asset.

3.2 GOODWILL

What is it?

The goodwill of a business is the advantage, whatever it may be, which a person gets by continuing to carry on, and being entitled to represent to the outside world that he is carrying on a business which has been carried on for some time previously. It is the benefit and advantage of good name, reputation and connection of a business. It is the attractive force which brings in customers. It is one thing which distinguishes and old established business from a new business.

From the accountant’s viewpoint, goodwill may be said to be that element arising from the reputation, connection of other advantages possessed by a business which enables it to earn greater profits than the return normally to be expected on the capital represented by the net tangible assets. This is the capability of a business to earn profit in the future. Goodwill is the amount by which the value of a business exceeds the value of all its net assets (its assets less liabilities). All successful businesses have goodwill, which means that buyers will pay more to acquire the business than the value of its net assets, (ICAN, 2014). Goodwill is an intangible asset which does not possess physical characteristics.

Reasons for Goodwill

These are the factors which induce purchasers to pay for goodwill:

i. Quality of goods and services sold: The purchaser can pay for goodwill when the products are durable and of standard quality.
ii. Personality of the owner: Personal reputation of the owner arising through his skill and influence can also bring goodwill.
iii. Value of Labour Force: Possession of efficient, effective and well trained employees may constitute another reason.
iv. Favourable location: A purchaser may pay for goodwill as a result of the location of the business in a conducive environment.
v. Possession of patents and trade mark
vi. Monopoly power: The business may enjoy some form of monopoly which may be due to some form of government licence.
vii. Cost of research and development: Product research and development may bring about cheaper methods of production.
viii. Good public relation: Public relation is the image building done by an organization to give the public favorable impression about its aims and policies.

Types of Goodwill

There are two types of goodwill. These are as follows:

1. **Inherent Goodwill:** This is a type of goodwill which does not arise from acquisition of a business by another but is generated internally.
2. **Purchased Goodwill**: This arises as result of acquisition of one business by another. It is excess of purchase price over the net realizable value of assets.

The following situations in partnership can give rise to adjustment for goodwill:

i. Admission of a partner
ii. Death or Retirement of a partner
iii. Change in profit-sharing ratio.

VALUING GOODWILL: The method chosen to value goodwill is arbitrary and is often dictated by the custom of the trade in which the firm is engaged. The common methods of valuing goodwill are:

(i) **Purchase of Average Profit:** Number of Past years profit for the year (Net Profit) are averaged and multiplied by a chosen number. Thus three years purchase of average profit implies that the average profits will be multiplied by 3 to obtain the value of goodwill.

SELF ASSESSMENT EXERCISE

What is goodwill? State reasons for goodwill

Example 1

ABC partnership profits for the four years ended 31st December, 2015 were as follows:

Year 2012	₦50,000
Year 2013	₦30,000
Year 2014	₦15,000
Year 2015	₦25,000

The ABC Partnership has agreed to value goodwill for purposes of change in partnership a 3 years purchase of average profit.

Solution to Example 1

The average annual profit: $\frac{50,000+30,000+15,000+25,000}{4}$ = ₦30,000

Goodwill = ₦30,000 x 3 = ₦90,000

(ii). **Weighted Average Profit Method:** This method will allocate weight in ascending order to each year's profit to get the total weighted profit.

Year	**Wright**	**Profit**	**Weighted Profit**
2010	1	50,000	50,000
2011	2	30,000	60,000
2012	3	15,000	45,000
2013	4	25,000	100,000
Total	10	120,000	255,000

Weighted Average Profit = $\frac{255,000}{10}$ = ₦25,500

Goodwill = ₦25,500 x 3

= ₦76,500

(iii). **Super Profit Method**: Super profit simply means those profits in excess of the normal profit which a business might be expected to make.

Example 3

The facts are the same as in example above, except that you are to assume that normal profit, based on the profits of comparable firms, is ₦15,000 per annum. You are to value goodwill at 3 years' purchase of the average super profit over the last four years. Calculate the value of goodwill.

Solution to Example 3

Average profit	=	$\frac{₦120,000}{4}$	= ₦30,000
Less Normal profit			= ₦<u>15,000</u>
Average super profit			₦<u>15,000</u>
Goodwill	= ₦15,000 x 3	=₦45,000	

Examples:

ABC partnership values its goodwill as three times the average of the annual profit in excess of ₦84,000 each year for the last five years. Profit from the last five years has been as follows:

Year 5	₦140,000
Year 4	₦126,000
Year 3	₦112,000
Year 2	₦98,000
Year 1	₦86,000

Compare the value of goodwill

Solution:

Profit in excess of ₦84,000 (super profit)

Year 5	(140,000 – 84,000)	=	56,000
Year 4	(126,000 – 84,000)	=	42,000
Year 3	(112,000 – 84,000)	=	28,000
Year 2	(98,000 – 84,000)	=	14,000
Year 1	(86,000 – 84,000)	=	<u>2,000</u>
Total super profit			**<u>142,000</u>**

Average super profit = $\frac{142,000}{5}$ = ₦28,400

The valuation of goodwill = 3 x ₦28,400 = ₦85,200

3.3. Admission of a New Partner

When a partner is to be admitted, an amount will be paid by an incoming partner as his capital. On the other hand, new partner may be required to pay a certain amount as his share of the firm's goodwill which he is coming in to enjoy. Assets of the firm may be revalued before the admission of a new partner. The following points must be noted when a new partner is admitted into the partnership.

(i) The old partnership will come to an end and a new partnership begins but the records of the old partnership continue as those of the new partnership with adjustment to reflect the change of ownership.

(ii) The adjustments must reflect each partner's share of the worth of the firm in old partnership (Goodwill and Revaluation of Assets). The revaluation of assets will results in revaluation gains or (losses).

(iii)Goodwill to be returned in the books: When a new partner is to be admitted, goodwill must be calculated and it belongs entirely to the old partners and they must be credited with its value.

SELF ASSESSMENT EXERCISE

State three scenarios that must be noted when a new partner is introduced.

Example 1

James and Joe share profit in the ratio of 3:2. Before admitting Dan to the partnership, the goodwill was value at ₦20,000. Each partner had contributed ₦9000 as his fixed capital. The statement of Financial Position of the firm before goodwill was introduced as follows:

Statement of Financial Position

		₦
Non-Current Asset		12,800
Current Assets (cash)		3,200
		16,000
Capital Accounts:	James	8,000
	Joe	8,000
		16,000

Prepare the necessary entries to record the goodwill and the amended statement of financial position.

Solution to Example 1

Dr **Capital Account** **Cr**

	James	Joe		James	Joe
Balance c/d	20,000	16,000	Balance b/f	8,000	8,000
			Goodwill	12,000	8,000
	20,000	16,000		20,000	16,000
			Balance b/d	20,000	16,000

Dr **Goodwill Account** **Cr**

Capital: James	12,000	Balance c/d	20,000
Joe	8,000		
	20,000		20,000
Balance b/d	20,000		

Statement of Financial Position

	₦
Non-current Assets	12,800
Goodwill	20,000
	32,800
Current Assets	3,200
Total Assets	36,000
Capital Accounts: James	20,000
Joe	16,000
	36,000

When goodwill is to be writing out of the books: In partnership accounting, it is the usual practice for goodwill not to be retained in the firm's book. All the necessary steps must be taken to eliminate goodwill from the books after the admission of a new partner.

Example 2

In the previous example, we will assume that Dan is admitted on condition that he introduces ₦4,000 in cash as his capital. New profit sharing ratios are 2:2:1 for James, Joe and Dan respectively. No account for goodwill is to be maintained in the books.

Solution to Example 2

Dr	Goodwill Account		Cr
Capital Account: James	12,000	Capital Accounts: James	8,000
Joe	8,000	Joe	8,000
		Dan	4,000
	20,000		20,000

Dr	Cash Account		Cr
Balance b/f	3,200	Balance c/d	8,200
Capital	5,000		
	8,200		8,200
Balance c/d	8,200		

Capital Account

Dr	James	Joe	Dan		James	Joe	Dan Cr
Goodwill	8,000	8,000	4,000	Balance b/f	8,000	8,000	-
Balance c/d	12,000	8,000	1,000	Cash	-	-	5,000
				Goodwill	12,000	8,000	-
	20,000	16,000	5,000		20,000	16,000	5,000
				Balance b/d	12,000	8,000	1,000

Statement of Financial Position

		₦
Non-current Assets		12,800
Current Assets		8,200
		21,000
Capital Account:	James	12,000
	Joe	8,000
	Dan	1,000
		21,000

Example 3

The balances in the capital accounts A and B are N10,000 and N15,000 respectively. The goodwill is N20,000, profit sharing ratios is A = 8/5 C come in after the adjustment for goodwill had been carried out with N8000 cash as his capital show the treatment of Goodwill in the account.

Solution to Example 3

Dr **Partners' capital Account** **Cr**

	A	B	C		A	B	C
					N	N	N
				b/r	10,0000	15,000	8000
Bal c/f	22000	23000	8000	Goodwill	12,000	8,000	
	22000	23,000	8000		22,000	23,000	8000
				Bal b/f	22,000	23,000	8000

Goodwill

A= 12,000

B = 8000

If the goodwill is not expected to appear in the book, it will be written of immediately on admission of C to their (i.e. A, B, C) Capital account in the new profit sharing ratio, thus goodwill account will be credited and the partners account debited.

Method 2: No Goodwill Account is raised in the books, but the proportion of the agreed value of goodwill attributable to the incoming partner's share of profit is paid for by him in cash. The additional cash brought in by the new partner for the acquisition of a share of goodwill is proportions in which they shared profit before the introduction of the new partner. The cash brought in by the new partner as his capital will be credited to his capital Account in the normal manner.

Example 1

Assuming the statement of financial position below for A, B and C who share profits & losses the proportion

A = ½ B ¼ C = ¼ . Old profit sharing ratio

A B and C
Statement of Financial Position as at 30th June 1988

Capital	₦		₦
A -	10,000	Net Assets	25,000
B =	15,000		
	25,000		25,000

Goodwill is valued at ₦20,000. No goodwill account is to be opened in the books on C's admission, C introduced ₦10,000 cash into the business including payment for the Goodwill required by A & B before his admission.

Show by ledger entries, the adjustments to be made on C's introduction and the Balance sheet of the new firm.

Solution to Example 1

Calculate the amount of Goodwill be credited to his capital account The amount attributable to goodwill will be debited to this account and credited to Goodwill Account.

Dr **Partners Capital Account** **Cr**

	A	B	C		A	B	C
	₦	₦	₦		₦	₦	₦
Goodwill	-	-	5000	b/r	10,000	15000	
Bal c/f	12,500	17500	5000	Goodwill			10,000
				Capital	2,500	12500	
	12,500	17500	10000		12,500	17500	10,000
				Bal b/f	12,5000	17500	5,000

Good will

Capital Accounts

A – 5000

The amount of ₦1,5000 in the Goodwill will be shared by A and B in their old profit sharing ratio:

Dr		Goodwill		Cr
Partners Capital	₦		Capital Accounts	₦
A =	2500			5,000
B =	2500			
	5000			

A B and C

Statement of Financial Position (New) after C's admission

Capital	₦		
A =	12,500	Net Assets	25,000
B =	17,500	Cash at Bank	10,000
C =	5, 000		
	35,000		35,000

General Treatment of goodwill

On the introduction of a new partner, the share of the profit take by each of the partner must change. The existing partners will expect to receive compensation for surrendering part of their profit. Then goodwill will be brought into the business. This will be dealt with as follows:

a. **Raising of goodwill account in the books**

Here, the value of goodwill is debited to goodwill account and credited to the capital account in the partners old profit and loss sharing ratio.

Accounting entries

Goodwill introduced

DR	Goodwill account	In partners
CR	Partners capital account	old profit or loss sharing ratio

Cash introduced by a new partner as capital

DR Cash book
CR Capital account

b. **Goodwill is written off**

If the firm does not desire to retain the goodwill in the books, it will be necessary to write it off to the capital account of partners in their new profit or loss sharing ratio.

Accounting entries

Goodwill written off

DR	Capital account	in their new
CR	Goodwill account	sharing ratio

Example 1

Gani and Festus are in partnership sharing profit and loss equally. The balance sheet as at 31st December, 2000.

Dr	₦		₦ Cr
		Net Assets	250,000
Capital	150,000		
Gani	100,000		
Festus	250,000		250,000

It was decided to admit Keyata to the partnership and he brought in cash ₦75,000 as capital. It was agreed that goodwill was worth ₦30,000. The new profit sharing ratio is to Gani 2: Festus 2: Keyata 2.

Required: Show the Journal entries and balance sheet after goodwill has been taken into account.

a. When goodwill accounts are opened
b. When good will is written off
a. When goodwill account is opened

Solution to Example 1

Journal Entries		**Dr**	**Cr**
Goodwill account		30,000	
Capital account:	Gani ½		15,000
	Festus ½		15,000
Being Goodwill at the date of Keyata's admission			
Capital: Keyata			75,000
Cash account		75,000	
Cash introduced by Keyata			

Dr Capital Account Cr

	Gani	Festus	Keyata		Gani	Festus	Keyata
Bal c/d	165,00	115,000	75,000	Bal b/d	150,000	100,000	-----
				Cash			75,000
				Share of Goodwill	15,000	15,000	------
	165,000	115,000	75,000		165,000	115,000	75,000

Share of goodwill: Old profit sharing ratio

Gani: ½ x 30,000 = ₦15,000

Festus: ½ x 30,000 = ₦15,000

Dr Balance Sheet Cr

	₦		₦
Capital:		Net Assets	250,000
Gani	165,000	Goodwill	30,000
Festus	115,000	Cash	75,000
Keyata	75,000		
	355,000		355,000

b. **When goodwill is written off**

Journal Entries	**Dr**	**Cr**
	₦	₦
Good will account	30,000	
Capital account		
Gani ½		15,000
Festus ½		15,000
Goodwill introduced and shared in old profit sharing ratio		
Goodwill account:		30,000
Capital account:		
Gani 2/6	10,000	
Festus 2/6	10,000	
Keyata 2/6	10,000	
Goodwill written off in new sharing ratio		
Capital: Keyata		75,000
Cash account	75,000	

Cash introduced by Keyata

Dr			Capital Account				Cr
	Gani	Festus	Keyat		Gani	Festus	
Keyata							
	₦	₦	₦		₦	₦	₦
Goodwill - Written off	10,000	10,000	10,000	Bal c/d	150,000	100,000	---
Bal c/d	155,000	105,000	65,000	Cash	-	-	75,000
				Share of Goodwill	15,000	15,000	
	165,000	115,000	75,000		165,000	115,000	75,000

Share of goodwill written off in new profit sharing ratio

Gani = 2/6 x 30,000 = ₦10,000

Festus = 2/6 x 30,000 = ₦10,000

Keyata = 2/6 x 30,000 = ₦10,000

Dr	Balance Sheet		Cr
	₦		₦
Capital account:		Net Assets	250,000
Gani	155,000	Cash	75,000
Festus	105,000		
Keyata	65,000		
	325,000		325,000

3.4 Death or Retirement of a Partner

Technically, retirement or death of a partner dissolves a partnership, but normally the business will continue to operate, being carried on by the surviving partners. Logically, it means that a new partnership will commence from the time of death or retirement. At the date of retirement, the retiring partner will be owed a certain sum of money by his firm. The balance on the retiring partner's capital account and current account represents the amount due to him while he is a partner. When a retiring partner is owed a substantial sum on capital account, the sudden withdrawal of a very large sum of money could have a crippling effect upon the future conduct of a business. Therefore, partnership agreement may contain a clause whereby a retiring partner or deceased partner's executor is required to leave the bulk of his share in the business as a loan.

Example 1

Abbey, Bukky and Cossy were in partnership sharing profit and loss in ratio: Abbey ½, Bukky 1/3, and Cossy 1/6. The draft statement of financial position as at 30th September, 2014 was as follows:

Statement of Financial Position as at 30th September 2014

Assets:				**₦**
Non-Current Assets:	Freehold Land & Building			52,500
	Plant and Machinery			60,000
	Motor Car			25,000
				137,500
Current Assets:	Inventory		32,000	
	Receivables		36,250	
	Cash		10,500	78,750
				216,250
Capital & Liabilities				
Capital Accounts:	Abbey			75,000
	Bukky			40,000
	Cossy			16,250
				131,250
Non-Current Liability:				
Loan – Abbey			15,000	
Provisions: Deferred repairs			25,000	
Staff Pension			20,000	60,000
Current Liability – Payable				25,000
				216,250

Abbey retired on 30 September, 2014 and Bukky and Cossy continued in partnership, sharing profits in the same ratio as before. It was agreed that Abbey should take over one of the firm's cars at the book value of ₦20,000 and should leave the balance due to him on loan. It was further agreed that, for the purpose of both the dissolution and the controlling partnership, the following adjustments should be made in the statement of financial position as at 30 September 2014.

i. Freehold land & Building should be revalued at ₦75,000 and Plant & Machinery at ₦50,000.

ii. The provision for deferred repairs was no longer required and the staff pensions provision should be increased by ₦10,000.

The partnership agreement provided that on the retirement of a partner, goodwill should be revalued at an amount equal to the average annual profit of the three years expiring on the date of retirement. The relevant profits were:

Year ended 30 September 2012	₦36,845
Year ended 30 September 2013	₦41,155
Year ended 30 September 2014	₦31,000

It was agreed that, for the purpose of valuing goodwill, the revaluation of the Non-current assets, the adjustments to the provision for deferred repairs and staff pensions should not be regarded as affecting the profit. Bukky and Cossy decided that goodwill should not be carried in the books as an asset.

Required:

i. Prepare the Revaluation Account
ii. Prepare Capital Accounts showing the balance due to Abbey on retirement.
iii. Prepare the statement of financial position as at 1 October, 2014

Solution to Example 1

i. Dr Revaluation Account Cr

		₦		₦
Plant Machinery		10,000	Freehold land & building	22,500
Staff pension		10,000	Provision for Repair	25,000
Capital account:				
Abbey	13,750			
Bukky	9,167			
Cossy	4,583	27,500		
		47,500		47,500

Workings

i. Calculation of Goodwill

	₦
Profit for the year ended 30 September 2012	36,845
	41,155
	31,000
	109,000

Average yearly profit = $\frac{109,000}{3}$ = ₦36,333

Goodwill = ₦36,333

NB: Goodwill is not to be retained in the books.

ii. Dr Partners Capital Account Cr

	Abbey	Bukky	Cossy		Abbey	Bukky	Cossy
	₦	₦	₦		₦	₦	₦
Motor car	20,000	-	-	balance b/f	75,000	40,000	16,250
Goodwill	-	24,222	12,111	Revaluation	13,750	9,167	4,583
Loan	86,916			Goodwill	18,166	12,111	6,056
Balance c/d		37,056	14,778				
	106,916	61,278	26,889		106,916	61,278	26,889
				Balance b/d	-	37,056	14,778

iii. Operating Statement of Financial Position as at 30 September, 2014

		₦	₦
Assets:	Non-Current Assets:		
	Freehold land & Building		75,000
	Plant and Machinery		50,000
	Motor car		5,000
			130,000
	Current Assets:		
	Inventory	32,000	
	Receivables	36,250	
	Cash	10,500	78,750
			208,750
Capital:	Bukky		37,056
	Cossy		14,778
			51,834
Non-Current Liabilities: Loan			101,916
Current Liabilities:	Pension payable	30,000	
	Trade Payable	25,000	55,000
			208,750

Example 2

The following is the Balance sheet of X,Y& Z on December 31st 1987 on which date X retires. Profits and losses have been shared in the ratio 3:2:1 and Y and Z continue the business sharing profits in the ratio of 2:1 for the purpose of X's retirement goodwill is valued at ₦10,000.

Statement of Financial Position as at 31st Dec. 1987

Capital Accounts:			Freehold property	
	₦			20,000
X	9600		Plant & machinery	10,000
Y	8400		Stock – in – Trade	5,500
Z	6200	- 24,200	Debtors	3,500
			Cash at Rank	1,400
Current Accounts				
X	1800			
Y	2900			
Z	3500	8200		
Creditors		8500		
		40900		40,900

Show by Journal entries the adjustments necessary on X's retirement

Solution to Example 2:

(i)	Capital Accounts:		₦	₦
	Y 2/5		3,333	
	Z 1/3		1,667	
	Capital Account X			5000

(Being purchase from x of ½ of Goodwill)

(ii)			₦	₦
	Current Account	X	1800	
	Capital "	Y		1800

(being transfer of balance on retirement.

			₦	₦
iii)	Capital Account	X	16400	
	Loan Account	X		16,400

(being transfer of balance due to X on his retirement pending settlement)

It could also be shown by ledger entries:
Partners Capital Account

Dr **Partners Capital Account** **Cr**

	X	Y	Z		X	Y	Z
	N		N			N	N
Goodwill	-	3,333	1667	b/r	9600	8400	6200
Bal c/f	16400			Goodwill	1800		
	-	5067	4533	Capital	5000		
	16400				16400		
				Bal b/f	-	5067	4533

Goodwill

Partner Capital		₦	Y -	3333
	X =	<u>5000</u>	Z -	<u>1667</u>
				<u>5000</u>

	Loan	Account	
	₦		Note that if the amount is paid
c/f	16,400	x – 16,400	immediately
		b/c 16,400	₦16,400 should be
			credited to Bank/Cash

Revised Statement of Financial Position After X's retirement

					₦
Capital Accounts,			Freehold Property		20,000
	₦			Plant & machinery	10,500
Y	5067			Stock-in-Trade	5,500
Z	4533			Debtors	3,500
Z				Cash at Rank	1,400
Current Accounts					
Y -	2900				
Z -	3500				
Loan		16,400			
Creditors		8,500			
		40,900			40,900

SELF ASSESSMENT EXERCISE

Enumerate steps involve when a partner died or retire in partnership account.

3.5 Changes in Profit Sharing Ratio

Changes in the proportion in which partners share profits and losses makes it imperative for all the assets of the firm, including Goodwill, to be revalued, in order that each partner, may be credited or changed, before the change in the division of profits takes effect, with his proper share of any unrecorded profit or loss in respect of these assets.

Change in profit sharing ratio may occur as a result of the following.

i. Changes in skill contributed by partners
ii. Ill health
iii. Old age

a. When goodwill is raised in the business

Dr	Goodwill account	
Cr	Capital account	in their old profit sharing ratio

b. Goodwill written off

Dr	Capital account	
Cr	Good will account	in their new profit sharing ratio

Example 1

The following is the Balance sheet of X, Y & Z, at 31st Aug, 2006. The partners agreed that from September 1st 1986 They will share profits in the ratio of 3:2:1, instead of in their former ratio of 2:2:1

X Y and Z

Statement of Financial Position as at 31st Aug. 2006

Capital Accounts:	₦	Goodwill	1000
X	2500	Plant & Mach	2000
Y	1500	Stock	1500
Z	1000	Debtors	1300
	5,800		5,800

The assets of the firm are revalued as order:

	₦
Goodwill	2800
Plant & machinery	2500
Stock	1000
Debtors	1,100

Show by ledger entries the adjustment which must be made on the occasion of the change in profit-sharing ratios between the partners & the Revised Balance Sheet.

Solution to Example 1

The net increase in the assets should be credited to the partners' capital Accounts in their original profit-sharing ratio.

Dr Revaluation Account Cr

Stock		500	Goodwill	1000
Debtors		200	Plant & Machinery	500
Capital Accounts:				
Net	X -	320		
Increase	Y -	320		
In	Z -	160		
Assets		1500		1500

Dr Goodwill Cr

	₦		₦
B/f	1,000		
Revaluation	1,000	C/f	2,000
	2,000		2,000

Dr Plant & Machinery Cr

	₦		₦
B/f	2,000		
Revaluation	500	c/f	2,500
	2,500		2,500

Dr Stock Cr

	₦		₦
b/f	1,500	Revaluation	500
		c/f	1,000
	1,500		1,500

Dr		Debtors	Cr
b/f	1,300	Revaluation	200
		c/f	1,100
	1,300		1,300

Dr **Partners capital Accounts** **Cr**

	X	Y	Z		X	Y	Z
				Balance b/f	2500	1500	1000
Balance c/f	2820	1820	1160	revaluation (2:2:1)	320	320	160
	2820	1820	1160		2820	1820	1160
				Bal. b/f	2820	1820	1160

Revised Statement of Financial Position is shown below:

X Y and Z

Revised Statement of Financial Position as at Sep. 2006

Capital Accounts:		Goodwill	2000
X -	2820		
Y -	1820	Plant & Machinery	2500
Z -	1160	stock	1000
Creditors	800	Debtors	1100
	6600		6600

Example 2

The balance sheet of A, B and C as at 31st December 2008 was a follows. They shared profit in the ratio A 4: B 3: C 1. They altered the ratio to A3: B5: C2.

Statement of Financial Position

	₦		₦
Capital		Assets	70,000
A	30,000		
B	24,000		
C	16,000		
	70,000		70,000

The partners agree to bring in goodwill being valued at ₦12,000 on the change. Show the balance sheet on 1st January 2009 after goodwill has been taken into account if.

a. Goodwill account was opened
b. Goodwill to be written off

Solution to Example 2

a. Goodwill account was opened

Dr Capital account Cr

	A	B	C		A	B	C
Bal c/d	36,000	28,500	17,500	Bal b/f	30,000	24,000	16,000
				Goodwill	6,000	4,500	1,500

	A	B	C		A	B	C
	36,000	28,500	17,500		36,000	28,500	17,500
				Balance b/d	36,000	28,500	17,500

Working: Sharing of goodwill in their old profit ratio

A = 4/8 x 12,000 = ₦6,000

B = 3/8 x 12,000 = ₦4,500

C = 1/8 x 12,000 = ₦1,500

Dr — Statement of Financial Position — Cr

		₦		₦
Capital			Assets	70,000
	A	36,000	Goodwill	12,000
	B	28,500		
	C	17,500		
		82,000		82,000

b. Goodwill to be written off

Dr — Capital Account — Cr

	A	B	C		A	B	C
Goodwill Written off	3,600	6,000	2,400	Balance b/f	30,000	24,000	16,000
Bal c/d	32,400	22,500	15,100	Goodwill	6,000	4,500	1,500
	36,000	28,500	17,500		36,000	28,500	17,500
				Balance b/d	32,400	22,500	15,100

Workings: Goodwill is written off in new profit ratio

A 3/10 x 12,000 = ₦3,600

B 5/10 x 12,000 = ₦6,400

C 2/10 x 12,000 = ₦2,400

Dr — Balance Sheet — Cr

		₦		₦
Capital			Asset	70,000
	A	32,400		
	B	22,500		
	C	15,100		
		70,000		70,000

Dr — Goodwill account — Cr

	₦		₦
Capital	12,000	Capital	12,000

3.6. Dissolution and Amalgamation of Partnership

3.6.1 Dissolution of Partnership

A partnership may be terminated by force of circumstances (such as Business Failure during economic recession or death of a partner) or by mutual agreement when one or more partners reach retiring age. Upon dissolution, the partnership firm stop trading or operating.

In the absence of agreement to the contrary the partnership Act 1890 provides that the following shall be grounds for the dissolution of partnership.

i. The expiration of the term for which the partnership was entered into, if a fixed term was agreed upon.
ii. The termination of the adventure or undertaking, when a single adventure or undertaking was the purpose of the partnership.
iii. When one partner gives notice to the others of the intension to dissolve the firm.
iv. The bankruptcy of a partner
v. The happening of an event which causes the partnership to become illegal.

In the other cases, excluding the above, dissolution may be obtained on application to the court.

(If any contributed by the partners to make up losses or deficiencies of capital, must be applied in the following manner and order.

1. In paying the debts and liabilities of the firm to persons who are not partners therein.
2. In paying to each partner rateably what is due from the firm to him for advances as distinguished from capital.
3. In paying to each partner the amount due to him in respect to his capital and current Account balance.

Then, in accordance with the Partnership Act 1890:

(i) the assets are disposed of;
(ii) the liabilities of the firm are paid
(iii) the partners are repaid their advances and current balances
(iv) the partners are paid the final amount due to them on their capital account.

Accounting Entries

a. The book values of all assets (excluding Bank and Cash) shall be transfer to Realization Account, that is:

Debit: Realisation Account
Credit: Assets Account
with the book values of the assets

b. Actual sum realized from disposal of assets

Debit: Bank Account
Credit: Realization account
with the amount realised

c. Partnership assets taken over by partners:

   Debit: Appropriate partner's capital account
   Credit: Realisation Account } with the book value of the asset

d. Dissolution Expenses

   Debit: Realisation account
   Credit: Bank account

e. Settlement of liabilities (current or non-current)

   Debit: Liability account
   Credit: Bank account

f. Balance on Realisation account representing either a surplus (credit balance) or a deficit (debit balances). This will be shared between partners in profit and loss sharing ratios:

   Surplus: Debit: Realisation Account
   Credit: Partners' capital account

   Deficit: Debit: Partners' capital account
   Credit: Realisation account

Note in a dissolution/termination situation net creditors are not transferred to realization accounts because liability for them is not assumed by another entity.

SELF ASSESSMENT EXERCISE

In the absence of agreement to the contrary, the partnership Act 1890 provides certain provision for the dissolution of partnership. State and explain briefly these provisions.

Example 1

On 31st March, 2015, the outline statement of financial position of Black, White and Green in partnership sharing profits and losses equally, was

Statement of Financial Position as at 31 March, 2015

		₦	₦
ASSETS:	Non-Current Assets		
	Freehold building & land		100,000
	Plant and Machinery		45,000
	Motor vehicles		37,500
			182,500
Current Assets:	Inventory	47,500	
	Receivables	35,000	
	Bank	5,000	87,500
			270,000
Capital Accounts:			
	Black		80,000
	White		70,000
	Green		40,000

			190,000
Current accounts:	Black	1,750	
	White	3,000	
	Green	(2,250)	2,500
Current Liabilities:	Payables	40,000	
	Bank overdraft	37,500	77,500
			270,000

On 31st March, 2015, the Partnership was dissolved and the asset sold publicly as follows:

	₦
Freehold building and land	150,000
Plant and Equipment	32,500
Motor vehicles	12,500
Inventory	36,250

Receivables realized ₦34,000. Payables were settled in full and the Bank overdraft was repaid. Black personally took over a vehicle at a valuation of ₦17,500 and white a vehicle at a valuation of ₦8,750. Dissolution expenses amounting to ₦2,500 were paid.

Required:

Prepare the Realisation account, Bank account and Capital accounts to record the dissolution

Solution to Example 1

Dr Realisation Account Cr

		₦		₦
Freehold Building & Land		100,000	Bank – Freehold Building	150,000
Plant & Machinery		45,000	- Plant & Machinery	32,500
Motor vehicles		37,500	- Motor vehicles	12,500
Inventory		47,500	- Inventory	36,250
Receivables		35,000	- Receivables	34,000
Bank – Dissolution		2,500	Capital – assets taken over	
Capital:	Black	8,000	- Black	17,500
	White	8,000	- White	8,750
	Green	8,000		
		291,500		291,500

Dr Capital Account Cr

	Black	White	Green		Black	White	Green
Current a/c	-	-	2,250	Balance b/f	80,000	70,000	40,000
Realisation (asset taken over	17,500	8,750	-	Current a/c	1,750	3,000	-
Bank	72,250	72,250	45,750	Realisation	8,000	8,000	8,000
	89,750	81,000	48,000		89,750	81,000	48,000

Dr	Bank Account		Cr
	₦		₦
Balance b/f	5,000	Realisation – Dissolution expenses	2,500
Freehold Building & Land	150,000	Payables	40,000
Plant & Machinery	32,500	Bank overdraft	37,500
Motor vehicle	12,500	Capital account:Black	72,250
Inventory	36,250	White	72,250
Receivables	34,000	Green	45,750
	270,250		270,250

Example 2

Data, Dele, Dotun who are in partnership sharing profits and losses 2:2:1 decide to dissolve the partnership on 30th September 1980 at which date their Balance sheet was: -

Dada, Dele, and Dotun
Statement of Financial Position as at 30th Sept, 1980

Capital Accounts:	₦		Fixed Assets (at bank):			₦
Dada	39,000		Freehold property			30,000
Dele	13,000		Equipment			15,000
Dotun	2,000	54,000				45,000
Current Assets						
Current Accounts						
Dada	700		stock		8000	
Dele	(300)		Debtors		4500	
Dotun	200	600	Cash at Bank		2100	14,600
Current liabilities:-						
Creditors	3000					
Loan – Dele	2000	5,000				
		59,600				59,600

The partners were unable to sell the business as a going concern and deposed of the assets separately for the following sums:

	₦
Freehold property	31,000
Equipment	4,800
Stock	2,900

Debtors paid in full and creditors gave discounts totalling ₦100. Dissolution expenses totalled ₦800.

Required: Prepare all the accounts of the partnership on dissolution.

Solution to Example 2

Dr Realization Account Cr

	₦		₦
Fixed Assets	30,000	Bank – Freehold property	31,000
Equipment	15,000	Equipment	4,800
Stock	8, 000	- Stock	2,900
Debtors	4,500	Discount (creditors)	100
Bank – Dissolution		bank – Debtors	4,500
Expenses	800	Capital- Dada -	6,000
		Dele	
		Dotun	6,000
			3,000
	58,300		58,300

Creditors:

	₦		
Realization (discount)	100	b/f	300
Bank	2900		

Dr Partners capital Accounts Cr

	Dada	Dele	Dotun		Dada	Dele	Dotun
	₦	₦	₦		₦	₦	₦
Current a/c		300		Bal b/d	39000	13,000	2000
Realization (loss)	6000	6000	3000	Currently	700	-	200
Bank	33700	6700		Bank	-	-	800
	39700	13000	3000		39700	13,000	3000

DR Partners capital Accounts Cr

	Dada	Dele	Dotun		Dada	Dele	Dotun
	₦	₦	₦		₦	₦	₦
Bal b/c	-	300	-	Bal b/d	700	-	200
Capital a/c (transfer)	700	-	200	Capital a/c (transfer)		300	
	700	300	200		700	300	200

Dr		Bank Account	Cr
	₦		₦
Balance b/c	2100		
Realization		Creditors	2900
- Freehold property			
	31,000	Realization Exp	800
- Equipment	4,800	Loan – Date	2000
- Debtors	4,500	Capital:	
- Stock	2,900	Dada	33,700
Capital:			
Dotun	800		
	46,100		46,100

Note: INCIDENCE OF PARTNER ON DISSOLUTION:
In the above solution, Dotun's capital Account was in debit to the extent to N800 after his share of the realization loss. Dotun eliminated this deficit by paying N800 into partnership bank Account.

If, however, at this point Dotun had been insolvent and therefore unable to make this contribution to eliminate his debit balance, his deficiency would, in the absence of any contrary agreement between the partners, be shared by the solvent partners (Dada and Dele) in the last capital account proportions. For this purpose current Account balance are disregarded. This arrangement is known as the rule in garner V. Murray who were two of the parties in a High court case decided in 1904.

Rules of Garner vs. Murray

The rules states that, "where upon dissolution, a partner's capital account is in debit and he is unable to contribute the full deficiency, the loss must be divided amongst the solvent partners in the ratio of their last agreed capital and not in the proportion ordinary losses are to be borne".

Procedures:

1. Sharing of profit or loss on realisation
2. Partner must be able to pay as much as he is able out to his debt balance
3. When the partner cannot pay in full, it must be divided amongst the other remaining partners in the ratio of other last agreed capitals.

Example 4

P, Q and R are in partnership, sharing profit and losses in the ratio 3:2:1 respectively. The balance sheet as the date of dissolution is as follows:

		₦		₦
Capital accounts:			Assets	
P	5,600		Fixtures and fittings	2,350
Q	3,400	9,000	Motor van	4,700
Creditors		4,500	Debtors	1,450
			Stock	1,750
			Bank	1,730
			R capital (Dr balance)	1,520
		13,500		13,500

The following assets were sold

	₦
Fixtures and fittings	2,100
Motor van	2,500
Debtors	500
Stock	1,250

The creditors were settled in full and the expenses on dissolution were ₦350. You are required to prepare the necessary accounts. Apply the rules of Garner vs Murray.

Solution to Example 4

Dr Realization account Cr

	₦		₦
Book value of assets		Asset sold	
Fixtures and fitting	2,350	Fixtures and fitting	2,100
Motor van	4,700	Motor van	2,500
Debtors	1,450	Debtors	500
Stock	1,750	Stock	1,250
Cost of dissolution	350	Share of loss:	
		P (3/6 x 4,250)	2,125
		Q (2/6x 4,250)	1,417
		R (1/6 x 4,250)	708
	10,600		10,600

Dr Capital Account Cr

	P	Q	R		P	Q	R
	₦	₦	₦		₦	₦	₦
Balance c/f	----	----	1,520	Balance b/f	5,600	3,400	---
Share of loss	2,125	1,417	708	Transfer to P	----	-----	1,386
Transfer from R	1,386	842	----	Transfer to Q	----	-----	842
Cash book	2,089	1,141	----				
	5,600	3,400	2,228		5,600	3,400	2,228

Dr Cash book Cr

Balance b/f	1,730	Creditors		4,500
Fixtures and fitting	2,100	Cost of dissolution		350
Motor van	2,500	Capital:		
Debtors	500	P	2,089	

Stock	1,250	Q	1,141	3,230
	8,080			8,080

Workings: Applying the rules of Garner vs Murray

R deficiency: ₦2,228

Transfer to P $= \frac{5,600 \times 2,228}{9,000}$ (deficiency share in proportion to capital)

$= 1,386$

Transfer to Q $= \frac{3,400 \times 2,228}{9,000}$ = ₦842

3.6.2. Amalgamation of Partnership

Amalgamation of Partnerships is a situation where two existing partnerships decide to join together and form one firm. That is where two or more partnerships combine together to form a new partnership.

Example 1

Abbey and Bekky are partners sharing profits or losses equally. Cossy and Dammy are partners in another firm. They also share profits equally. The two firms are to amalgamate with Abbey, Bekky, Cossy and Dammy sharing profits or losses in the ratio of 6:6:4:4. The statement prior to the amalgamation and before any of the necessary amalgamation adjustment was as follows:

			AB	CD
Non-Current Assets			550,000	481,250
Current Assets			275,000	220,000
			825,000	701,250
Capital:	Abbey		330,000	
	Bekky		330,000	
	Cossy			275,000
	Dammy			275,000
Current Liabilities:		Payables	165,000	151,250
			825,000	701,250

The goodwill of AB & Co was agreed to be ₦275,000 and its Non-current assets were to be revalued by ₦137,500. The goodwill of CD & Co was agreed at ₦220,000 and its Non-current assets were also to be revalue by ₦137,500. The partners in the new firm have decided that the assets will be carried forward at their revalued amounts in the general ledger of the new firm but goodwill is to be eliminated.

Required:

a) Prepare partner's capital account in columnar form, recording these transactions.

b) The opening statement of financial position

Solution to Example 1

a. **Dr** **Partners Capital Account** **Cr**

	Abbey	Bekky	Cossy	Dammy		Abbey	Bekky	Cossy	Dammy
Capital	148,500	148,500	99,000	99,000	Balance b/f	330,000	330,000	275,000	275,000
Balance c/d	387,750	387,750	354,750	354,750	Goodwill	137,500	137,500	110,000	110,000
					Revaluation	68,750	68,750	68,750	68,750
	536,250	536,250	453,750	453,750		536,250	536,250	453,750	453,750
					Balance b/d	387,750	387,750	354,750	354,750

Workings:

Goodwill (AB & Co)		275,000
Goodwill (CD & Co)		220,000
	Total Goodwill	495,000

To eliminate total goodwill using new profit sharing ratio: Abbey 6; Bekky 6; Cossy 4; Dammy 4

Abbey $= \frac{6}{20} \times \frac{495,000}{1} = 148,500$

Bekky $= \frac{6}{20} \times \frac{495,000}{1} = 148,500$

Cossy $= \frac{4}{20} \times \frac{495,000}{1} = 99,000$

Dammy $= \frac{4}{20} \times \frac{495,000}{1} = 99,000$

495,000

Dr Goodwill Account Cr

	₦		₦
Capital:		Capital:	
Abbey	148,500	Abbey	137,500
Bekky	148,500	Bekky	137,500
Cossy	99,000	Cossy	110,000
Dammy	99,000	Dammy	110,000
	495,000		495,000

Dr Non-Current Assets Cr

	₦		₦
Balance b/f (AB & Co)	550,000	Balance c/d	1,306,250
Balance b/f (CD & Co)	481,250		
Revaluation (137,500+137,500)	275,000		
	1,306,250		1,306,250
Balance b/d	1,306,250		

Opening Statement of Financial Position (New Firm)

		₦
Assets:	Non-current Assets	1,306,250
	Current Assets (275,000 + 220,000)	495,000
		1,801,250
Capital:	Abbey	387,750
	Bekky	387,750
	Cossy	354,750
	Dammy	354,750
Current Liabilities: Payables (165,000 + 151,250)		316,250
		1,801,250

4.0 CONCLUSION

It can be concluded that the adequate knowledge of accounting treatments of partnership transaction will assist accountant in the preparation of the annual reports of partnership business. The accounts must be prepared in accordance with relevant accounting standards.

5.0 SUMMARY

This unit explores the statutory framework guiding the formation of partnership. Different scenarios as regards the changes in the constitution of partnership were clearly examined and simplified.

6.0 TUTOR MARKED ASSIGNMENT

Question 1

Babu and Lukudi are in partnership sharing profits or losses in ratio 2:1 respectively. On October 31, 2014, the partners decided to dissolve the partnership. The statement of financial position at the date is set out below:

	₦'000	₦'000
Non-Current Assets:		
Plant and machinery		75,000
Motor vehicles		15,000
		90,000
Current Assets:		
Inventories	120,000	
Account receivable	36,000	
Bank balance	12,000	168,000
		258,000
Capital		
Babu		120,000
Lukudi		30,000
		150,000
Account payables		108,000
		258,000

Notes:

i. The plant and equipment were sold at ₦79m

ii. Babu took over one of the vehicles with a book value of ₦1.5m for ₦800,000. The remaining vehicles were sold for ₦12m.

iii. Inventories were sold for ₦92m while account receivable realised ₦34.3m.

iv. The account payable gave a discount of ₦0.10 on every ₦1 owed.

v. The realization expenses were settled for ₦4.5m.

You are required to prepare:

a. Realisation Account
b. Capital Accounts
c. Bank Account

Question 2

Canz, Pand and Danz are in partnership sharing profits and losses in the ratio 3:2:1 respectively. The Statement of Financial Position of the Partnership is shown below:

Statement of Financial Position as at 31 December, 2014

	₦	₦		₦	₦
Capital accounts			Non Current Assets		
Canz	1,160		Premises	1,200	
Pand	520		Motor van	700	
Danz	715	2,395	Furniture & Fittings	30	1,930
Current Accounts			Current Assets		
Canz	210		Inventories	190	
Danz	79		Trade receivables	210	
Trade payables	375	664	Current account:		
			Pand	124	
			Cash at bank	605	1,129
		3,059			3,059

On 1 January 2015 Pand retired from the partnership on the following terms:
Goodwill was valued at ₦400,000. The current value of the premises and motor van were ₦1,400,000 and ₦60,000 respectively. The inventory was to be reduced by ₦16,000 and provision for doubtful debts was put at ₦10,000. No goodwill account was to be opened and the balances of the assets in the books were not to be altered. Any adjustments considered necessary are to be made through the Partner's Capital Accounts. Pand's balance should be left as loan in the partnership.

You are required to show the revised statement of financial position in vertical format as it would appear immediately after Pand's retirement. ***(Show all workings).***

Question 3

In the absence of agreement to the contrary, the partnership Act 1890 provides certain provision for the dissolution of partnership. State and explain briefly these provisions.

Question 4

Explain the Rules of Garner vs. Murray

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UNIT 3: CONVERSION OF PARTNERSHIP INTO LIMITED COMPANY

1.0 INTRODUCTION

This section deals with conversion of partnership to Limited Liability Company.

2.0 OBJECTIVES

After studying this unit, you should be able to:
1. Explain accounting treatment of the conversion of partnership to Limited Liability Company.

3.0MAIN CONTENT

3.1 Introduction

When a partnership is so converted, there are two separate set of problems – those concerned with dissolving the partnership and those concerned with consulting the limited company.

3.2 Accounting Entries

Entries in partnership ledger

a. All assets account

Debit: Realisation Account
Credit: Asset Account   with the book value of all the assets

b. Assets taken over

Debit: Partner’s capital account
Credit: Realisation account

c. Dissolution Expenses

Debit: Realisation account
Credit: Bank account

d. Purchase consideration

Debit: Account opened in the name of the company
Credit: Realisation Account

NB: The consideration may be discharged by an issue of shares or by payment of cash or by an issue of debentures or by any combination of these methods.

e. When purchase consideration received

Debit: Bank/Share in New Company
Credit: New Company Account

Entries in the Company's Ledger

a. Business Purchase account is opened

Debit: Liabilities taken over

Credit: Purchase consideration

When the purchase consideration passes, Business purchase account is debited and share capital. Bank and Debenture are credited.

SELF ASSESSMENT EXERCISE

Enumerate the accounting entries for conversion of partnership to Limited Liability Company

Example 1

On 31st March, 2015, the outline statement of Financial Position of Black, White and Green in partnership sharing profit and losses equally was

Statement of Financial Position as at 31 March, 2015

		₦	₦
Assets: Non-Current Assets			
Freehold Building & Land			100,000
Plant & Machinery			45,000
Motor vehicles			37,500
			182,500
Current Assets:			
Inventory		47,500	
Receivables		35,000	
Bank		5,000	87,500
			270,000
Capital Accounts:			
Bank			80,000
White			70,000
Green			40,000
			190,000
Current Accounts:			
Black		1,750	
White		3,000	
Green		(2,250)	2,500
Current Liabilities:	Payables	40,000	
	Bank Overdraft	37,500	77,500
			270,000

On that date, the partnership was converted into a limited company, Colour Ltd. The agreed consideration was ₦207,500 to be discharged by a payment to the partners of ₦45,000 and by the issue of 125,000 Ordinary shares of ₦1 per share at a premium of 30k fully paid. The shares were taken on by Black 50,000 shares, White 50,000 shares and Green 25,000 shares.

Required:
Prepare the Realisation, Colour Ltd and Capital Account of the partnership to record the conversion.

Solution to Example 1

Dr — Realisation Account — Cr

	₦		₦
Freehold land	100,000	Payables	40,000
Plant & Machinery	45,000	Bank overdraft	37,500
Motor vehicles	37,500	Colour Ltd	207,500
Inventory	47,500		
Receivables	35,000		
Bank	5,000		
Profit on Conversion:			
Black (1/3 x 15,000)	5,000		
White (1/3 x 15,000)	5,000		
Green (1/3 x 15,000)	5,000		
	285,000		285,000

Dr — Colour Ltd — Cr

Realisation	207,500	Share in Colour Ltd	
		(125,000 x N1.30)	162,500
		Bank	45,000
	207,500		207,500

Dr — Capital Account — Cr

	Black	White	Green		Black	White	Green
Current account	-	-	2,250	Balance b/f	80,000	70,000	40,000
Share in Colour Ltd	65,000	65,000	32,500	Current a/c	1,750	3,000	-
				Realisation	5,000	5,000	5,000
Bank (Balancing figure)	21,750	13,000	10,250				
	86,750	78,000	45,000		86,750	78,000	45,000

Example 2

The facts are as in Example 1, Colour Ltd revealed assets as follows:

	₦
Freehold building & land	115,000
Plant & Machinery	40,000
Inventory	42,500

The former partners then acquired additional shares for cash (at a premium of 30k per share) as follows:

	No of shares
Black	25,000
White	25,000
Green	50,000

The company settled the outstanding liability of the overdraft.

Required: Prepare the statement of financial position of Colour Ltd immediately after the above arrangements had been affected.

Solution to Example 2

Workings: (i) Calculation of Goodwill

Purchase Consideration – Revalue Net Assets

Revalued Net Assets:		₦	₦
Freehold Building & Land			115,000
Plant & Machinery			40,000
Motor vehicles			37,500
			192,500
Current Assets:	Inventory	42,500	
	Receivables	35,000	
	Bank	5,000	
		82,500	
Current Liabilities:	Payables	(40,000)	
	Bank overdraft	(37,500)	5,000
Net Assets			197,500

Goodwill = ₦207,500 – ₦197,500
= ₦10,000

ii. Bank Account

Dr		Cr	
Balance b/f	5,000	Payment to partners	45,000
Share for cash (100,000 x 1.30)	130,000	Overdraft settlement	37,500
		Balance c/d	52,500
	135,000		135,000
Balance b/d	52,500		

Colour Ltd
Statement of Financial Position as at 31 March, 2015

		₦	₦
Assets: Non-Current Assets:			
Freehold Building and Land			115,000
Plant and Machinery			40,000
Motor vehicles			37,500
Goodwill (wk 1)			10,000
			202,500
Current Assets:			
Inventory		42,500	
Receivables		35,000	
Bank & Cash (wk 2)		52,500	130,000
			332,500
Equity & Liabilities: Equity			
Ordinary share of ₦1 each (225,000 x ₦1)			225,000
Share Premium (225,000 x 30k)			67,500
			292,500
Non-Current Liability:	Payables		40,000
			332,500

Examples 3

Messrs Adamu & Hassan who are friends are also majority shareholders and managing directors of their respective construction businesses of Adamu and Sons Limited, and Hassan & Sons Limited. For the purpose of access to more funds and rationalization, it was agreed that Adamu & Sons Limited should absorb the business of Hassan & Sons Limited. The statement of financial position of the two companies prior to absorption on 30 April 2010 was as follows:

		Adamu & Sons limited ₦	Hassan & Sons limited ₦
Assets:	Non-Current Assets	2,450,000	375,000
	Goodwill	-	150,000
		2,450,000	525,000
	Current Assets	775,000	600,000
Total Assets		3,225,000	1,125,000
Equity & Liabilities			
Equity			
50k Ordinary shares		2,000,000	250,000
Redeemable preference share		100,000	
Share premium		250,000	
Revenue Reserve		450,000	750,000
Total Equity		2,800,000	1,000,000

Current Liabilities	425,000	125,000
Total Equity & Liabilities	3,225,000	1,125,000

The redemption at 5% premium or redeemable preference shares took place on 1st May, 2010. In order to partially finance the redemption 200,000 ordinary shares at a premium of 5 kobo were issued to existing shareholders and paid in full on that date. Hassan & Sons Limited was liquidated on 1 May, 2010 when all its assets, except certain items of inventory valued at ₦100,000, were purchased from the liquidator by Adamu & Sons limited. The company was also to assume all the liabilities of Hassan & Sons Limited, and

(i) To issue 650,000 of its ordinary share of 50k cash at a premium of 8kobo per share and;

(ii) To pay ₦750,000 in cash.

The purchase consideration was affected on 2 May, 2010 and share issue expenses amounted to ₦152,000

Required:

a. Prepare the statement of Financial Position of Adamu & Sons Limited after the absorption had been affected.

b. Show your working for calculations of:

i. Current Assets   ii. Share Premium and   iii. Revenue reserve

Solution to Example 3

a. **ADAMU & SONS LIMITED**

Statement of Financial Position as at 1 May, 2010

	₦	₦
Assets		
Non-Current Assets		2,825,000
Goodwill		377,000
		3,202,000
Current Assets		378,000
Total Assets		3,580,000
Equity and Liabilities		
Equity		
4,850,000 ordinary shares @ 50k		2,425,000
Share premium account		155,000
Revenue reserve		450,000
Total Equity		**3,030,000**
Current Liabilities		550,000
Total Equity & Liabilities		**3,580,000**

b. Current Assets

Dr	₦		₦ Cr
Balance b/f	775,000	Redemption of Red. Pref. shares	100,000
Vendor	500,000	Premium on Redemption (Bank)	5,000
Ordinary share (Bank)	100,000	Share issue expenses	152,000
Share premium (Bank)	10,000	Vendor	750,000
		Balance c/d	378,000
	1,385,000		1,385,000
Balance b/d	378,000		

Notes: All cash and Bank transactions are reflected in the current assets accounts.

ii. SHARE PREMIUM ACCOUNT

Dr	₦		₦ Cr
Share issue expenses (Bank)	152,000	Balance b/d	250,000
Bank (Redemption premium)	5,000	Vendor	52,000
Balance c/d	155,000	Bank	10,000
	312,000		312,000
		Balance b/d	155,000

iii. Revenue Reserve Account

Dr			Cr
Balance c/d	450,000	Balance b/f	450,000
		Balance b/d	450,000

Workings:

(i) Non-Current Assets

Dr			Cr
Balance b/f	2,450,000	Balance c/d	2,825,000
Vendor	375,000		
	2,825,000		2,825,000
Balance b/d	2,825,000		

(ii) Ordinary Shares Capital Account

Dr			Cr
Balance c/d	2,450,000	Balance b/f	2,000,000
		Vendor	325,000
		Bank	100,000
	2,450,000		2,450,000
		Balance b/d	2,450,000

(iii) Current Liabilities Account

Dr			Cr
Balance c/d	550,000	Balance b/f	425,000
		Vendor	125,000
	550,000		550,000
		Balance b/d	550,000

(iv) LEDGERS TO CLOSE THE BOOKS OF HASSAN & SONS LTD

Realization Account

Dr			Cr
Goodwill	150,000	Adamu & Sons (PC)	1,252,000
Non-current Assets	375,000		
Current Assets	600,000		
Sundry member	127,000		
	1,252,000		1,252,000

Dr		Adamu & Sons Ltd	Cr
Realization (PC)	1,252,000	Ordinary share	377,000
		Cash	750,000
		Current liabilities	125,000
	1,252,000		1,252,000

Dr		Sundry Members Account (Ordinary)	Cr
Ordinary share in Adamu	377,000	Ordinary shares	250,000
Cash	750,000	Revenue Reserve	750,000
		Realisation	127,000
	1,127,000		1,127,000

Dr		Current Liabilities	Cr
Adamu & Sons	125,000	Balance b/d	125,000

Dr		Ordinary Share in Adamu & Sons Ltd	Cr
Adamu & Sons Ltd	150,800	Sundry Member	150,800

v. Determination of Purchase Consideration

	₦
650,000 Ordinary shares of 50k cash @58k	377,000
Cash	750,000
Current liabilities taken over	125,000
	1,252,000

4.0 CONCLUSION

It can be concluded that the adequate knowledge of accounting treatments of partnership transaction will assist accountant in the preparation of the annual reports of partnership business. The accounts must be prepared in accordance with relevant accounting standards.

5.0 SUMMARY

This unit explores the statutory framework guiding the conversion and amalgamation of partnership. Different scenarios as regards the changes in the constitution of partnership were clearly examined and simplified. The conversion of partnership and amalgamation of partnership were explored in this unit.

6.0 TUTOR MARKED ASSIGNMENT

1. Muse and Adam were in partnership sharing profits and losses,

Musa 3/5 Adam 2/5

The following as the summarized statement of financial position of the partnership as at 31st Dec.. 1987

Statement of Financial Position as at 31st Dec 1987

		₦		₦
Capital:			Non-Current Assets	16,800
	Musa	21,192	Sundry Assets	6,400
	Adam	8,816	Stock	8,000
	Creditors	5,000	Debtors	7,000

Overdraft	3,192	
	38,200	38,200

Musa and Adamu wishing to dissolve the partnership accepted offer of USMA Ltd to purchase the business.

The company agreed:

- That a consideration of ₦40,000 will be paid.
- That the consideration of ₦40,000 will be paid.
- That the consideration should be satisfied. By a cash payment of ₦22,000 and 18000 ordinary shares at ₦1.00 each.

The cash realized on the sale of other assets was ₦8000 the Debtors realized ₦6,000 and creditors were settled for ₦4,800.

The cost incurred in winding up the affairs of the partnership was ₦300.

The partners agreed to divide ordinary shares in the proportion Musa, Adam 1/5

You are required to:

(a) preparation a realization account

(b) bank Account

(c) Partners capital Account

(d) Journal Entries, in the book of the new company.

Question 2

Danjuma, Tamuno and Esset have been in partnership business sharing profit and loss in ratio 2:2:1 and making account to 31st March annually. On 31st of March 2007, the statement of financial position of the firm was as follows:

Dr Statement of Financial Position as at 31/3/87 Cr

	D	T	E	TOTAL				
Capital A/c	15,000	10,000	5,000	30,000	Motor Vehicle			20,000
Current a/c	(1,000)	1,000	-	(900)	Furniture & Fitting		10,000	
				29,100	Less Depreciation		2,000	8,000
Reserves				1,900	Goodwill			2,000
10% Loan				10,000				30,000
Creditors				3,700	Current Assets			
					Stock		7,200	
					Trade Debtors	5,800		
					Less Provision	300	5,500	
					Prepaid Rent		300	
					Cash & bank		1,700	14,700
				44,700				44,700

On the date of the statement of financial position, a limited liability company known as DET Ltd was formed with the following authorised share capital:-

Ordinary shares of 50k each	₦180,000
5% Preference shares of N1 each	20,000
	₦200,000

All assets minus cash were taken over. Of the total creditors, ₦1,300 were taken over by the company while Danjuma agreed to settle the balance of the trade creditors for ₦2500. For the assets taken over, DET Ltd issued to the partnership.

(I) 55,000 ordinary shares of 60k#
(II) 10,000 5% Preference share at par
(III) ₦3000 10% Debenture Stock at 98
(IV) Gave a cheque of ₦1060.

A dissolution expense of ₦2,700 was incurred of which DET Ltd agreed to pay ₦1,000 and the balance was settled by the partnership. The 10% Loan was discharged in full by payment of ₦9,250 by the partnership.

The partners decided to share the securities in proportion to their fixed capital and the balance of the entitlement were offset by withdrawal or addition of cash. After conversion, the company revalued the motor vehicle to ₦30,000, furniture and fittings to ₦5,000. The company also maintained adequate fund as working capital. By issuing 80,000 ordinary shares at par for cash while a leasehold premises was acquired for ₦25,000.

You are required to:

a. Prepare the necessary ledger account to close the partnership book.
b. Prepare the necessary journal entry to open the book of the company.
c. Prepare the balance sheet of DET Ltd after all the transactions immediately after conversion have completed.

7.0 REFERENCES/FURTHER READING

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MODULE 4: COMPANY ACCOUNTS

UNIT 1: FORMATION OF COMPANY

1.0 INTRODUCTION

This section deals with conversion of partnership to Limited Liability Company.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Explain accounting treatment of the conversion of partnership to Limited Liability Company.

3.0 MAIN CONTENT

3.1 Introduction

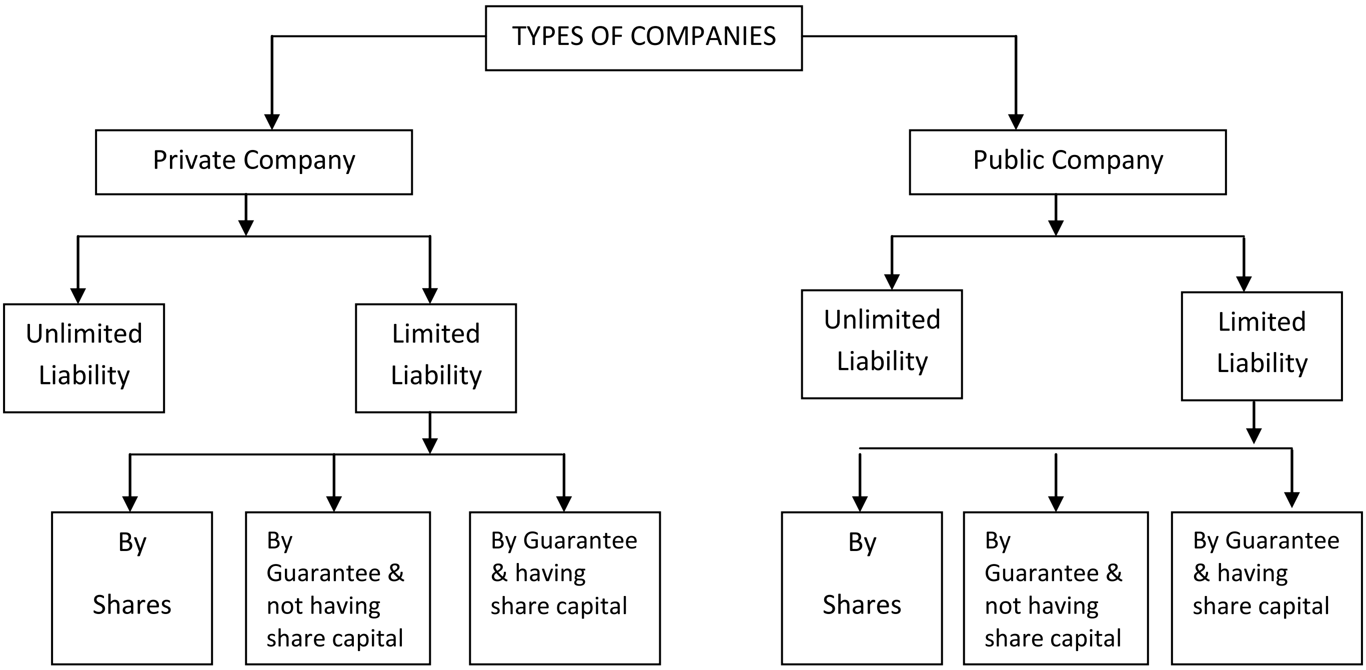
A company can be defined as a business owned by an association of people, and operated as a legal person on behalf of its owners with the usual motive of profit maximization. A company can be defined as a body corporate (i.e. an aggregation of persons or individuals), having a distinct legal personality created by or under: CAMD 90 or an enabling statute of government. Joint Stock Companies represent the third stage in the evolution of forms of business organisation. Unlike sole proprietorship and partnership firms, a company enjoys a separate legal status. The company is managed by a Board of Directors elected by the Shareholders.

In a company, rights of management are delegated to directors who alone can act on behalf of the owners of the company. Powers are defined by the memorandum of Association which can be altered within the limits provided by the companies Act 1968. Powers and duties of directors are defined by the Articles of Association and can be varied by passing a special resolution of the company in general meeting. The authorized capital is fixed by the memorandum of association; it can be increased by resolution of the company in general meeting; it cannot be reduced except by special resolution sanctioned by the court.

SELF ASSESSMENT EXERCISE

Explain company account.

3.2 TYPES OF COMPANIES



Private Companies

A private company is defined as a company which by its articles:

1. Restricts the right to transfer its shares

2. Limit the number of its members to fifty

3. Prohibits any invitation to the public to subscribe to its shares

4. The private company end their names with the word “Limited”.

Public Companies

These are companies which invite the public to subscribe to its shares. The minimum number of shareholders required to form a public limited company is given. There is no restriction on the maximum number of shareholders. The shares are transferable to other persons without informing other shareholders. The name of the company must end with "PLC or Public Liability Company". Examples are Lever Brothers PLC, Nestle PLC, Total PLC etc.

Limited Company

1. **Company Limited by Shares:** This is a company whose liabilities are limited to the amount invested in the business in the event of liquidation.
2. **Company Limited by Guarantee:** These are companies whose liabilities are limited to the amount guaranteed by the members in the event of liquidation e.g Clubs. That is, liability of members is limited to the amount which they have agreed to contribute in the event of liquidation. Where a company is to be formed for promoting commerce, art, science, religion, sports, culture, education, research, charity or other similar objects, and the income and property of the company are to be applied solely towards the promotion of its objects and no portion thereof is to be paid or transferred directly or indirectly to the members of the company except as permitted by this Act, the company shall not be registered as a company limited by shares, but may be registered as a company limited by guarantee.

   As from the commencement of this Act, a company limited by guarantee shall not be registered with a share capital and every existing company limited by guarantee and having a share capital shall, not later than the appointed day, alter its memorandum so that it becomes a company limited by guarantee and not having a share capital (CAMAD 20014). A company limited by guarantee shall not be incorporated with the object of carrying on business for the purpose of making profits for distribution to members. The memorandum of a company limited by guarantee shall not be registered without the authority of the Attorney-General of the Federation.

SELF ASSESSMENT EXERCISE

Distinguish between private and public companies

3.3 CHARACTERISTICS OF LIMITED COMPANY

1. **Legal entity:** A company as an artificial person can sue and be sued. Its personality is distinct from the owners.
2. **Limited Liability:** The liabilities of members are limited to the amount invested in the business.
3. **Perpetual existence:** The ownership of a company can change without changing the company.
4. It is authorized by law to carry on a specific line of business.
5. Limited Liability companies that have profit as their motive of operation

Differences between Private and Public Companies

Private Companies	**Public Companies**
1. The minimum number of members is 2 and the maximum is 50	The minimum number of members is 7 and there is no maximum
2. There is restriction on transfer of its shares	There is no restriction
3. The name ends with “Ltd”	The name ends with “Plc”
4. Doesn’t hold statutory meeting	Holds statutory meetings
5. It is owed and controlled by the owners	It is owned by the shareholders and controlled by the Board of Directors.

SELF ASSESSMENT EXERCISE

State and explain the features of public companies.

3.4 FORMATION OF A COMPANY

In the formation of a limited liability company, the following procedures must be followed:

1. The first step is to get the promoters. They are individuals who conceive the idea of a company and undertake to fulfil all legal requirements of the venture.
2. The following documents will be filled with the Registrar of Companies. These are Memorandum and Article of Association and Statement of Nominal Capital.

i. The memorandum of Association

ii. The Articles of Association

iii. A declaration of compliance signed by a solicitor engaged in the formation of the company or by a person named in the Articles as a director or secretary of the company, that all statutory requirement of the companies Act 1968 have been complied with.

iv. The situation of the company's registered office.

A public company, in addition to the above must also filed:-

v. A list of the persons who have consented to act as director and secretary:

vi. Their written consent to act; and

vii. An undertaking in writing by each person to take up and pay for the minimum number of shares (if any) stated in the Articles as the qualification of a director.

3. The documents are stamped and submitted to the Registrar of Companies for verification.
4. When the Registrar of Companies receives and approves the necessary documents, the registrar issues a certificate of incorporation.

3.4.1 Capacity of Individual to Form Company

(1) Subject to subsection (2) of this section, an individual shall not join in the formation of a company under this

Act if-

(a) he is less than 18 years of age; or

(b) he is of unsound mind and has been so found by a court in Nigeria or elsewhere; or

(c) he is an undischarged bankrupt; or

(d) he is disqualified under section 254 of this Act from being a director of a company.

(2) A person shall not be disqualified under paragraph (a) of subsection (1) of this section, if two other persons not disqualified under that subsection have subscribed to the memorandum.

(3) A corporate body in liquidation shall not join in the formation of a company under this Act.

(4) Subject to the provisions of any enactment regulating the rights and capacity of aliens to undertake or participate in trade or business, an alien or a foreign company may join in forming a company.

3.4.2 The Memorandum of Association

The Memorandum of Association: is the document forming the constitution of a company and defining its objects and powers. The memorandum of association contains the external rules of the company.

The memorandum of Association of a company limited by shares contains five clauses:

1. The name of the company, followed by the word ‘limited’.
2. The domicile of the company (i.e where its registered office is situated).
3. The object of the company.
4. A declaration that the liability of the members is limited.
5. The amount of authorized capital. The amount of capital, and the shares into which it is divided. The memorandum must be signed by not less than seven persons, or not less than two in a private company, agreeing to take up not less than one share each.

3.4.3 The Articles of Association

This is a document which states the internal regulations of a limited company. It contains the regulations which govern the internal management and running of the company’s affairs. It defines the rights of the members and the powers and duties of the directors. The clauses deal with:

1. The regulations for the issue of capital and variation of rights of members.
2. The making of calls on shares
3. The transfer and transmission of shares
4. The forfeiture and surrender of shares.
5. the holding, notice of, and procedure at general meetings.
6. The voting rights of members, pills and proxies
7. The directors-their number, remuneration qualification,
8. Rotation, disqualification and removal.
9. The appointment and power of managing directors.
10. The proceedings and powers and duties of the board of directors.
11. Notices to members.

3.4.4 Prospectus

This is a document issued by limited companies inviting the public to subscribe to its shares. The prospectus contains detailed information about the company. It is prepared by only public companies.

3.4.5 Certificate of Incorporation

This is a document which gives legal authority to the company to operate as a legal personality. It is issued by the Registrar of Companies after due consultation with the various documents submitted.

SELF ASSESSMENT EXERCISE

Enumerate the content of both Article and Memorandum of Association

3.5 CLASSES OF SHARE CAPITAL

Definition: A share has been defined as the interest of a shareholder in the company measured by a sum of money for the purpose of liability in a limited company in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders. This refers to a unit of a company's capital held by a shareholder entitling him to share in the profit of the company. Shares can be consolidated to blocks of 100, 1000 etc and referred to as stock. Share is evidence of ownership of a company.

It is an ownership right acquired in a company which may be transferable. Share is issued by a company at par value or no par value. Par value share is a share that has a face value, that is, its issue price is written on it. No par value share has no face value. That is the issue price is not stated on it.

The share capital of a company may be divided into different classes of shares of which the following are the most usual:

a. Preference shares: entitles the holders to a fixed rate of dividend before any dividend is paid on other classes of shares. They may also carry the right in the Articles to repayment of capital, on a winding up, in priority to other types of shares preference shares may be either cumulative of non-cumulative. Non-cumulative preference shares only carry a right to a fixed dividend out of the profits of any year, and if there are insufficient profits in that year to any the full dividend they have no right to have the arrears made up out of future profits. Preference shares may or may not have a right, in liquidation, to repayment of capital in priority to their classes of shares.

Cumulative preference shares entitle the holders to a fixed rate of dividend in the same way as non-cumulative preference shares, but with the additional right to have any arrears of dividend paid out of future profits before any dividends are paid on other classes of shares.

A company may have participating shares, which carry a right, in addition to a fixed divided, and to further participation in profits after a dividend of a specified rate has been paid on the ordinary shares. In the absence of express or implied provision in the Articles to the contrary, preference shares are cumulative as to dividend, but are only entitled to rank paripassu with others classes of shares in repayment of capital on liquidation.

Cumulative preference share: These shares entitled its holders to dividend whether or not the company makes profit. Dividends are carried forward from the year of loss or illiquidity to year of profit of liquidity.

Participating preference shares: These shares entitled its holders to additional dividend aside their fixed rate of dividend in the year of huge profit.

Redeemable preference shares: These shares are issued with the aim of buying them back after a specified period of time and at a preset term.

Convertible preference shares: These shares are issued with the aim of converting them to ordinary shares at a specified date and at a preset term.

b. Ordinary shares: These are shares held by the real owners of the company. They are also referred to as equity capital. They share in the profit of the company in the form of dividend after all other types of shareholders have been settled. Where the company is liquidated, they are the last to be settled.

The Distinction between Stock and Shares

A share in a company is an individual unit of capital and is indivisible. A holding must consist of a number of complete shares, and although there may be two or more joint holders of a share, no fraction of a share can be held or transferred.

Stock consists of capital consolidated into bulk, which can be made divisible in any monetary fractions. It has been aptly termed a bundle of shares'.

Other differences between stock and shares are:

(a) Stock must be fully paid up, whereas shares and need not be.
(b) Stock may be issued or transferred in fractional parts. A share cannot be divided, but can only be transferred as a complete until.
(c) Each share must be distinguished by a separate number until all the shares of the class in question are fully paid. Stock need possess no distinguishing numbers.

A company cannot issue stock in the first instance; if it wishes to issue stock it must first issue shares, and then convert them into stock when they are fully paid.

3.5.1 Par Value and No Par Value

The fixed amount that must be paid on each share of a company is called nominal value or par value. Where a share carries no fixed amount, such a share is referred to as a share of no par value.

3.5.2 Prices of Share

1. **Nominal price:** This is the price per share as stated in its memorandum of association. It is also referred to a par value
2. **Premium Price:** This referred to a situation where shares are issued at a price above their nominal price.
3. **Discount Price:** This referred to a situation where shares are issued at a price below their nominal price.

Market Price: This is the price at which a share can be bought from existing shareholders, it is also referred to as quoted price for shares of company quoted on a stock exchange.

SELF ASSESSMENT EXERCISE

Define share. State the difference between share and stock

4.0 CONCLUSION

It can be concluded that the adequate knowledge of the formation of company will enhance the skill of accountant in the preparation of the annual reports of private and public companies. The accounts must be prepared in accordance with relevant accounting standards.

5.0 SUMMARY

This unit explores the meaning of company, types of companies, formation of company and different types of share. Article and Memorandum of association were explained in this unit.

6.0 TUTOR MARKED ASSIGNMENT

1. Distinguish between private and public companies.
2. Outline the procedure of company formation in Nigeria.
3. Distinguished between Stock and Shares.
4. List 5 items in the Memorandum and Article of Association respectively
5. What is the meaning of Incorporation? State the importance of Certificate of Incorporation.
6. Explain the meanings of the following terms:
   - i. Cumulative Preference Share
   - ii. Participating Preference Share
   - iii. Redeemable Preference Share
   - iv. Convertible Preference Share

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UNIT 2: ISSUE OF SHARES AND DEBENTURES

1.0 INTRODUCTION

This unit deals with issue of share at different prices and redemption of shares and debentures.

2.0 OBJECTIVES

After studying this unit, you should be able to:
1. Explain limited and unlimited liability companies.
2. Explain Article and Memorandum of Association

3.0 MAIN CONTENT

3.1 SHARE CAPITAL

A share is a unit of capital of a company allocated to an individual. There are two (2) classes of shares, which are:

a. Ordinary shares   b. Preference shares

Ordinary Shares: These are shares that receive the residue of the distributed profit after commitments of preference shares have been met. They are referred to as equity finance.

Preference Shares: These are shares that convey preferential right of the holders to some level of profit before other types of shareholders. Holders received dividend before other shareholders.

Types of Share Capital

1. **Authorized Share Capital:** This is also known as nominal or registered capital. This is the amount of capital stated in the memorandum of association of the company that can be issued out.

2. **Issued Capital:** This is the total number of shares the company actually issued out to the public from the authorized capital.
3. **Paid-up Capital:** This is the amount actually paid or payable on the shares issued out to the public.
4. **Called-Up Capital:** This is the total amount of shares called for by the public from the issued shares.
5. **Uncalled-Up Capital:** This is the total amount that was not asked for from the issued share capital.
6. **Call in advance:** This is the money received on shares before the payment is being requested.
7. **Call in Arrears:** This is the amount called for but not yet received.

   a. Working capital　　b. Loan capital　　c. Reserve capital

SELF ASSESSMENT EXERCISE

Outline the types of share capital in company account

3.2. METHODS OF ISSUING NEW SHARE

1. **An Offer for Subscription:** It is also referred to as prospectus issues; it involves the company directly issuing shares to the public to purchase by advertisement. This method of issuing new shares can take any of the following form:

   Initial Public Offer: Where the company is issuing its shares to the public for the first time.

   Public Offer: Where the company is issuing additional shares after it initial public offer.

2. **Offer for sale:** Here the company sells all the shares to an issuing house, usually a financial institution which in turn sells them to the public at profit.
3. **Private Placement:** It is an arrangement whereby shares are offered and sold to selective individuals or institutions in other words; the shares are not available for the public to buy. It is usually bought through the issuing houses and stockbrokers. His reward is called brokerage
4. **Right Issue:** This occurs where the company is issuing additional shares to already existing shareholders to subscribe to on pro-rata basis. The price of issue is usually lower than the existing market price. The shareholder has the option to take up the offer, sell the right or renounce it.

5. **Bonus Issue:** This is a situation whereby a company issues shares to existing shareholders without asking for payment. It is also referred to as Scrip Issue. The consideration involves transfer surplus to stated capital.
6. **Underwriting:** It involves providing advice on the issue, buying a new issue from issuing company and reselling it to the public. In some case, the underwriter or syndicate enters into fixed commitment and deals with the issue on "Best effort or all-or-none basis,"

SELF ASSESSMENT EXERCISE

List and explain methods of issuing new share

3.3 STAGES OF ISSUES

The following stages may the involved:

1. Application invited and received with the agreed consideration
2. Applications considered and unsuccessful ones rejected and monies refunded
3. Allotment is made to successful applicants and monies received accordingly
4. First call and subsequent calls (per the agreement) made and monies received
5. Shares of defaulting shareholders forfeited and share retired to treasury.
6. Treasury share re-issue and monies sent to share deals.

Legal considerations Guiding Issue of Shares

1. Shares up to the total number authorized by the regulations may be issued at any time and for any consideration determined by the company.
2. Shares issued may be paid for at such time as are agreed between the member & company or as determined by the regulation.
3. All shares, except for bonus shares, should be issued for valuable consideration paid or payable to the company.
4. Shares shall be paid for in cash unless otherwise agreed.
5. Where payment is agreed in forms other than cash, registrar of companies should be informed of such agreement in writing within 28 days after allotment.
6. A company must deliver a share certificate to the registered holder within 2 months after issue.

SELF ASSESSMENT EXERCISE

What are the legal consideration guiding issue of shares?

3.4 ACCOUNTING FOR THE ISSUE OF SHARES

Shares may be issued by a new company or by an existing company increasing its issued share capital. It is an original offence for a private limited to issue its shares to the public. The consideration is usually, but not necessarily in cash. The prices at which shares are issued may be nominal value of the share or above it (at a premium) or below it (an issue at a discount). Accounting issues are uncomplicated when full payment is required on application. The issue of forfeiture will not apply. In this case we debit bank account and credit stated capital with the amount. Where instalment basis is applied then the stages will be followed through and through.

Shares can only be issued at a discount after a resolution to that effect must have been sanctioned by a court of law. If shares are issued at a price above par the excess must be transferred to a share premium account. The balance in this account may be used for the following purposes only.

a. To pay up unissued shares for distribution to members as bonus shares.
b. To write off the preliminary expenses of forming the company.
c. To write off expenses of issuing shares and debentures.
d. To write off debentures.
e. To provide the premium payable on redemption or redeemable debentures, and, under limited circumstances, of redeemable shares.

To issue shares at a discount the following conditions must be fulfilled:-

a. The shares must be of a class already issued.
b. The discount issue must be sanctioned by the High Court having previously been authorized by a resolution passed in general meeting.
c. At least one year must have elapsed since the date on which the company was entitled to commence business.
d. The shares must normally be issued within the month after permission has been granted by the High court. When shares are issued the purchases price may be payable in full on application or in a series of instalments named, in sequence, application, allotment, 1st call, 2nd call etc. The premium, if any, is included with the allotment monies.

Allotment of Shares

Allotment is the acceptance of the offer to take up shares. It is usually done by a resolution of the Board of Directors.

Minimum Subscription

A company cannot proceed to make any allotment of its shares to the public for subscription unless the minimum subscription i.e. 90% of the issued amount has been received. If at the closing date, this has not been attained, the company has to repay or refund the entire subscription money.

Issue of Shares: Shares can be issued on the following terms:

1. Shares issued at a discount
2. Shares issued at premium
3. Shares issued at par

Shares issued at a discount: this is the case where shares are quoted below the nominal value. An example is when a company issues out 100,000 ordinary shares of ₦1.00 each at 50k per share. Share can be issued at discount if:

i. The shares to be issued at a discount must be of a class already issued.
ii. A resolution is passed at the Annual General Meeting
iii. The shares must be issued within one month after the date of sanction of court.
iv. The consent of the court is obtained.

Shares issued at premium: this is the case where shares are quoted above the nominal value. An example is when a company issues out 400,000 ordinary shares of ₦1.00 each for ₦2.00 per share.

The premium can be used for the following:

i. In issuing fully paid bonus issue
ii. In writing off expenses of issuing shares or debentures such as commission.
iii. In providing for a premium on redeemable preference shares.
iv. In writing off preliminary expenses.

Shares issued at par: this is the case where shares are quoted at a price equal to the nominal value. It is neither quoted at discount or premium. An example is when a company issues out 300,000 ordinary shares of ₦1.00 each for the same ₦1.00

Accounting Entries

There are two methods of collecting money when shares are issued out.

1. Payable in full on application
2. Payable by installment.

SELF ASSESSMENT EXERCISE

Identify two methods of collecting money when shares are issued out.

1. SHARES PAYABLE IN FULL ON APPLICATION

a) Shares issued at par

- On receipt of application money
  Debit: Bank account
  Credit: Application account
- On allotment
  Debit: Application account
  Credit: Ordinary share capital account

Example 1

Akande Ltd issues out 200,000 ordinary shares of ₦1.00 at par. Application together with the total amount is received. The shares are allotted to the applicants. You are required to prepare the necessary accounts.

Solution to Example 1

Journal entries	Dr	Cr
	₦	₦
Bank account Application account **Money collected in respect of 200,000 shares**	200000	 200000
Application account Ordinary share capital **Allotment of 200,000 ordinary shares of ₦1.00 each**	200000	 200000

LEDGER ENTRIES

Dr — Bank Account — Cr

	₦		₦
Application	200000		

Dr — Application account — Cr

	₦		₦
Share capital	200000	Bank	200000

Dr — Share capital account — Cr

	₦		₦
		Application	200000

b) Shares issued at a premium

- On receipts of application money:
  Debit: Bank account
  Credit: Application account
- On allotment:
  Debit: Application account
  Credit: Share premium account
  Credit: Ordinary share capital account

Example 2

Akande Ltd issues out 200,000 ordinary shares of ₦1.00 at ₦2.00. Application together with the total amount is received. The shares are allotted to the applicants. You are required to prepare the necessary accounts.

Solution to Example 2

Journal entries	**Dr**	**Cr**
	₦	₦
Bank account	400000	
Application account		400000
Being ₦2 on 200,000 shares		
Application account	400000	
Premium account		200000
Ordinary share capital		200000
Allotment of ordinary share of ₦1 each at a premium of ₦1		

Workings: Application= 200000 × ₦2 = ₦400000

Ordinary share capital= 200000 × ₦1 = ₦200000

Premium= 200000 × (2-1) = ₦200000

Ledger entries

Dr Bank Account Cr

	₦		₦
Application	400000		

Dr Application Account Cr

	₦		₦
Premium	200000	Bank	400000
Ordinary share capital	200000		
	400000		

Dr Premium Account Cr

	₦		₦
		Application	200000

Dr Ordinary Share Capital Account Cr

	₦		₦
		Application	200000

c) Shares issued at discount

- On receipt of application money:
  Debit: Bank account
  Credit: Application account
- On allotment:
  Debit: Application account
  Debit: Share discount account
  Credit: Ordinary share capital account

Example3

Akande Ltd issues out 200,000 ordinary shares of ₦1.00 at 50k. Applications together with the total amount are received. The shares are allotted to the applicants. You are required to prepare the necessary accounts.

Solution to Example 3

Journal entries	Dr	Cr
	₦	₦
Bank account	100000	
Application account		100000
Being 50k on 200,000 shares		
Application account		200000
Share discount account	100000	
Ordinary share capital	100000	
Allotment of ordinary share of ₦1 each at a discount of 50k		

LEDGER ENTRIES

Dr Bank Account Cr

	₦		₦
Application	100000		

Dr Application Account Cr

	₦		₦
Ordinary share capital	200000	Bank	100000
		Share discount	100000
	200000		200000

Dr Share Discount Account Cr

	₦		₦
Application	100000		

Dr Ordinary Share Capital Account Cr

	₦		₦

Application	200000

Over subscription and under subscription

Under subscription: this is when the number of shares offered for sale is more than the number of shares applied for e.g. Sola Ltd offered 5000 shares to the public but only 3000 shares was applied for.

Over subscription: this is when the number of shares offered for sale is less than the number of shares applied for. Allotment would be made to this application on pro-rata basis in this situation.

Call in advance: this is the amount paid up in excess of the instalment requested and thus transferred to a separate call in advance account.

- Call in advance:
  Dr: Call in advance account
  Cr: Call account

Call in arrear: This is the amount yet unpaid on the instalment requested. This is when the shareholders fail to pay the sum due on calls.

- Call in arrears:
  Dr: Call in arrears account
  Cr: Call account

2. SHARES ISSUED PAYABLE BY INSTALMENT

a. Receipts of application money
   Dr: Bank account
   Cr: Application account
b. On allotment
   Dr: Application account
   Cr: Share capital account (with application money)
   Dr: Allotment account
   Cr: Share capital account (amount due on allotment)
c. Refund to rejected applicants
   Dr: Application account
   Cr: Bank account
d. Excess application money retained on account of allotment
   Dr: Application account
   Cr: Allotment account
e. Money received on allotment
   Dr: Bank account
   Cr: Allotment account
f. Calls made
   Dr: Call account

Cr: Share capital account

g. First call money received

Dr: Bank account

Cr: First call account

h. On making final call

Dr: Final call account

Cr: Share capital account

i. Final call money received

Dr: Bank account

Cr: Final call account

Example 1

Kay Ltd has a nominal share value of ₦200000 comprising 200000 ordinary share of ₦1 each. The whole of the capital was issued at par on the following terms:

- Payable on application 15k
- Payable on allotment 20k
- First call 30k
- Second call 35k

Applications were received for 250000 ordinary shares and it was decided to allot the shares on the basis of 4 for every 5 of which application had been made. The balance of the application money was applied to the allotment, no cash refunded. The balance of the allotment money was paid in full by all the members.
Required: Show the ledger account recording all the above transactions and relevant extracts.

Solution to Example 1

Dr Application Account Cr

	₦		₦
Allotment	7500	Bank	37500
Ordinary shares	30000		
	37500		37500

Dr Allotment Account Cr

	₦		₦
Ordinary share capital	40000	Application	7500
		Bank	32500
	40000		40000

Dr First Call Account Cr

	₦		₦
Ordinary share capital	60000	Bank	60000

Dr Second Call Account Cr

	₦		₦
Ordinary share capital	70000	Bank	70000

Dr		Ordinary Share Capital Account	Cr
	₦		₦
Balance c/d	200000	Application	30000
		Allotment	40000
		First call	60000
		Second call	70000
	200000		200000

Dr		Bank Account	Cr
	₦		₦
Application	37500	Balance c/d	200000
Allotment	32500		
First call	60000		
Second call	70000		
	200000		200000

Workings:

- Pro-rata basis(4 for 5): 4/5 × 250000 shares= 200000 shares
- Application: 250000 × 15k = ₦37500
- Money received on application= 200000 shares × 15k= ₦30000
- Excess on application: ₦37500-₦30000= ₦7500
- Allotment: 200000 shares × 20k= ₦40000
- First call: 200000 shares × 30k= ₦60000
- Second call: 200000 shares × 35k= ₦70000

Example 2

High Ltd issued 200000 ordinary shares of ₦1 each payable in instalment as follows:

- Application 65k
- Allotment 55k
- First call 10k
- Second call 20k

Application were received for 400000 shares and it was decided to deal with them as follows:

i. To accept in full 50000 shares.
ii. To return cheque for 150000 shares
iii. To allot the remaining shares on the basis of 3 for every 4 applied for.

All applicants paid on due date.

Required: Post into all necessary books.

Solution to Example 2

Dr		Application Account	Cr
	₦		₦
Bank- refund	97500	Bank	260000
Allotment	130000		
Ordinary shares	32500		

	260000		260000

Dr Allotment Account Cr

	₦		₦
Ordinary share capital	10000	Application	32500
Share premium	100000	Bank	77500
	110000		110000

Dr First Call Account Cr

	₦		₦
Ordinary share capital	20000	Bank	20000

Dr Second Call Account Cr

	₦		₦
Ordinary share capital	40000	Bank	40000

Dr Ordinary Share Capital Account Cr

	₦		₦
Balance c/d	200000	Application	130000
		Allotment	10000
		First call	20000
		Second call	40000
	200000		200000

Dr Bank Account Cr

	₦		₦
Application	260000	Refund- Application	97500
Allotment	77500	Balance c/d	300000
First call	20000		
Second call	40000		
	397500		
397500			

Dr Share Premium Account Cr

	₦		₦
Balance c/d	100000	Allotment	100000

Example 3

Raphel Limited was registered with a share capital consisting of 250,000 ordinary shares of N1 each and 50,000 6% preference share of ₦1.00 each. It offered 200,000 ordinary shares for public subscription as follows:

25k on application

35k on allotment

20k each on 1st and final calls.

All shares were applied for and allotted. However a shareholder who had been allotted 5,000 shares failed to pay the first call.

The second call has not yet been made.

Calculate the following:

(a) Authorised share capital
(b) Nominal share capital
(c) Subscribed share capital
(d) Issue share capital
(e) Un-issued share capital
(f) Called up share capital
(g) Uncalled up share capital
(h) Calls in arrears
(i) Paid up share capital

	₦
Ordinary share capital	250,000
6% Preference share capital	50,000
Authorized or Nominal or Registered Share capital	300,000

b. Same as above

c. N200,000 (200,000 x N1).

d. N200,000 (200,000 x N1).

e.

Authorised Share Capital	N300,000
Less Issued Share Capital	200,000
Un-issued Share Capital	100,000

f.

Application Money	25k
Allotment Money	35k
First Call	20k
Total Par Value Called Up	80k

Called up Share Capital is this ₦160,000 (₦200,000 x 0.8)

g. ₦200,000 – ₦160,000 = ₦40,000 (This is equal to the total value of the uncalled second and final call of 20k per share on 200,000 shares.

h. One shareholder with 5,000 shares has failed to pay the first all. This call in arrears is ₦1,000 (5,000 x 0.20k)

i. Paid up share capital:
₦160,000 – ₦1,000 = ₦159,000 (which is also the sum of actual cash received).

	₦
Authorised Share Capital	300,000
Less: Un-issued Share Capital	100,000
Issued Share Capital	200,000
Less: Uncalled Share Capital	40,000
Called Up Share Capital	160,000
Less: Calls – In – Arrears	1,000
Paid up Share Capital	159,000

Example 4

The nominal value of the Ordinary Shares Capital of Osun Ltd is ₦1 per share. The company issued 200,000 of this ordinary share on 1st January 20x1 payable as follows: Application 25k, Allotment 40k, 1st Call 35k and Final Call 20k.

When application register were closed 250,000 applications were received. The shares were allotted and excess applications fees were refunded. Allotment fees and calls fees were received when due. You are required to prepare:

i. Bank Account

ii. Application Account

iii/ Allotment account

iv. 1st Call account

v. Final Call account

(b) Prepare the abridged Statement of Financial Position after the above transactions were completed.

Solution to Example 4

Dr	Application Account		Cr
Ordinary share capital	10,000	Bank	62,500
Share premium	40,000		
Allotment	12,500		
	62,500		62,500

Dr	Bank Account		Cr
App.	62,500	Bal c/d	240,000
Allotment	67,500		
1st call	70,000		
Final call	40,000		
	240,000		240,000
Bal b/d	240,000		

Dr	Ordinary share Capital Account		Cr
Bal c/d	200,000	Allotment	80,000
		App	10,000
		1st Call	70,000
		Final call	40,000
	200,000		200,000

Dr	Allotment Account		Cr
Ordinary Share Capital	80,000	Application	12,500
		Bank	67,500
	80,000		80,000

Dr	1st Call Account		Cr
Ordinary Share Capital	70,000	Bank	70,000

Dr	Final Call Account		Cr
Ordinary Share Capital	40,000	Bank	40,000

Osun Ltd
Abridge Statement of Financial Position as at…

Asset:	
Bank	240,000
Financed by:	
Share capital	
Ordinary share of N1 each	200,000
Reserves	
Share premium	40,000
Shareholders funds	240,000

3.5 ISSUE OF DEBENTURE

Definition: A debenture is a written acknowledgement of a debt by a company, usually under seal and generally. A company may raise loan by issue a debenture or debenture stock. A debenture holder is a special creditor who is entitled to fixed interest whether profit is made or not. Containing provisions for payment of interest and repayment of capital; a simple or naked debenture carries no charge on assets; a secured debenture carries either a fixed charge on a specific asset or a floating charge on all or some of the assets.

A fixed charge is a mortgage on specific assets, under which the company loses the right to deal with the assets charged, except with the consent of the mortgaged.

A floating charge is not a mortgage at all, since the charge is such that so long as the company continues to carry on its business and obsence the terms of the charge, the directors are entitled to deal in any way then please in the ordinary course of business with the assets of the company, and may even make specific change on property which, subject to the terms of the floating charge given, will have priority to the floating charge.

Types of debenture

i. Redeemable or perpetual debenture

ii. Convertible debenture

i. Secured or naked debenture

Debenture may be secured by a floating charge or a fixed charge or both. Debenture is show as long term-liability in the Statement of Financial Statement.

Types of Issue of Debenture

The mode of issue of debenture is similar to that of shares (On Application, Allotiment, Call etc) and the accounting entries are the same except the change in account names.

- Debenture may be payable full on application or installment basis.

- Debenture may be issued **at par, discount or premium.**

Issue of debenture at Par

- It means that the debenture is issued at a price equal to the nominal value
- Accounting entry:
  - Dr. bank
  - Cr. Debenture (specific) with the amount received
- Example: GHS20,000 20% debenture was issued at par to the public payable on application.
  - Dr Bank 20,000
  - Cr. 20% Debenture 20,000

Issue at Discount

- Here the issue price is lower than the nominal value, hence there is a to the issuer.
- Accounting entry
  - Dr. Bank with amount received
  - Dr. Discounts on debenture with discount
  - Cr. Denture (specific)
- Example: GHs20,000 20% debenture was issued at 98 to the public.
  - Dr. bank GHs 19,600
  - Dr. Discount 400
  - Cr. 20% debenture 20,000

Issue at Premium

Debenture is issued at a price above nominal value, resulting in capital gain. Debenture Account is credited with the nominal amount and Debenture premium Account with the premium. Debenture premium Account can be shown in the Statement of Financial Position as a (revenue) reserve.

- Account entry
  - Dr. Bank with all amounts
  - Cr. Premium with the gain
  - Cr. 20% debenture with value of debenture
- Example: GHs20,000 20% debenture issue at 102.
  - Dr bank 20,400
  - Cr. Premium 400
  - Cr 20% debenture 20,000

The companies Acts do not specify the uses of the Debenture premium Account; but common uses are;

a. to write off fictitious assets
b. to write off debenture issue expenses.

Debentures can be issued at a discount, but must be redeemed at par or a premium.

A debenture is a bond acknowledging a loan to a company. It is usually issued under the company's seal (i.e. is an official document issued by the company, similar to a share certificate) and bears a fixed rate of interest. Debenture interest is payable whether or not profits are made.

A debenture may be **redeemable**, i.e. repayable at or by a specified date or **irredeemable**, i.e. taking place only when the company goes into liquidation.

SELF ASSESSMENT EXERCISE

Define debenture. State the classes of debenture

Accounting Entries for the issue of debentures

The accounting entries of the issue of share capital and that of issue of debenture and similar and thus the "share capital" should be substituted for "debentures" in the earlier entries. Note that, debentures are now issued at nominal value.

Example 5

Several years ago, Matanmi Limited issued 6,000 5% Redeemable Debentures of ₦100 each at 96, payable in full on issue. A debenture Redemption fund has been established by annual appropriations of ₦40,000 and has been invested ingeltedged securities.

At 31st December 2000 the account balances were: -

5% Redeemable Debentures	600,000
Debenture Redemption Fund	255,000
i.e. (sinking fund)	
Investments (ie. Sinking fund inv. a/c)	200,000

During the year 2001, transactions took place as follows:

2001			₦
Jan	12	Investment purchased (at cost)	40,000
July	5	Interest for first –have year received	15,000
July	20	Investment (cost 140,000) sold	160,000
Aug.	1st	Debentures redeemed (nominal) 300,000	350,000
Sept	30	Investments (cost 60,000) sold	55,000
Sept	30	Investments purchased (at cost)	52,000
Dec.	29	Interest for second half year received	6,000
Dec.	30	Annual appropriation	40,000
Dec.	31	Paid interest on 5% Red Debentures	15,000

Required: - Post the appropriate accounts for the year 2001

Solution to Example 5

Debenture Interest

Dr			Cr
2001	₦	2001	₦
Aug. 1st Deb Red	8750		
Dec 31 Bank	18,000		
(5% x 300,000)			
	26,750	Dec 31 Profit & Loss	26,750

5% Redeemable Debentures

Dr			Cr
2001	₦	2001	₦
Aug 1st debenture			
Redemption	300,000		
Dec 31 Balance c/d			
	300,000		
	600,000	Jan 1Balance b/d	600,000

Debenture Redemption Fund (Sinking Fund)

Dr			Cr
2001	₦	2001	₦
Sep 30: Sinking		Jan 1 Balance b/d	255,000
Fund inv.	5000	July 5 Bank	15,000
Capital Res	300,000	July 20 Sink F Inv.	20,000
Dec. 31			
Balance c/d	89,750	Aug 1st Deb Redemption	58,750
		Dec 29 Bank	6000
		Dec 30 P & L App	40,000
			394,750
		2001	
		Jan 1 Balance b/d	89,750

Debenture Redemption Fund Investment

Sinking Fund Inv. Account

Dr			**Cr**
2001	₦	2001	₦
Jan 1 Balance b/d	200,00	July 20 Bank	160,000
Jan 12 Bank	40,000	Sept 30	55,000
July 20 Sinking Fund	20,000	Sept Sinking Fund	5,000
Sept 30 Bank	52,000	Dec 31 Bal c/d	92,000
	312,000		312,000
Balance b/d	92,000		

Redemption

Dr			Cr
2001	₦	2001	₦
Aug 1st Bank	50,000	Aug 1st 5% Red Debs	300,000
" " Deben Redemption		" Deb Interest	8750
Fund	258,750	(7 /12 x 5/100x300,000)	
	308,750		30,8750

4.0 CONCLUSION

Debenture plays a significant role in business financing, therefore, accountant know the accounting principles guiding issues of debenture in order to facilitate the preparation of the annual reports of private and public companies.

5.0 SUMMARY

This unit explores the meaning of share and debenture, different types of share and debenture and their accounting entries.

6.0 TUTOR MARKED ASSIGNMENT

1. Sunshine limited borrowed ₦2625 on 31st December 1974 under a debenture which was to be redeemed three years later i.e. 31st December, 2007. An annual sum of ₦832.67 was set aside from profits at the end of each year and credited to sinking fund. A similar amount was invested each year at 5% compound interest. Post the appropriate accounts for the year involved.

2. Ade and Company Limited decided to issue 400,000 N1 ordinary shares at N1.20 each. The terms of issue are 30k on application, 45k (including the premium) on allotment, 20k to be called one month after allotment, with the final call of 25k being made four months after allotment.

On December 29th applications were received for 600,000 shares. On 1st January, the shares were allotted so that every applicant received two-thirds of the number of shares applied for. Excess application monies were held against the amount due on allotment. On January 4th the cash due on allotment were received. February 1st, the first call was made and February 3rd the cash was received. On May 1, the second call was made and cash was received on May 3rd.

Required: Make the necessary journal and ledger entries to record these transactions.

3. ABC (Nig) Ltd issued 200,000 ordinary shares of ₦1.00 each at ₦1.20 per share payable as follows:

(a) 25k per share on application

(b) 40k per share on allotment (including the premium)

(c) 35k per share on first call

(d) 20k per share on second and final call

Required: Show the ledger accounts to record the above transactions.

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UNIT 3: FORFEITURE AND REDEMPTION OF SHARES

1.0 INTRODUCTION

This unit deals with forfeiture of shares and redemption of shares in line with ordinary and preference shares.

2.0 OBJECTIVES

After studying this unit, you should be able to:
1. Explain Forfeiture and redemption of share.
2. Explain Preference share and redeemable preference share

3.0 MAIN CONTENT

3.1 FORFEITURE OF SHARES

The directors have power conferred on them by the Articles of Association to forfeit shares on which calls have not been paid. The shareholders involved should be notified.

Accounting Entries

i. **Share forfeited**:
   Dr: Share capital account
   Cr: Forfeited share account
   } with the nominal value payable on the share forfeited at the date of forfeiture

ii. **Transfer of unpaid calls on the shares forfeited to the forfeited account:**
   Dr: Forfeited share account
   Cr: Call in arrears account
   } with the amount unpaid on the share forfeited

Re-issue of forfeited shares

Any share forfeited can be re-issued at any price so far the sum received on re-issue and the amount received from the original allotee before forfeiture makes up together at least the nominal value of the shares forfeited , any excess should be transferred to share premium account.

Accounting entries

I. **Re-issue of forfeited shares:**
   Dr: Re-issue of forfeited shares account — with the nominal value called-up to date of re-issue
   Cr: Share capital account

II. **Transfer the balance of the forfeited shares account:**
   Dr: Forfeited share account
   Cr: Re-issue of forfeited shares account

III. **Cash received from new shareholders:**
   Dr: Bank account
   Cr: Re-issue account

IV. **Premium on re-issue:**
   Dr: Re-issue account
   Cr: Share premium account

Example 1: F Ltd has an authorised capital of ₦1m comprising of ordinary share capital of ₦1 each, the shares were issued at par, payment been made as follows:

- Payable on application 10k
- Payable on allotment 25k
- Payable on first call 35k
- Payable on second call 30k

Applications were received for 1.28m shares. It was decided to refund money on 80000 shares & allot the shares on the basis of 5 for every 6 applied for. The excess application money sent by the successful applicant is not to be refunded but is to be held & so reduce the amount payable on allotment.

Calls were made & paid in full with the exception of 3 members holding a combine total of 6000 shares who paid neither the 1st nor the 2nd call and another member who did not pay the 2nd call on 2000 shares. These shares were forfeited & reissued to Tayo at a price of 85k per share.

You are required to draft the ledger accounts to record the transaction.

Solution to Example 1

Dr Application Account Cr

	₦		₦
Bank- refund	8000	Bank	128000
Allotment	100000		
Ordinary shares	20000		
	128000		128000

Dr Allotment Account Cr

	₦		₦

Ordinary share capital	250000	Application	20000
		Bank	230000
	250000		250000

Dr First Call Account Cr

	₦		₦
Ordinary share capital	350000	Bank	347900
		Forfeiture	2100
	350000		350000

Dr Second Call Account Cr

	₦		₦
Ordinary share capital	300000	Bank	297600
		Forfeiture	2400
	300000		300000

Dr Ordinary Share Capital Account Cr

	₦			₦
Forfeiture	6000	Application		100000
Forfeiture	2000	Allotment		250000
Balance c/d	1000000	First call		350000
		Second call	300000	
		Dayo	8000	
	1008000			1008000

Dr Bank Account Cr

	₦		₦
Application	128000	Refund- Application	8000
Allotment	230000	Balance c/d	1002300
First call	347900		
Second call	297600		
Dayo	6800		
	1010300		1010300

Dr Share Premium Account Cr

	₦		₦
Balance c/d	2300	Dayo	2300

Dr Forfeiture Account Cr

	₦		₦
First call	2100	Ordinary share capital	6000
Second call	2400	Ordinary share capital	2000
Dayo	3500		
	8000		8000

Dr Dayo's Account Cr

	₦		₦
Ordinary Share Capital	8000	Bank	6800
Share premium	2300	Forfeiture	3500
	10300		10300

Workings

- Money on application: 1280000 × ₦0.10 = ₦128000
  Refund: 80000 × ₦0.10= ₦8000
  Applied for: 5/6(1280000-80000) × ₦0.10 =₦100000
  Excess: 200000 × ₦0.10 = ₦20000
- Allotment: 1000000 shares × ₦0.25 = ₦250000
- First call:
  Money on 1st call: 1000000 shares × ₦0.35 = ₦350000
  Forfeiture: 6000 shares × ₦0.35 = ₦2100
- Second call:
  Money on 2nd call: 1000000 shares × ₦0.30 = ₦300000
  Forfeiture: (6000 + 2000) shares × ₦0.30 = ₦2400
- Forfeited shares(nominal value): 6000 shares × ₦1 = ₦6000
- Re-issued(Bank): 8000 × ₦0.85 = ₦6800

Re-issue of Forfeited Shares

It is possible to re-issue forfeited shares as fully paid by selling them to a new buyer at any price provided that the amount received on the re-issue, plus the amount received on the shares from the original holder, is at least equal to the called-up value in the case of shares not fully paid or to the nominal value in the case of fully paid shares (Ishola, 2012).

When a forfeited share is re-issued, the necessary accounting entries are:

a. **Credit:** Share Capital Account with total amount called

Debit: Forfeited share Re-Issued Account

b. **Debit:** Forfeited Shares Account with balance outstanding

Credit: Forfeited Shares Re-issued Account

c. **Debit:** Cash account with amount received

Credit: Forefeited Share Re-issue Account. It should be noted that if the amount payable on re-issue is the same as the amount unpaid by the original member, plus the amount of any calls made since the date of forfeiture, the Forfeited Shares Re-issued Account will be closed by the above entries, but if the new buyer agrees to pay more than this amount, the account will still show a credit balance which represents a profit or premium on the re-issue of the shares. Therefore, the necessary accounting entries are:

d. Debit: Forfeited Share Re-Issued Account with amount necessary to close off the account.

Credit: Share Premium Account

The balance in the Share Premium Account is shown as a separate item in the Statement of Financial Position grouped under the heading: “Capital Reserve”.

Example 2

Ayo and Company (Nigeria) Limited invited applications for 400,000 shares of ₦1.00 each at a premium of 30k per share as follows:

January 1 20x7 on application	20k
January 10 20x7 on allotment (including the premium)	50k
January 20 20x7 First call	30k
January 25 20x7 Second call	30k

Applications were received for 480,000 shares. Allotments were made of 400,000 shares pro rara to all applicants and the balance of the application money was credited towards the amount payable on allotment.

One applicants who had been alloyed 2,400 shares did not pay the allotment money and the directors decided to forfeit the shares. Another shareholder who had been allotted 4,000 shares did not pay either of the two calls and the directors then forfeited the shares. All the shares forfeited were re-issued as fully paid at a price of 90k per share on 27 January 20x1

Required: Record the above mentioned transactions in the appropriate ledger accounts and show how the balances on such accounts should appear in the company’s statement of financial position as on 31st January, 20x7

Solution to Example 2

Dr Application & Allotment a/c Cr

	₦		₦
Jan. 10 Share Capital	160,000	Jan. 1 Bank	96,000
Jan 10 Share Premium	120,000	Jan 10. Bank	182,800
		Jan 10 Forfeited Shares	1,200
	280,000		280,000

Dr Bank A/c Cr

	₦		₦
Jan 1 Application & Allotment	96,000	Jan. 27 Balance c/d	520,720
Jan 10. Application & Allotment	182,800		
Jan 20 First Call	118,080		
Jan 25 Second Call	118,080		
Jan 27 Forfeited shares Re-issued a/c	5,760		
	520,720		520,720
Jan 31 Balance b/d	520,720		

Dr **Share Capital a/c** **Cr**

	₦		₦
Jan 10. Forfeited share a/c	960	Jan 10 Application & Allotment	160,000
Jan 20 Forfeited shares	4,000	Jan 20 First call	119,280
Jan 27 Balance c/d	400,000	Jan 25 Second Call	119,280
		Jan 27 Forfeited shares Re-issued a/c	6,400
	404,960		404,960
		Jan 31 Balance b/d	400,000

Dr **Share Premium** **Cr**

	₦		₦
Jan 10 Forfeited shares	720	Jan 10 Application & Allotment	120,000
Jan 27 Balance c/d	120,720	Jan 27 Forfeited shares Re-issued a/c	1,440
	121,440		121,440
		Jan 31 Balance b/d	120,720

Dr **Forfeited Shares a/c** **Cr**

	₦		₦
Jan 10 Application & Allotment	1,200	Jan 10 Share Capital	960
Jan 20 First call	1,200	Jan 10 Share Premium	720
Jan 25 Second Call	1,200	Jan 20 Share Capital	4,000
Jan 27 Forfeited shares Re-issued a/c	2,080		
	5,680		5,680

Dr **First Call a/c** **Cr**

	₦		₦
Jan 20 Share Capital	119,280	Jan 20 Bank	118,080
		Jan 20 Forfeited shares	1,200
	119,280		119,280

Dr **Second and Final Call** **Cr**

	₦		₦
Jan 25 Share Capital	119,280	Jan 25 Bank	118,080
		Jan 25 Forfeited shares	1,200
	119,280		119,280

Dr **Forfeited Share Re-Issued a/c** **Cr**

	₦		₦
Jan 27 Share Capital	6,400	Jan 27 Forfeited Share a/c	2,080
Jan 27 Share Premium	1,440	Jan 27 Bank	5,760
	7,840		7,840

AYO & COMPANY (NIGERIA) LIMITED STATEMENT OF FINACIAL POSITION (EXTRACT)

Issued Share Capital:	
400,000 shares of N1 each	400,000
Capital Reserve:	
Share Premium	120,700
	520,720
Current Asset:	
Bank	520,720

Workings

Application money received 480,000 x 20k = ₦96,000

Share capital:

On application 400,000 x 20k = 80,000

On Allotment 400,000 x 20k = 80,000

160,000

Share Premium 400,000 x 30k = 120,000

Money Received on Allotment

= (400,000 x 50k) – (80,000 x 20k) - (2,400 x 50k)

= 200,000 – (160,000 + 1,200) = ₦182,800

First call = (400,000 – 2,400) x 30l = ₦119,280

Money received on First Call

= ₦119,280 – (4,000 x 30k)

= ₦119,280 – ₦1,200) = ₦118,080

Second call (400,000 – 2,400) x 30k = ₦119,280

Money received on Second Call

= ₦119,280 – ₦1,200 = ₦118,080

Money received on Re-issue == (4000 + 2,400) x 90k = ₦5,760

SELF ASSESSMENT EXERCISE

What do you understand by forfeiture of share?

3.2 REDEMPTION OF SHARES

In the context of shares and loan, the word “purchasing & redeeming” may appear to be identical and interchangeable. They both involve an outflow of cash incurred by a company in getting back its own shares so that it may then cancel them. **Redeeming of shares** simply means buying back of shares from the shareholders by the company in accordance with earlier agreement.

The provisions on redemption of shares are:

- Notice must be given to the registrar
- It can only be redeemed when they are fully paid
- It must not be regarded as a reduction of the authorized share capital

- Redemption must be authorized by the article
- Premium on redemption must be paid out of profit or share premium account.

Reasons for Redemption

i. To buy out troublesome shareholders
ii. To reduce the dividend bill of the company
iii. To take advantage of declining share prices in the market and buy it at a discount
iv. Take out the company from public market
v. To enjoy the market prospect of the shares
vi. Employment-based share offering may be redeemed when employee resigns.

SELF ASSESSMENT EXERCISE

List reasons for redemption of share.

3.3 ACCOUNTING ENTRIES

1) Transfer the balance of redeemable preference share to the redemption account
   Dr: Redeemable preference shares account
   Cr: Redemption of redeemable preference shares account
2) Premium payable on redemption
   Dr: Share premium/ profit and loss account
   Cr: Redemption of redeemable preference shares account
3) Provision for arrears of cumulative preference dividend
   Dr: Profit and loss account
   Cr: Redemption of redeemable preference share account
4) New issue of shares at a premium
   Dr: Bank account
   Cr: Share capital account
   Cr: Share premium account
5) Transfer to capital redemption reserve fund
   Dr: Profit and loss account
   Cr: Capital redemption reserve fund account
6) Redemption of the redeemable preference share
   Dr: Redemption account
   Cr: Bank account

Scenarios:

1. **Share redeemed at par out of profit**: an amount equal to the value of shares redeemed must be transferred out of profit and loss to the capital redemption reserve fund.

Journal entries	Dr	Cr
% Redeemable preference shares Redemption account **Preference shares to be redeemed**	xx	 xx
Profit and loss account Capital redemption reserve fund account **Transfer an amount equal for redemption from profit and loss to CRRF**	xx	 xx
Redemption account Bank account **Cash paid on redemption**	xx	 xx

Shares redeemed at par out of new issue of share:

Journal entries	Dr	Cr
Redeemable preference share account Redemption account **Share to be redeemed**	xx	 xx
Application account Bank account **Cash received on issue**	xx	 xx
Application account Share capital **Allotment of shares**	xx	 xx
Bank account Redemption account **Cash paid on redemption**	xx	 xx

2. **Shares redeemed at par partly from new issue and partly from profit**

Journal entries	Dr	Cr
Application account Bank account **Cash received on issue of shares**	xx	 xx
Application account Share capital account **Allotment of shares**	xx	xx
Profit & loss account Capital redemption reserve fund account **Part of redemption not covered by new issue**	xx	xx
Redeemable preference share account	xx	xx

Redemption account **Shares to be redeemed**		
Redemption account Bank **Cash paid on redemption**	**xx**	**xx**

3. **Shares redeemed at a premium out of profit:** there is no premium account

Journal entries **Dr** **Cr**

Redeemable preference share account Redemption account **Share to be redeemed**	**xx**	 **xx**
Profit and loss account Redemption account **Premium on share redeemed**	**xx**	 **xx**
Redemption account Bank account **Cash paid on redemption**	**xx**	 **xx**
Profit and loss account Capital redemption reserve fund **Transfer of nominal value of shares redeemed**	**xx**	 **xx**

4. **Share redeemed at a premium partly from new issue and from profit**

Journal entries **Dr** **Cr**

Redeemable preference share account Redemption account	**xx**	 **xx**
Bank account Application account	**xx**	**xx**
Profit & loss account Capital redemption reserve fund account	**xx**	**xx**
Application account Ordinary share capital account Share premium **Ordinary issue of shares at a premium**	**xx**	 **xx** **xx**
Share premium account Redemption account **Premium on share being redeemed**	**xx**	**xx**
Redemption account Bank account	**xx**	 **xx**

Note: If the balance of the share premium account is insufficient to cover premium on redemption, the remaining balance will be taken from profit and loss.

Example 1

The balance sheet of Kay Ltd as at 31st December 2015 is given below:

	₦
Net Assets	7500
Bank	2500
	10000
Financed by:	
Ordinary Shares	5000
Preference share capital	2000
Retained profit	3000
	10000

₦2000 preference shares were redeemed at par by partly issuing ₦1200 from ordinary share at par and partly using retained profit.

i. Show the journal entry of the above transaction.
ii. Show the ledger entry.
iii. Show the balance sheet after the transaction happened.

Solution to Example 1

KAY LTD

Journal entries	**Dr**	**Cr**
	₦	₦
Bank account	1200	
Ordinary share application account		1200
Being money received on application		
Ordinary share application account	1200	
Ordinary share capital account		1200
Being shares allotted		
Profit & loss account	800	
Capital redemption reserve fund account		800
Being partly financed by profit		
Preference share capital account	2000	
Preference share redemption account		2000
Being shares to be redeemed		
Preference share redemption account	2000	
Bank account		2000
Being money paid on redemption		

Ledger entries:

Dr Bank Account Cr

	₦		₦
Balance b/f	2500	Preference share redemption	2000
OSC application	1200	Balance c/d	1700
	3700		3700

Dr	Ordinary Share Capital Account		Cr
	₦		₦
Balance c/d	6200	Balance b/d	5000
		OSC Application	1200
	6200		6200

Dr	Ordinary Share Application Account		Cr
	₦		₦
Ordinary Share Capital	1200	Bank	1200

Dr	Preference Share Capital Account		Cr
	₦		₦
Preference Share redemption	2000	Balance b/d	2000

Dr	Profit & Loss Account		Cr
	₦		₦
Capital redemption	800	Balance c/d	3000
Balance c/d	2200		
	3000		3000

Dr	Preference share redemption Account		Cr
	₦		₦
Bank	2000	Balance c/d	2000

Dr	Capital Redemption Reserve Account		Cr
	₦		₦
Balance c/d	800	Profit and Loss	800

Statement of Financial Position Extract:

	₦
Net Assets	7500
Bank	1700
	9200
Financed by:	
Ordinary Share Capital	6200
Retained Profit	2200
Capital Redemption Reserve	800
	9200

3.4 REDEMPTION OF REDEEMABLE PREFERENCE SHARES

Some preference shares issued by a company may be stated at redeemable; this means that they can be redeemed i.e. bought back by the company on the specified date or range of dates. For example, an issue of 8% redeemable preference shares 1990/1995, means that the share holders would get a dividend of 8% per annum until the shares are redeemed and that redemption may take place any time between 1990 and 1995.

The company, not a share holder takes the initiative in instituting redemption procedure. The timing is entirely at the company's discretion and it would choose a time when conditions are most favourable, for example, when the listed price of shares is relatively low and/or the company is in a strong liquid position.

Redeemable preference shares, like redeemable debentures, provide a company with medium term to long term finance until it is no longer needed.

Redemption of preference shares may take place provided that:

a. Authority for the issue is contained in the company's articles.
b. No such shares shall be redeemed unless they are fully paid.

3.5 Accounting Entries for Redemption of Redeemable Preference Shares

1. Open a redeemable preference share account and credit it with the preference shares to be redeemed .i.e: -

	Dr	Cr
Preference shares account	XX	
Redeemable preference shares account		XX

This entry will not be required where the preference shares is stated as redeemable preference shares. Here the amount standing to the credit of redeemable preference shares is brought forward e.g.

₦100 8% redeemable preference shares to be redeemed by A ltd; from the amount of ₦2000 standing to the credit of 8% redeemable preference shares. The ledger entries for this are shown below: -

8% Redeemable pref shares

Pref share	₦	b/f	2000
Redemption Account 100			

2. Open a premium on redemption of preference shares account (if the preference shares are to be redeemed at a premium) and credit it with the premium. Debit share premium account.

	Dr	Cr
Share premium Account	XX	
Premium on redemption of pref shares		XX

(With provision for premium on redemption out of share premium account)

3. Open a preference shares redemption account and close the entries in the redeemable preference shares account, and the premium on redemption of preference shares account by Debiting them and crediting the preference shares redemption account:

	Dr	Cr

Redeemable pref shares	XX	
Premium on redemption of pref shares	XX	
Pre shares redemption account		XX

4. Open an application and allotment account if shares are to be issued for the purpose of redeeming the preference shares. Debit App &All otment account and credit share capital account (with nominal value) share premium account (with the premium on the shares issued)

	Dr	Cr
Application and Allotment Account	XX	
Share capital account		XX
Share premium account (if any)		XX

Example: To assist in financing the redemption of a redeemable preference shares.
A limited issue 100 ordinary shares of ₦1,00 each, at a premium of 10k (The entries are:

	Dr	Cr
Application and Allotment Account	110	
Share capital Account		100
Share premium Account		10

5. Debit can with the proceeds from the issue of shares and credit the Application and Allotment account.

	Dr	Cr
Cash/Bank	XX	
Application & Allotment		XX

6. Debit the preference shares redemption account with cash sufficient to close the account (Mominal value of pref shares and premium). Credit cash/Bank Account.

7. Open a capital redemption reserve fund and transfer from accumulated profit an equivalent amount relating to the nominal value of the shares redeemed to the account. This is applicable where shares are redeemed out of profit.

	Dr	Cr
Profit and loss	XX	
Capital redemption reserve fund		XX

Example 2

Part of the share capital of P Ltd. consisted of 600,000 8% Redeemable preference shares of ₦1,00 per share fully paid. The company decided to exercise its rights and redeemed 200,000 of these shares at a premium of 40k per share. To assist in financing the redemption, P Ltd issued a further 120,000 ordinary shares of ₦1,00 per share at a premium of 20k per share.
Prior to the above events, the balance standing to the credit of the company's ordinary share capital, share premium and unappriopriated profits accounts were ₦900,000, ₦26,000 and ₦400,000 respectively. You are required to post the relevant accounts (excluding Bank) in P limited's ledger to record these transactions.

Solution to Example 2

Dr % Redeemable Preference shares Cr

	₦		₦
Preference share Redemption account	200,000	Bal b/d	600,000

Balance C/D	400,000		
	600,000		600,000
		Balance b/f	400,000

Dr Premium on Redemption of Pref Shares Cr

	₦		₦
Pref share redemption Account	80,000	Share premium	50,000
		P & Account	30,000
	80,000		80,000

Dr Pref shares redemption Account Cr

	₦		₦
		8% Red pref shares	200,000
Bank	280,000	Premium on redemption Of pref shares	80,000
	280,000		280,000

Dr Ordinary share capital Cr

	₦		₦
		b/f	900,000
Balance c/d		App & All	120,000
	1,020,000		1,020,000
		Balance b/d	1,020,000

Dr Profit & Loss A/c Cr

	₦		₦
Premium on redemption of pref shares	30,000	Balance b/d	400,000
Capital Red Reserve Fund	80,000		
Balance c/f	290,000		
	400,000		400,000
		Balance b/f	290,000

Dr Share premium Cr

	₦		₦
Premium on red Emption of pref shares	50,000	b/f	26,000
		App & All	24,000
	50,000		50,000

Dr APPLICATION AND ALLOTMENT ACCOUNT Cr

	₦		₦
Share capital	120,000	Bank	144,000
Share premium	24,000		
	144,000	Bank	114,000

Capital Redemption Reserve fund

	₦
Profit and Loss	80,000

The balance sheet extract is shown below: -

Balance sheet Extract

Share capital		₦
Ordinary shares of N1.00 each		1,020,000
8% Red pref shares of N1,00 each		400,000
		1,420,000
Reserves:		
Capital Redemption Reserve Found	80,000	
Profit and loss Account	290,000	370,000
		1,790,000

4.0 CONCLUSION

The unit discusses the forfeiture of shares, redemption of ordinary share and redemption of redeemable preference shares.

5.0 SUMMARY

Adequate knowledge of the treatment of forfeiture share and redemption are pertinent to the principle of accounting.

6.0 TUTOR MARKED ASSIGNMENT

Question 1

The Statement of Financial Position of B Limited at December 31st 2007 was as follows:

B Limited

Statement of Financial Position as at 31st Dec 2007

Authorized & Issued capital:	₦		₦
45,000 6% Pref shares of		Sundry Assets	60,000
₦1,000 each fully paid 45,000			
20,000 ordinary shares			
Of ₦1.00 each fully		Bank	40,000
Paid	20,000		
Profit and loss	20,000		
Liabilities	15,000		
	100,000		100,000

By the terms of their issue the preference shares were redeemable at a premium of 4% on the following Jan 1st 1988 and it was decided to arrange this as far as possible out of the company's resources subject to leaving a balance of ₦8000 to the credit of the profit and loss account. It was also decided to raise the balance of money required by the issue of a sufficient number of ordinary shares at a premium of 30k per share.

Show the necessary journal entries and ledger accounts giving effect to the transactions and the statement of financial position thereafter.

2. The Goodness Company Ltd advertised an issue of 750,000 12% preference shares of ₦1 each to be issued at ₦1.50 per share. Applications for 1,370,000 shares were received with the correct application money for 30k per share, 70k per share (including premium) was due on allotment while 25k per share was due on each of the remaining two calls. All amounts due were received. Application money for 120,000 shares was refunded to unsuccessful applicants and the remaining applications were allotted shares on a pro-rata basis.

You are required to:

(a) Open all necessary ledger accounts and post the above transactions.

(b) Calculate the number of shares issued to Musa, Obi and Alakija who applied for 275,000; 180,000 and 50,000 shares respectively and were among the successful applicants.

3. Iwarere Ltd has a nominal capital of ₦40,000 divided into 40,000 ordinary shares of ₦1 each. The whole of the capital has been issued at par on the following terms.

Payable on Application	12½k per share
Payable on Allotment	12½k per share
First Call	50k per share
Second Call	25k per share

The calls have been made and paid in full by the members with the exception of S. Ajao who has failed to pay the first and second calls on 400 shares allotted to him. On January 1st, the directors resolved to forfeit the shares.

Required

Show the journal and ledger entries recording the forfeiture, the Ordinary Share Capital Account, the Call Accounts and Forfeited Share Account, and show how the above items will appear in a Statement of Financial Position prepared immediately after the forfeiture.

7.0 REFERENCES/FURTHER READING

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UNIT 4: AMALGAMATION AND ABSORPTIONS

1.0 INTRODUCTION

This unit deals with meaning, types and formation of Liability Company.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Explain amalgamation and absorption.
2. Explain legal framework of amalgamation and absorption

3.0 MAIN CONTENT

INTRODUCTION

The term "business combination" is a circumstance whereby one business gains control of one or more other business. That is, an arrangement where two or more businesses owned and operated as separate entity come together to become a single entity under the same ownership. The reasons for this occurrence are many and varied but are usually to enable advantage to be gained or disadvantages to be avoided. Business combination can take two forms: a. Amalgamation b. Absorption

3.1 Amalgamation: This involves the formation of a new business which then acquires the assets and liabilities of the two or more existing businesses, which are then liquidated. That is the two businesses that amalgamate will no longer exist.

For example: X Ltd and YLtd becomes XYLtd.

3.2 Absorption: This applies when a relatively large, dominant, business acquires the assets and possibly the liabilities of one or more existing businesses. The company that is being taken over will lose its identity (that is, wind up) while the assets and liabilities of the absorbing company will increase after the absorption. For example, company X Plc can absorbed company Y Plc to form a bigger company X i..e X Plc and Y Plc becomes Y Plc.

Unlike in amalgamation where all the amalgamating businesses lose their identities, only one (absorbed company) losses identity in the case of absorption.

The components of the purchase consideration in amalgamation and absorption of companies can take one of several forms:

a. Payment of cash
b. Issue of shares (ordinary/preference shares)
c. Issue of loan capital (debenture) etc.

SELF ASSESSMENT EXERCISE

Differentiate between amalgamation and absorption.

3.3 DEFINITION OF CONCEPTS

Reorganization: This is when internal surgical operation is undertaken by a company by way of changing the capital structure, in form of reduction in issued share capital, which therefore affects the rights of existing shareholders. It is normally called internal Reconstruction.

Business Combination: occurs when 2 or more entities join under common control;

Control: This is the ability to direct policies and management of another entity.

Merger: A business combination when the acquired company's assets and liabilities are combined with those of the acquiring company. This results in no additional organizational segments;

Controlling ownership: Where the subsidiary remains as a separate entity with a majority of its ordinary shares held by the holding company or what we call Parent-Subsidiary relationship.

Non-Controlling ownership: Where the holding company holds non-majority interest in another company, that is when a company has ordinary investment in another company, such holding is called non-controlling interest;

Absorption and Amalgamation: In absorption, one business is swallowed up by another company, the former ceases to have its personality any longer while the latter continues to exist in a bigger way than before, therefore the former is dissolved entirely. In amalgamation, a business is formed to take over the assets and liabilities of existing company, which now dissolve consequent upon the merger arrangement.

SELF ASSESSMENT EXERCISE

Write short note on the following:

(i) Control (ii) Merger (iii) Business combination (iv) Reorganization

3.4. STATUTORY FRAMEWORK

Since absorption and amalgamation involve winding up of a company and formation of another one, we would have to restate few important statutory requirements relating to winding up of companies, as winding up is the key issue here.

- Section 538 of Companies and Allied Matters Act (CAMA 1991) states that a company may pass a special resolution winding up its business and authorize the liquidator to sell the whole or part of its business to another body corporate on terms that the consideration be distributed amongst members of the transferor company.

By way of clarity, the section is saying that the court has the power to facilitate amalgamation and absorption making provision for the following:

(i) Transfer of assets and liabilities to any transferee company;
(ii) The payment of purchase price by that company through allotment of shares and debentures and even direct allotment to shareholders of old business;
(iii) Continuation of legal proceedings;
(iv) Dissolution of the old company without winding up
(v) Protection of interest of those who oppose the scheme.

Though the shares of the transferee company may be allotted directly to the members of Transferor Company their value must be introduced to the account in the realization account of the old company.

- Section 27 of Insurance Decree is however affirmative on the issue of voluntary winding up of insurance company as it states that a life insurance business cannot be voluntarily wound up except for purposes of amalgamation or transfer.

REGULATORY FRAMEWORK

Business combinations and related matters cover substantial part of IAS and IFRS as itemized below:

- IFRS 3/IAS 22	Business Combination
- IFRS 10/IAS 27	Consolidated Financial Statement
- IAS 28	Investment in Associated Company
-IFRS 11/IAS 31	Interest in Joint Venture
- IFRS 5	Non current assets held for sale and discontinued operations
- IFRS 8	Operating Segments
- IAS 1	Presentation of Financial Statements

The above standards have been considered in the relevant chapters of the book.

SELF ASSESSMENT EXERCISE

Briefly discuss the legal framework guiding absorption and amalgamation.

3.5 ACCOUNTING ENTRIES

The following entries are needed, as appropriate in the accounts of the companies being wound up under an amalgamation or an absorption scheme:

S/N	Events	Debited	Credited
1.	Book value of assets taken over	Realisation account	Individual asset account
2.	Liability taken over	Individual payable Account	Realization account
3.	Discount received from creditors	Payables account	Realization account
4.	Purchase consideration agreed	New company Account	Realization account
5.	Realisation Expenses	Realisation account	Bank account
6.	Profit on Realization (it is to be derived)	Realisation account	Sundry shareholder account
7.	Loss on Realisation (it is to be derived)	Sundry shareholders account	Realisation account
8.	Statement of payables	Payables account	Bank account
9.	Receipt of Purchase Consideration From new/existing company	Bank/Share in new company account	New company account
10.	Transfer of shareholder's Fund	Share capital Reserve account	Sundry shareholders' account
11.	Distribution of Purchase	Sundry shareholder account	Bank and/or shares in Consideration to new company account

When an amalgamation or an absorption takes place, the following extra entries considered appropriate in the books of the new or existing businesses, respectively:

S/N	Events	Debited	Credited
1.	Purchase consideration agreed	Acquisition of….. New company's Name	Liquidation of New Company's Name
2.	Assets taken over (at current valuation)	Individual assets account	Acquisition of account
3.	Liabilities taken over (at actual amount to be liquidated)	Acquisition of….	Individual payables account.

Example 1

A new company, Goodness Ltd was formed on the 30 April 2012 to take over the business of each of the following companies, all of which went into voluntary liquidation on the following day. The new company was incorporated with a capital of ₦750,000 divided into 500,000 ordinary ₦1 shares and 250,000 10% ₦1 cumulative preference shares.

Summary Statement of Financial Position as at 30th April, 2012

	Good Ltd	Better Ltd	Best Ltd
	₦	₦	₦
Debit Balances			
Plant and Machinery	55,000	20,000	10,000
Land & Building	50,000	15,000	-
Investments	25,000	-	-
Goodwill	45,000	-	10,000
Preliminary Expenses	-	2,500	-
Bank	37,500	-	-
Receivables	125,000	120,000	20,000
Inventory	82,500	32,500	20,000
Profit and Loss		30,000	
	420,000	220,000	60,000
Credit Balances			
Payables	87,500	50,000	50,000
Bank Overdraft	-	45,000	2,500
Issue and paid up capital			
- Ordinary ₦1 shares	250,000	125,000	25,000
- 10% Cumulative preference	-	-	25,000
Profit and Loss	32,500	-	2,500
Revenue Reserve	50,000	-	-
	420,000	220,000	60,000

The bases of absorption of the three companies were:

1. Good Ltd: All assets and liabilities to be taken over at book values and settlement to be by 5 fully paid ordinary shares in Goodness Ltd to be issued for every shares held in Good Ltd.

2. Better Ltd: All assets and liabilities to be taken over at book value and settlement to be by 1 fully paid ordinary shares and 3 cumulative preference shares paid 50k each in Goodness Ltd to be issued for every 5 shares held in Better Ltd. Goodness Ltd was to provide for doubtful debt of ₦22,500 and revalue the inventory in hand at ₦25,000.

3. Best Ltd: Goodness Ltd to purchase the assets and Goodwill for ₦50,000 cash. Payables to be settled by Best Ltd. Best Ltd also to pay liquidation expenses of ₦2,500 and to provide for debts and to revalue inventory at ₦17,500.

4. 100,000 cumulative shares in Goodness Ltd are offered to and subscribed for by the public, 50k being called and all but ₦2,500 being received by 30 June, 2012.

5. All Goodness Ltd shares are issued at par. You are required to prepare

(i) The liquidation accounts and sundry shareholders accounts for the three vendor companies with the addition in the case of Best Ltd of its Bank account showing the distribution of the available cash among the payables and respective classes of shareholders.

(ii) The statement of financial position of Goodness Ltd, as at 30June 2012, there being no transaction other than those above between 30 June 2012.

Solution to Example 1

Realisation Account

	Good	Better	Best		Good	Better	Best
Plant & Machinery	55,000	20,000	10,000	Payables	87,500	50,000	-
Land & Building	50,000	15,000	-	Bank Overdraft	-	45,000	-
Investment	25,000	-	-	Goodness Ltd	312,500	62,500	-
Goodwill	45,000	-	10,000	Cash		50,000	
Bank	37,500	-	-	Sundry shareholders	20,000	30,000	12,500
Receivables	125,000	120,000	20,000				
Inventory	82,500	32,500	30,000				
Bank – Liquidation	-	-	2,500				
	420,000	187,500	62,500		420,000	187,500	62,500

Workings

Goodness Ltd: Settlement

Good Ltd : $\frac{5}{4}$ x 250,000 = 312,500

Better Ltd:

Preference share: $\frac{3}{5}$ x 125,000 x 0.5 = 37,500

Ordinary shares: $\frac{1}{5}$ x 125,000 = 25,000

62,500

Goodness Ltd

	Good	Better	Best		Good	Better	Best
	₦	₦	₦		₦	₦	₦
Realisation	312,500	62,500	50,000	Shares in Goodness Ltd	312,500	62,500	-
				Bank	-	-50,000	
	312,500	62,500	50,000		312,500	62,500	50,000

Dr Sundry Shareholders Cr

	Good	Better	Best		Good	Better	Best
Realisation	20,000	30,000	12,500	Ordinary shares	250,000	125,000	25,000
Profit & Loss	-	32,500	-	10% Pref. share			25,000
Shares in Goodness	312,500	62,500	-	Profit & Loss	32,500		
Bank	-	-	37,500	Revenue Reserve	50,000		
	332,500	125,000	50,000		332,500	125,000	50,000

Dr Bank Account Cr

	₦		₦
Goodness Ltd	50,000	Balance b/f	2,500
		Preference dividend	2,500
		Payables	5,000
		Realisation	2,500
		Sundry shareholders	37,500
	50,000		50,000

Business Purchase

	Good	Better	Best		Good	Better	Best
Payables	87,500	50,000		Bank	37,500		
Bank overdraft		45,000		Investment	25,000		
Provision for B.D		22,500	5,000	Receivables	125,000	120,000	20,000
Liquidator	312,500	62,500	50,000	Inventory	82,500	25,000	17,500
Goodwill	20,000	-	2,500	Plant & Machinery	55,000	20,000	10,000
				Land & Building	50,000	15,000	
				Goodwill	45,000		10,000
	420,000	180,000	57,500		420,000	180,000	57,500

Goodness Ltd
Statement of Financial Position as at 30 June, 2012

	₦	₦
Assets: Non-Current Assets:		
Land & Building (50,000 + 15,000)		65,000
Plant & Machinery (55,000 + 20,000 + 10,000)		85,000
Goodwill (55,000 – 22,500)		32,500
Investment at cost		25,000
		207,500
Current Assets:		
Inventory (82,500 + 25,000 + 17,500)	125,000	
Receivables (125,000 + 120,000 + 20,000 – 27,500)	237,500	
Bank (37,500 + 47,500 – 50,000)	35,000	397,500
		605,000
Equity & Liabilities		
Equity:		
Ordinary shares (312,500 + 25,000)		337,500
Cumulative Pref. Share	87,500	
Less: Call in arrears	(2,500)	85,000
Total Equity		422,500
Non-Current Liabilities:		
Payables (87,500 + 50,000)	137,500	
Bank Overdraft	45,000	182,500
		605,000

Examples 2

Messrs Adamu & Hassan who are friends are also majority shareholders and managing directors of their respective construction businesses of Adamu and Sons Limited, and Hassan & Sons Limited. For the purpose of access to more funds and rationalization, it was agreed that Adamu & Sons Limited should absorb the business of Hassan & Sons Limited. The statement of financial position of the two companies prior to absorption on 30 April 2010 were as follows:

		Adamu & Sons limited	Hassan & Sons limited
		₦	₦
Assets:	Non-Current Assets	2,450,000	375,000
	Goodwill	-	150,000
		2,450,000	525,000
	Current Assets	775,000	600,000
Total Assets		3,225,000	1,125,000
Equity & Liabilities			
Equity			
50k Ordinary shares		2,000,000	250,000
Redeemable preference share		100,000	
Share premium		250,000	
Revenue Reserve		450,000	750,000
Total Equity		2,800,000	1,000,000

Current Liabilities	425,000	125,000
Total Equity & Liabilities	3,225,000	1,125,000

The redemption at 5% premium or redeemable preference shares took place on 1st May, 2010. In order to partially finance the redemption 200,000 ordinary shares at a premium of 5 kobo were issued to existing shareholders and paid in full on that date. Hassan & Sons Limited was liquidated on 1 May, 2010 when all its assets, except certain items of inventory valued at ₦100,000, were purchased from the liquidator by Adamu & Sons limited. The company was also to assume all the liabilities of Hassan & Sons Limited, and

(iii) To issue 650,000 of its ordinary share of 50k cash at a premium of 8kobo per share and;

(iv) To pay ₦750,000 in cash.

The purchase consideration was affected on 2 May, 2010 and share issue expenses amounted to ₦152,000

Required:

a. Prepare the statement of Financial Position of Adamu & Sons Limited after the absorption had been affected.
b. Show your working for calculations of:

i. Current Assets ii. Share Premium and iii. Revenue reserve

Solution to Example 2

a.

ADAMU & SONS LIMITED

Statement of Financial Position as at 1 May, 2010

	₦	₦
Assets		
Non-Current Assets		2,825,000
Goodwill		377,000
		3,202,000
Current Assets		378,000
Total Assets		3,580,000
Equity and Liabilities		
Equity		
4,850,000 ordinary shares @ 50k		2,425,000
Share premium account		155,000
Revenue reserve		450,000
Total Equity		**3,030,000**
Current Liabilities		550,000
Total Equity & Liabilities		**3,580,000**

b. Dr Current Assets Cr

	₦		₦
Balance b/f	775,000	Redemption of Red. Pref. shares	100,000
Vendor	500,000	Premium on Redemption (Bank)	5,000
Ordinary share (Bank)	100,000	Share issue expenses	152,000
Share premium (Bank)	10,000	Vendor	750,000
		Balance c/d	378,000
	1,385,000		1,385,000
Balance b/d	378,000		

Notes: All cash and Bank transactions are reflected in the current assets accounts.

ii. Dr SHARE PREMIUM ACCOUNT Cr

	₦		₦
Share issue expenses (Bank)	152,000	Balance b/d	250,000
Bank (Redemption premium)	5,000	Vendor	52,000
Balance c/d	155,000	Bank	10,000
	312,000		312,000
		Balance b/d	155,000

iii. Dr Revenue Reserve Account Cr

Balance c/d	450,000	Balance b/f	450,000
		Balance b/d	450,000

Workings:

(i) Dr Non-Current Assets Cr

Balance b/f	2,450,000	Balance c/d	2,825,000
Vendor	375,000		
	2,825,000		2,825,000
Balance b/d	2,825,000		

(ii) Dr Ordinary Shares Capital Account Cr

Balance c/d	2,450,000	Balance b/f	2,000,000
		Vendor	325,000
		Bank	100,000
	2,450,000		2,450,000
		Balance b/d	2,450,000

(iii) Dr Current Liabilities Account Cr

Balance c/d	550,000	Balance b/f	425,000
		Vendor	125,000
	550,000		550,000
		Balance b/d	550,000

(iv) LEDGERS TO CLOSE THE BOOKS OF HASSAN & SONS LTD

Realization Account

Dr			Cr
Goodwill	150,000	Adamu & Sons (PC)	1,252,000
Non-current Assets	375,000		
Current Assets	600,000		
Sundry member	127,000		
	1,252,000		1,252,000

Adamu & Sons Ltd

Dr			Cr
Realization (PC)	1,252,000	Ordinary share	377,000
		Cash	750,000
		Current liabilities	125,000
	1,252,000		1,252,000

Sundry Members Account (Ordinary)

Dr			Cr
Ordinary share in Adamu	377,000	Ordinary shares	250,000
Cash	750,000	Revenue Reserve	750,000
		Realisation	127,000
	1,127,000		1,127,000

Current Liabilities

Dr			Cr
Adamu & Sons	125,000	Balance b/d	125,000

Ordinary Share in Adamu & Sons Ltd

Dr			Cr
Adamu & Sons Ltd	150,800	Sundry Member	150,800

v. Determination of Purchase Consideration

	₦
650,000 Ordinary shares of 50k cash @58k	377,000
Cash	750,000
Current liabilities taken over	125,000
	1,252,000

Example 3

CJ Limited and BK Limited have agreed to amalgamate with effect from January 1 2012, CJBK Limited was established to take over the business and has issued 150,000 ₦1 Ordinary shares and ₦100,000 7½ Debentures, in each case for cash by 31 December, 2011.

Below are the Statement of Financial Positions of CJ Limited and BK Limited on 31 December, 2011.

Statement of financial position as at 31st December, 2011

		CJ Limited		BK Limited
	₦	₦	₦	₦
Ordinary Share Capital of N1 each		200,000		300,000
Reserves		50,000		100,000
		250,000		400,000
Non-current Assets (Book value)				
Land and Building		100,000		120,000
Plant and machinery		-		100,000
Furniture and Fittings		50,000		-
Motor vehicle		30,000		50,000
		180,000		270,000
Current Assets				
Inventories	60,000		150,000	
Receivables	30,000		70,000	
Bank	25,000		10,000	
	115,000		230,000	
Current Liabilities				
Account Payables	(45,000)		(60,000)	
Proposed Dividend	-		(20,000)	
Bank Overdraft		70,000	(20,000)	130,000
		250,000		400,000

Assets of CJ Limited and BK Limited were taken over by CJBK Limited as follows:

	CJ Limited	BK Limited
Land and Building	100,000	200,000
Plant and Machinery	---	120,000
Motor Vehicle	18,000	50,000
Inventories	75,000	100,000
Receivables	30,000	70,000
Payables	---	70,000
Goodwill	64,500	100,000

CJBK Limited acquired all the assets of CJ Limited except for bank balance which was retained by the latter to discharge some of the Account Payables. The agreed purchase consideration consisted of ₦27,500 in cash and 300,000 ordinary share of ₦1 in CJBK Limited at a premium of 10k. The liquidator of CJ Limited agreed to discharge the remaining payables.

CJBK Limited acquired all assets in BK Limited and also assumed responsibility for discharging all payables. The purchase consideration of ₦500,000 was discharged by the issue of 400,000 ordinary share of ₦1 each in CJBK Limited and the payment of ₦75,000 to settle outstanding debts including proposed dividend and ₦7,500 liquidation expenses.

Required to prepare the necessary account:

(a) To liquidate CJ Limited and BK Limited

(b) To record amalgamation in the book of CJBK Limited and

(c) Statement of Financial Position for CJBK Limited immediately after the transaction on 1 January 2012.

Solution to Example 3

(ai) In the Book of Liquidator of CJ Limited

Dr — Bank Account — Cr

	₦		₦
Balance b/d	25,000	Payables	45,000
CJBK Ltd	27,500	Sundry members	7,500
	52,500		52,500

Dr — Business Realisation Account — Cr

	₦		₦
BV of assets taken over		CJBK Limited	
Land and Building	100,000	Purchase consideration	357,500
Motor Vehicle	30,000		
Furniture & Fitting	50,000		
Inventories	60,000		
Receivables	30,000		
Sundry members	87,500		
	357,500		357,500

Dr — CJBK Limited — Cr

	₦		₦
Bus Realisation	357,500	Bank a/c	27,500
		Share in CJBK Ltd	330,000
	357,500		357,500

Dr — Share in CJBK Limited — Cr

	₦		₦
CJBK Limited	330,000	Sundry members	330,000

Dr — Sundry Members' Account — Cr

	₦		₦
Bank a/c	7,500	Ordinary share capital	200,000
Share in CJBK	330,000	Reserves	50,000
		Bus Realisation a/c	87,500
	337,500		337,500

(aii) In the book of Liquidator of BK Limited

Dr — Bank Account — Cr

	₦		₦
Balance c/d	10,000	Bank overdrafts	20,000
CJBK Ltd	75,000	Proposed dividend	20,000
		Liquidation expenses	7,500

	₦		₦
		Sundry member's a/c	37,500
	85,000		85,000

Business Realisation Account

Dr	₦	Cr	₦
BV of asset taken over		CJBK Limited	
Land and Building	120,000	Purchase consideration	500,000
Motor Vehicle	50,000	Acc. Payable taken over	60,000
Plant & Machinery	100,000		
Inventories	150,000		
Receivables	70,000		
Liquidation expense	7,500		
Sundry members	62,500		
	560,000		560,000

CJBK Limited

Dr	₦	Cr	₦
Bus Realisation	500,000	Bank a/c	75,000
		Share in CJBK Ltd	425,000
	500,000		500,000

Share in CJBK Limited

Dr	₦	Cr	₦
CJBK Limited	425,000	Sundry members	425,000

Sundry Members Account

Dr	₦	Cr	₦
Bank a/c	37,500	Ordinary share capital	300,000
Share in CJBK L	425,000	Reserves	100,000
		Bus Realisation a/c	62,500
	462,500		462,500

(b) Amalgamation in CJBK Limited

Business Acquisition (Purchase) Account

Dr	₦	Cr	₦
Liability taken over		Asset acquired	
Payables	70,000	Goodwill	164,500
Liquidator of CJ	357,500	land & Building	30,000
Liquidator of BK	500,000	Plant & Machinery	120,000
		Motor Vehicle	68,000
		Inventories	175,000
		Receivables	100,000
	927,500		927,500

Liquidator of CJ Limited

Dr	₦	Cr	₦
Bank	27,500	Bus. Purchase a/c	357,500
Ordinary share	300,000		

Share premium	30,000		
	357,500		357,500

Dr Liquidator of BK Limited Cr

	₦		₦
Bank	75,000	Bus. Purchase a/c	500,000
Ordinary share	400,000		
Share premium	25,000		
	500,000		500,000

Dr Bank Account Cr

	₦		₦
Ordinary share	150,000	Liquidator of CJ	27,500
7½% Debenture	100,000	Liquidator of BK	75,000
		Balance c/d	147,500
	250,000		250,000

Dr 7½ Debenture Account Cr

	₦		₦
Balance c/d	100,000	Bank account	100,000

Dr Ordinary Share capital account Cr

	₦		₦
Balance c/d	850,000	Bank a/c	150,000
		Liquidator of CJ	300,000
		Liquidator of BK	400,000
	850,000		850,000

Dr Share Premium Account Cr

	₦		₦
Balance c/d	55,000	Liquidator of CJ	30,000
		Liquidator of BK	25,000
	55,000		55,000

(d) CJBK Limited

Statement of Financial Position as at 1 January, 2012

		₦
Non-Current Assets (at valuation)		
Goodwill		164,500
Land and Building		300,000
Plant and Machinery		120,000
Motor Vehicle Account		68,000
		652,500
Current Assets		
Inventories	175,000	
Receivables	100,000	
Bank/cash	147,500	
	422,500	

Less: Payables	70,000	352,500
Financed by:		
Share Capital fully paid		
850,000 Ordinary share of ₦1 each		850,000
Reserves		
Share Premium		55,000
		905,000
Long Term Liabilities		
7½ Debenture		100,000
		1,005,000

Note:
Share Premium in BK Limited was derived as follows:

Purchase consideration agreed		500,000
Less: Cash	75,000	
Shares (nominal value)	400,000	475,000
Share Premium on acquisition		25,000

4.0 CONCLUSION

Absorption and amalgamation of business are inevitable in the business world. Accountants must be well equipped in the knowledge of accounting treatment of business combination transactions.

5.0 SUMMARY

The unit focuses on the accounting treatment of business combination inform of absorption and amalgamation.

6.0 TUTOR MARKED ASSIGNMENT

1. The following are the summarised Financial Statement of Kris Limited and Wren Limited as at 31 December, 2006.

			Kris Limited	Wren Limited
			₦	₦
Ordinary share (80,000 of ₦1)			80,000	
(20,000 of 25k)				5,000
Revenue Reserve			33,480	
Income account (debit)				(3,340)
Current account – Kris Limited				28,560
9% Debenture (secured)			20,000	
			133,480	30,220
Represented by:				
Non-current assets (BV)			49,420	14,300
Investment in Wren 16,000 shares			5,400	
₦4,000 9% Debenture in Kris				4,200
Current account with Wren			28,560	
Current Assets				
Inventories	35,760	6,800		
Receivables	9,320	2,440		
Cash	22,920	7,400		
	68,000	16,640		
Current Liabilities				

Payables	17,900	50,100	4,920	11,720
		133,480		30,220

A new company, Kriswren Limited, has been formed with a capital of 100,000 ₦1 shares to be issued to the shareholders of Kris Limited, and to the "outside" shareholders of Wren Limited for the acquisition of the two companies at 30 September, 2006. Each company will pay off its Account Payables and the expenses of liquidation which were ₦3,800 and N840 for Kris and Wren Limited respectively. The new company is to take over the balance of cash, the goodwill and the assets of the two companies. For the purpose of the scheme, the assets were revalued as follows:

	Kris Limited	Wren Limited
	₦	₦
Non-currents assets	110,000	19,600
Inventories	33,400	5,600
Receivables	6,820	1,720
Goodwill	50,000	10,000

The outside Debenture holder of Kris Limited are to be issued with 10% Debentures in the new company at the same par value as their present holding.

Required:

- To prepare the ledger account showing the liquidation of the two companies as they would appear in the respective books;
- To prepare the outline financial statement of Kriswren Limited as it would appear immediately after amalgamation indicating by way of note the number of shares in Kriswren held by the former outside shareholders of Wren Limited.

Question 2

The Statement of Financial Position as at 31 December 2011 of two companies which were in liquidation for the purpose of amalgamation are:

	Beta	**Trade**
Share Capital of N1 each	150,000	125,000
General Reserve	20,000	10,000
Profit and Loss account	6,500	5,200
	176,500	140,200
Current Liability		
Sundry Payables	13,500	9,800
	190,000	150,000
Non-Current Assets:		
Goodwill	40,700	26,500
Land and Building	29,200	35,500
Plant and Machinery	30,100	30,000
	100,000	92,000
Current Assets:		
Inventories	50,000	20,000
Receivables	20,000	22,000
Bank	20,000	16,000
	190,000	150,000

A new company BT Limited acquired both companies on 1 January, 2012 (excluding ₦5,000 retained in cash by the liquidators of each company to meet expenses) and assumed their liabilities as on that date. Provision for doubtful debts was agreed at 5% of amount outstanding and to write down the plant of Beta Limited by 12½% and that of Tade by 10%.

Aside from these, the book value of tangible assets were agreed to be correctly sated for all purpose.
It was also agreed that there was no goodwill and that no item for this should appear in the books of BT Limited, but for the purpose of apportionment of purchase consideration between the two liquidators, goodwill should be taken into account at the respective statement of financial position figures.

The purchase consideration was by agreement duly satisfied on 1st February, 2012 by the allotment at par to the respective liquidators of the necessary number of ordinary shares of 25k each in BT Limited, credited as fully paid.
Required:
a. Prepare the necessary ledger recording the above transactions in the books of the liquidators of both companies.
b. Prepare the account of the new company, BT Limited, indicating the apportionment of purchase consideration between the liquidators and indicating the numbers of shares allotted to each.

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UNIT 5: FINAL ACCOUNT OF A LIMITED COMPANY

1.0 INTRODUCTION

This unit deals with the features of a company's financial statement and preparation of final account for both internal and external users.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Explain the characteristics of company's financial statement
2. Explain basic components of each account in the financial statement

3.0 MAIN CONTENT

Apart from the normal accounting practices and procedures which are followed when final accounts are prepared, there are a number of legal and other requirements which have to be observed when the final accounts of limited companies are being prepared for publication purposes.

3.1 PECULIAR FEATURES OF A COMPANY'S FINANCIAL STATEMENT

1. Director's fee/remuneration and auditors' fees: These should be deducted before arriving at the profit before tax.

2. Share capital:

- **i.** ***Authorized share capital:*** This is the amount of capital (stipulated in the MOA) which the company has been authorized to raise.
- **ii.** **Paid up capital:** The total amount paid up, or credited as paid up, on the issued share capital. Part of the called-up capital against which the payment has been received, i.e. paid by the S/holders.
- iii. **Uncalled-up capital:** The total amount which has not been called up on the issued share capital.
- iv. **Calls in arrears:** This relates to amounts called for but not yet received.

v. **Calls in advance:** This relates to money received prior to payment being requested.

vi. **Reserve Capital:** This is a kind of capital that is kept to meet contingencies. By special resolution sets apart certain amount of share capital that is not called-up except in the event of winding up or for payment of meeting contingencies.

vii. **Allotment of Share:** Allotment is the acceptance of the offer to take up shares. A public company offering shares to the public for subscription cannot proceed to make a valid allotment unless it complies with the CAMD requirement and MOU.

viii. **Minimum Subscription:** A company cannot proceed to make any allotment of its shares to the public for subscription unless the minimum subscription of the issued amount has been received.

ix. **Under-subscription:** A case where all shares offered for public subscription may not be taken up by the public and that amount to under-subscription.

x. **Oversubscription:** It means the subscription received more than 100% of the issued amount.

3. **Taxation:** The taxation provision on current year's profit is deducted from the profit before tax and shown in the published Statement of Financial Position under the heading, "creditors: amounts falling due within one year".
4. **Appropriation account:** This is the account where the profit after tax is shared (i.e. appropriated). Items normally found in this account include transfer to reserves, interim dividend paid and proposed dividend.
5. **Reserves:** Reserves are amounts set aside out of profits earned by the company which are not designed to meet any liability, contingency, commitment or diminution in value of assets known to exist at the balance sheet date. Reserves may be voluntarily created by directors (as in the case of sinking fund reserves and general reserves) or statutorily required (as in the case of statutory reserves of banks).

The trading account of a Limited liability Company is the same as any other business.

However, the Statement of Comprehensive Income of a limited liability company contains items which would not be found in the Statement of Comprehensive Income of a Sole Trader and Partnership. These items are:

(i) Directors fees and salaries

(ii) Interest on debentures

(iii) Auditors fees

(iv) Taxation

The following accounts are prepared for a limited company:

a. Trading, Profit and Loss Account (Statement of Comprehensive Income)

b. Appropriation Account

c. Statement of Financial Position (Balance Sheet)

3.2 THE INFORMATION TO BE DISCLOSED UNDER STATEMENT OF PROFIT & LOSS AND OTHER COMPREHENSIVE INCOME ACCOUNT AND STATEMENT OF FINANCIAL POSITION

3.2.1 Statement of Profit & Loss and other Comprehensive Income account

Items to be disclosed are set out in the orderly manner in the following three clear divisions.

a. Items of expenses i.e. Which are normally regarded as being charges against the profit.
b. Items of income: and
c. Appropriations made out of profit.

a. The items of expense which must be shown in the published profit and loss Account are:

i. Depreciation of fixed assets.

ii. Debenture interest and other loan interest repayable within five years of the first day of the next financial year.

iii. Auditors' emoluments: - These fall into seven subsections namely.

1. Salary for services
2. fees, as a member of the Board
3. Benefits in kinds the cash value of which must be disclosed.
4. prior year adjustments arising from the disallowance of expenses for Nigeria tax.
5. The number of directors of the company earning over N20,000 pa. a.
6. The emoluments of the highest paid directors during the financial year.
7. The number of directors who have waived rights to receive emoluments during the year and the aggregate amount thereof.

iv. Directors pensions, but not including pension from contributory schemes.
v. Directors' compensation for loss of office.
vi. If material, the expenses for the hire of plant and machinery,
vii. Chairman's emoluments during the year
viii. Cash emoluments of employees who receive more than N10,000 per annum.

TURNOVER

The turnover (i.e. sales or main source of income) of a company for any financial year must be stated, either in the published accounts or by way of a note. The method by which the turnover is arrived at must also be disclosed. (Banks and discount houses: are exempted from this disclosure).

b. On the credit side of the published Statement of Comprehensive Income details of the following income must be shown.

i. Dividends and interest received from quoted investments.

ii. Dividends and interest from unquoted investments.

iii. Details of income from rents of land (if substantial) after deduction of rates and other outgoings.

c. **Appropriation of profit:** This section involves no difficulty since it covers the normal appropriations which are made after the net profit has been established. Two of these are:

i. Amount charged for corporation tax.

ii. Dividend paid and proposed.

3.2.2 Disclosures in the Statement of Financial Position

The following items must be shown either on the face of the Balance sheet or by additional notes attached to it.

1. The Authorised share capital .
2. The issued share capital-showing the amount called up.
3. The share premium Account
4. Shown under separate headings to far as they are not written off:
   a. The preliminary expenses
   b. Issue and commission expenses of shares and debentures.
   c. Discounts on Debentures
   d. Discount on shares.
5. Shown under separate headings.
   a. Non-Current assets
   b. Current assets
   c. Assets that are neither fixed nor current
   Non-current assets:
      i. To be stated at cost of valuation
      ii. Aggregate depreciation to data of Balance sheet must be shown where any fixed assets are shown at valuation other than cost, than the company should disclose the years of the valuations and the values applicable to each year, so far as they are known to the directors. This part should be shown by way of notes.
      In the year which the fixed asset is revalued the company must give particulars of the valuers or their qualifications, and of the bases of valuation used by them.
6. Aggregate reserves and provisions (other than depreciation provisions which are shown against fixed assets) must be shown, if material.
7. The following items must be shown:

a. Quoted investments. This means investments that are dealt in on a recognized stock Exchange.

The market value of the investments at the Balance sheet date must be shown as a note,

b. Unquoted investments. These are investments obviously not dealt in on a recognized stock Exchange.

c.i. Loans not repayable within five years

ii. Loans which will not be fully repaid within five years.

3.3 FORMAT OF THE FINAL ACCOUNTS

a. Using the columnar format (Internal Use)

Pelumi Ltd

Statement of Profit and Loss and other Comprehensive Income Account for the year ended xxxx

Dr							**Cr**
		₦	₦		₦	₦	
Opening Inventory			xx	Sales		xx	
Add: Purchases	xx		Less:	Return inwards	xx		
Carriage inwards	xx						
Less: Return outwards		xx	xx				
			xx				
Less: Closing Inventory		xx					
COST OF GOODS SOLD		xx					
GROSS PROFIT		xx					
			xx			xx	
Expenses:				Gross Profit b/d	xx		
Wages and salaries			xx	Discount received		xx	
General expenses			xx	Income from quoted investment	xx		
Advertising			xx	Income from unquoted investment	xx		
Insurance			xx	Reduction in provisions	xx		
Debentures Interest			xx	Interest receivables		xx	
Provisions for doubtful debt			xx				
Directors remuneration		xx					
Auditors remuneration		xx					
Depreciation			xx				
NET PROFIT			xx				
			xx			xx	

Dr		Appropriation Account		Cr
		₦		₦
General reserve	xx		Profit b/f from last year	xx
Revenue reserve	xx		Net profit b/d	xx
Corporate tax		xx		
Proposed divided		xx		
Goodwill written off		xx		
Balance c/f		xx		
		xx		xx

Dr **Statement of Financial Position As At xxx** **Cr**

		₦	₦	**Non-Current**	₦	₦	₦
Authorised Capital:				Assets:	Cost	Depr.	NBV
500 ordinary share at ₦0.25 each		x		Land & Building	x	x	x
8% preference share @ ₦1 each		x		Furniture	x	x	x
			x	Equipment	x	x	x
Issued Capital:				Premises	x	x	x
250 ordinary shares at ₦0.25 each		x			x	x	x
8% Preferences shares at ₦1 each		x		Goodwill			x
Reserves:				Investments:			
Retained profit	x			Quoted Investments		x	
Share premium	x			Unquoted investments	x		
Revaluation reserve		x		Shares in group company	x	x	
General reserve	x	x		Current Assets:			
Non-Current Liabilities:				Inventory		x	
10% Debenture		x		Receivables		x	
Current Liabilities:				Bank		x	
Trade payables	x			Cash		x	
Overdraft		x		Accrued Income	x		
Bank loan		x		Prepared expenses		x	
Bills payable		x		Bills receivables	x	x	
Accrued expense	x						
Prepaid income	x						
Proposed dividend		x					
Corporate tax		x	x				
			xx				xx

b. Vertical Format (Internal Use)

Formats PRINCE PLC

Statement of Profit or Loss Account for the period ended 31st March 20xx

Turnover		xx
Less returns inward		(xx)
Net sales		**xx**
Less Cost of Sales		
Opening Inventory	xx	
Add purchases	xx	
Add carriage inwards	xx	
Less returns outward	(xx)	
Cost of goods available for sales	**xx**	
Less closing inventory	(xx)	
Cost of goods sold		(xx)
Gross Profit		**xx**
And Other Incomes		
Commission income	xx	
Rental income	xx	
Dividend/Investment income	xx	
Royalty receivable/income	xx	
Other incomes	xx	xx
Total income		**xx**
Less Expenses		
Salaries and wages	xx	
Rent and rates	xx	
Insurance premium	xx	
Carriage outwards	xx	
Electricity	xx	
General expenses	xx	
Advertisement	xx	
Bad debts/irrecoverable debts	xx	
Increase in provisions for doubtful debts	xx	
Audit fees	xx	
Director’s remuneration	xx	
Debenture interest/loan interest	xx	
Other expenses	xx	(xx)
Profit before tax		xx
Income tax expense (i.e. taxation)		(xx)
Profit for the period		**xx**

Statement of Financial Position as at 31st March 20xx

Non-Current Assets	**Cost**	**Accum. Depn**	**NBV**
Freehold land & building (properties)	xx	xx	xx
Plants and equipment	xx	xx	xx
Motor vehicles	xx	xx	xx
Furniture and fittings	xx	xx	xx
	xx	**xx**	**xx**
Goodwill			xx
Long term investments			xx
Other intangible assets			xx
Total non-current assets			**xx**
Current Assets			
Inventory (i.e closing inventory)		xx	
Trade receivables (i.e. trade debtor)	xx		
Less provision for doubtful debts	(xx)	xx	
Prepaid expenses		xx	
Accrued incomes		xx	
Bills receivables		xx	
Short term investments		xx	
Bank balance		xx	
Cash in hand		xx	
Total current assets			**xxx**
Total assets			**xxx**
Equity and Liabilities			
Equity (Capital & reserves):			
Share capital		xx	
CRRF		xx	
Share premium		xx	
Revaluation surplus reserves		xx	
Other reserves		xx	
Retained earnings		xx	
Shareholders' funds		**xxx**	
Non-Current Liabilities			
Debentures stock	xx		
Loan stock/loan notes	xx		
Other long term loans	xx		
Deferred tax	xx		
Long term provisions	xx	xx	
Current Liabilities			
Trade payable (i.e. trade creditors)		xx	
Accrued expenses		xx	
Accrued loan/debenture interest		xx	
Income in advance		xx	
Bills payable		xx	
Short term loans		xx	
Income tax payable		xx	
Short term provisions		xx	
Total equity and liabilities			xx

Total equity and liabilities	**xxx**

FORMAT FOR EXTERNAL USERS (Published Account)
A complete set of published financial statement will include the following:

i. Statement of financial position (formally known as balance sheet).

ii. Statement of profit or loss and other comprehensive income

iii. Statement of changes in equity

iv. Statement of cash flows

v. Statement of value added (not compulsorily required by the IFRS).

vi. Accounting policies and explanatory notes.

HOLINESS PLC
Statement of Profit or Loss and Other Comprehensive Incomes
For the Period ended 31st December, 20xx

	$
Revenue	x
Cost of sales	(x)
Gross profit	**x**
Other incomes	x
Distribution costs	(x)
Administrative expenses	(x)
Other expense s	(x)
Financial costs	(x)
Profit before tax	**x**
Income tax expense	(x)
Profit for the period (or year)	**x**
Other comprehensive income	
Gains on property revaluations	x
Total comprehensive income	**xx**

The following should be noted:

- That the impact or effect of a discontinued operation has been ignored for simplicity purpose.
- That the other items of other comprehensive income have been ignored for easier understanding.
- Other comprehensive income includes:

Actuarial gains or losses on defined benefits pension, exchange difference on translating foreign operations, cash flow hedges etc.

Explanation and Breakdown of the Format

1. Revenue

Sales	x
Less return inwards	(x)

Revenue	**xx**

That is revenue represent net sales and the above sales doe not includes sales tax, VAT and ttrade discounts to customers.

2. **Cost of Sales**

Opening inventory	x
Add purchases	x
Add carriage inward if any	x
Less return outwards	(x)
Less closing inventory	(x)
	xx

NB: All manufactory cost or cost of production if any will be added in deriving the above cost of sales including depreciation charges on manufacturing building and manufacturing plant and equipment.

3. **Other income**

This is the additions of all forms of income earned other than sales revenue

4. **Distribution Cost**

Depreciation charges on motor vehicles	x
Sales person commission	x
Salaries to sales director/other sales person	x
Carriage outwards	x
Selling expenses	x
Discount allowed	x
Other distribution cost	x
	xx

5. **Administration Expenses**

Salaries and wages	x
Rents and rates	x
Insurance premium	x
Advertisement	x
Impairment loss	x
Depreciation charges	x
Bad debts/irrecoverable debts	x
Increase/(decrease) in provisions for bad debts	x/(x)
Postages and stationers	x
Audit fees	x
Directors remunerations	x
Other administrative expenses	x
	xx

6. **Other Expenses**

This is the addition of all expense which is not part of cost of sales, distribution cost, administrative expenses and finance cost e.g. redundancy cost.

7. **Finance cost**

Interest expenses on debentures and other loans	x

Add preference dividends on redeemable preference shares	x
	xx

8. Income Tax Expenses

Current period income tax provision (Always in the additional information	x
Less over-provision of tax in the preceding period	(x)
Add under-provision of tax in the preceding period	x
Less decrease in deferred tax provisions	(x)
Add increase in deferred tax provisions	x
	xx

Under-provisions of tax is excess of the amount of tax actually paid in respect of the preceding period over the estimated amount or over the amount of tax provided in the preceding period (always on the debit column of the trial balance if it exist).

Over-provision of tax is excess of tax estimated or provided in the preceding period over the amount of tax actually paid in respect of the preceding period (always on the credit column of the trial balance if it exist).

9. Gains on Property Revaluation

This represents the revaluation surplus from the revaluation of non-current assets during the current period or year,

Example 1

The following trial balance is extracted from the books of Joloade Ltd as an 31st December, 2013.

PARTICULARS	Dr ₦	Cr ₦
Inventory 1/1/2013	10,000	
Sales		95,250
Purchases	65,340	
Carriage Inwards	440	
Carriage outwards	160	
Debtors and Creditors	21,000	23,000
Ordinary share capital		100,000
7% Preference share capital		30,000
6% Debentures		24,000
Goodwill	20,050	
Preliminary expenses	3,210	
Land and Building	45,000	
Equipment	35,000	
Motor vehicle	55,000	
Bank	28,560	
Cash in hand	24,000	
Provision for depreciation: Equipment		3,050
Motor vehicle		4,300
General reserve		13,200
Share premium		5,000
Interim ordinary dividend	4,050	
Profit and loss		28,200
Motor expenses	780	
General expenses	480	
Debenture interest	740	
Rates	1,520	
Salaries & Wages	4,370	

Directors remuneration	4,250	
Auditors remuneration	2,050	
	326,000	326,000

Additional Information:

i. Inventory at 31/12/2013 was ₦30,000.
ii. Accrued debenture interest and salary are ₦700 and ₦250 respectively.
iii. Transfer ₦4100 to general reserve
iv. Authorized share capital is ₦50,000 in Preference shares and ₦300,000 in ordinary shares.
v. Provision for depreciation: Motor vehicle – ₦4,5000
Equipment - ₦2,300
vi. Write off goodwill ₦1,500; Preliminary expenses ₦3,210
vii. Corporation Tax – ₦2,500
viii. Provide for preference dividend ₦2,100 and final ordinary dividend of 5%. You are required to prepare the final accounts of Jolaade Ltd for the year ended 31st December, 2013.

Solution to Example 1

Jolaade Ltd

Dr Trading, Profit and Loss Account for the year ended 31st December 2013 Cr

		₦	₦		₦
Opening inventory			10,000	Sales	
	95,250				
Add: Purchases	65,340				
Carriage Inwards	440	65,780			
			75,780		
Less: Closing Stock			30,000		
COST OF GOODS SOLD			45,780		
GROSS PROFIT		49,470			
		95,250			95,250
Expenses:				Gross profit b/d	49,470
Carriage outwards			160		
Salaries & Wages(wk1)		4,620			
Directors remuneration		4,250			
Auditors remuneration		2,050			
Rates			1,520		
Motor expenses		780			
Debenture Interest (wk2)		1,440			
General expenses			480		
Depreciation:	Motor vehicle		4,500		
	Equipment		2,300		
NET PROFIT			27,370		
			49,470		49,470

Dr Appropriation Account Cr

			₦		₦
Goodwill			1,500	Net profit b/d	
27,370					
General reserve		4,100		Profit from last year	28,200
Preliminary expenses written off		3,210			
Corporation tax		2,500			
Ordinary dividend:	Interim		4,050		
	Final(wk6)		5,000		
Preference dividend – Final			2,100		
Retained Profit		33,110			
			55,570		
55,570					

Statement of Financial Position As At 31st December, 2013

	₦	₦
Authorized Share Capital:		
Ordinary share capital		300,000
Preference share capital		50,000
		350,000
Issued share capital:		
Ordinary share capital		100,000
Preference share capital		30,000
		130,000
Reserves:		
Share premium	5,000	
General reserve(wk5)	17,300	
Retained profit	33,110	55,410
Long Term Liabilities		
6% Debenture		24,000
Current Liabilities:		
Creditors	23,000	
Debenture accrued	700	
103,560		
Salary accrued	250	
Corporation tax	2,500	
Proposed Dividend:		
Ordinary shares (wk6)	5,000	
Preference shares	2,100	33,550
		242,960

	₦	₦	₦
Non-Current Assets:	Cost	Depr	NBV
Land & Building	45,000	-	45,000
Motor vehicle	55,000	8,800	46,200
Equipment	35,000	5,350	29,650
	135,000	14,150	120,850
Goodwill (wk3)			18,550
Current Assets:			
Inventory		30,000	
Debtors		21,000	
Bank		28,560	
Cash		24,000	
		242,960	

Workings (contd):

1. Ordinary shares dividend: 5% x ₦100,000 = ₦5,000
2. Depreciation:
   a. Motor vehicle: ₦4,300 + ₦4,500 = ₦8,800
   b. Equipment: ₦3,050 + ₦2,300 = ₦5,350

Workings

Dr Salaries and Wages A/c Cr

	₦		₦
Bal b/f	4,370	Bal c/d	4,620
Accrual	250		
	4,620		4,620

Dr Cr

	₦		₦
Bal b/f	4,370	Bal c/d	4,620
Accrual	250		
	4,620		4,620

Dr Goodwill Cr

	₦		₦
Bal b/d	20,050	Written off	1,500
		Bal c/d	18,550
	20,050		20,050

Example 2

Goodness Plc is an established merchandising business making accounts annually to 30th September.

The following is the trial balance of the company as at 30th September, 20x5

	Dr	Cr
	₦'000	**₦'000**
Ordinary shares of 50k each		150,000
Share premium		230,000
Revaluation surplus		80,000
Retained earnings		310,500
Sales		1,800,000
Purchases	950,000	
Inventory at 1st October 20x4	300,000	
Returns inwards	120,000	
Returns outwards		100,000
Salaries and wages	200,000	
Directors remunerations	160,000	
Insurance and rates	140,000	
Land	250,000	
Building at cost	400,000	
Accumulated depreciation on building		110,000
Plant and equipment at cost	850,000	
Accumulated depreciation on plant and equipment		220,000
Motor vehicles at cost	350,000	
Accumulated depreciation on motor vehicles		130,000
Furniture and fitting at cost	550,000	
Accumulated depreciation on F&F		200,000
Trade receivables	250,000	
Trade payables		310,000
Long term investment	400,000	
Short term investment	200,000	
Cash in hand	150,000	
Long term loan		250,000
Investment income		120,000
Commission received		150,000
Other income		510,000
Short term loan		280,000
Loan interest	56,000	
Sundry expenses	100,000	
Bank overdraft	-	475,500
	5,426,000	5,426,000

Relevant notes

i. Inventory at 30th September 20x5, valued at cost was ₦500 millions. Its net realizable value is estimated at ₦420 million as a result of obsolescence.
ii. At 30th September, insurance and rates outstanding amounted to ₦60 million.
iii. At 30th September, prepaid wages amounted to $30 million.
iv. Provision for corporation tax of ₦180 million is to be made on the profit for the year.
v. The company depreciates non-current assets as follows:

Land	0% on cost
Building	10% on cost
Plant and equipment	20% on cost
Motor vehicles	25% on reducing balance
Furniture and fittings	15% on reducing balance

Required:

a. Prepare the following statements for internal use:
b. Statement of profit or loss and other comprehensive income for the year ended 30th September, 20x5
c. Statement of Financial Position at 30th September, 20x5

Solution

Tutorial notes

1. **Closing inventory:** since the NRV of ₦420m is lower than the cost value of $500m, it means that, the closing inventor should be recognized at ₦420m (IAS 2) while the cost value of ₦500m should be ignored.
2. **Accrued insurance and rate:** The accrued insurance and rate of ₦60m should be recognized under current liabilities in the SOFP. In the income statement, the accrued expense of ₦60m will be added to the trial balance value of ₦140m (i.e. ₦60m + ₦140m = ₦200m.
3. **Prepaid wages:** The prepaid usages of ₦30m should be recognized under current asset (after trade receivables) in the SOFP. The prepaid wages of 30m will be subtracted from the trial balance value of ₦200,000 in the income statement,
4. **Provision for income (corporate) tax:** The provision for income tax of $180m should be recognized under current liabilities in the SOFP. The ₦180m tax provision will be subtracted from profit before tax in order to derive profit for the year in the income statement.

5. Calculations of depreciation charges:	**₦'000**
Land	0
Buildings	40,000
Plant and equipment	70,000
Motor van	55,000
Furniture & fittings (15% on NBV) = 15% x (550,000)	82,500

The calculated current yea depreciation charges should be recognized as an expense in the income statement. It should be added to the given accumulated depreciation in the trial balance if any, in other to derive the net book value or carrying amount of non-current assets that will shown in the SOFP.

Goodness Plc

Statement of Profit or Loss year ended 30 September, 20x5

	₦'000	₦'000
Sales		1,800,000
Less returns inwards		(120,000)
Net sales		**1,680,000**
Less cost of sales		
Opening inventory	300,000	
Add purchases	950,000	
Less returns outwards	(100,000)	
Cost of goods available for sale	**150,000**	
Less closing inventory (nt 1)	(420,000)	
Cost of goods sold		**(730,000)**
Gross Profit		**950,000**
Add other incomes		
Commission received	150,000	
Investment income	120,000	
Other incomes	510,000	780,000
Total incomes		**1,730,000**
Less expenses		
Salaries & wages (200,000 – 30,000)	170,000	
Directors remunerations	150,000	
Insurance & rates (140,000+60,000)	200,000	
Loan interest	56,000	
Sundry expenses	100,000	
Depreciation charges		
Buildings	40,000	
Plant and equipment	70,000	
Motor vehicles	55,000	
Furniture & fittings	82,500	(923,500)
Profit before tax (PBT)		**806,500**
Taxation (note 4)		(180,000)
Profit for the year		**626,500**

Calculation of movement in retained earnings

	₦'000
Retained earnings in the trial balance	310,500
Add profit for the year	626,500
Less dividends paid	(0)
SOFP retained earnings	**937,000**

Statement of financial position as at 30 September 20x5

Non-current assets	Cost	Accum. Dep	Carrying amount
	₦'000	**₦'000**	**₦'000**
Land	250,000	0	250,000
Buildings	400,000	150,000	250,000
Plant and equipment	350,000	290,000	60,000
Motor vehicles	350,000	185,000	165,000
Furniture & fittings	550,000	82,500	467,500
	1,900,000	**707,500**	**1,192,500**
Long-term investment			400,000
			1,592,500
Current assets			
Inventory		420,000	
Trade receivables		250,000	
Prepaid wages		30,000	
Short term investments		200,000	
Cash in hand		150,000	1,050,000
Total assets			**2,642,500**
Equity & Liabilities			
Equity (capital & reserves):			
Ordinary share capital			150,000
Share premium			230,000
Revaluation surplus			80,000
Retained earnings (from movement in retained earnings)			937,000
			1,297,000
Non-current liability			
Long-term loans			250,000
Current liabilities			
Short-term loan		280,000	
Bank overdraft		475,500	
Taxation (nt 4)		180,000	
Accrued insurance and rates		60,000	995,500
Total equity and liabilities			**2,642,500**

4.0 CONCLUSION

Preparation of final account of a limited company for both internal users and external users (public) is crucial in financial accounting.

5.0 SUMMARY

This unit discussed in detail the accounting and recommended format guiding the preparation of final account of a limited company. Peculiar features are clearly explained and accounting treatment of each element.

6.0 TUTOR MARKED ASSIGNMENT

1. List 5 peculiar features of a Company Financial Statement

2. Explain the following terms:

i. Authorised share capital
ii. Paid up capital
iii. Reserves capital
iv. Allotment of shares
v. Under-subscription

3. OGO OLUWA Ltd presents to you the following list of balances of 31st December 20x1

	₦
200,000 ordinary shares of N1 each	200,000
Cash and bank balances	39,686
Freehold Premises	50,000
Wages and Salaries	21,400
Profit and Loss Account 1/1/20x1	2,500
Discount allowed	6,450
Purchases	281,600
Trade Debtors	30,030
Interim Preference Dividend	3,000
50,000 8% Preference shares of N1 each	50,000
Provision for bad debts 1/1/20x1	905
Return inwards	10,300
Debenture interest	3,000
10% Debenture Interest	50,000
Interim Ordinary dividend	5,000
Directors fees	15,600
Share premium	8,000
Postages and telephone	5,800
General reserves	10,000
Plant and machinery (cost N300,000)	180,000
Insurance expenses	2,000
Trade creditors	20,020
Return outwards	17,350
Sales	409,641
Stock 1/1/20x1	23,800
Discount received	9,250

Additional information are as follows:-

(a) The authorised share capital of the company is ₦400,000 ordinary share of ₦1 each and 100,000 8% preference share of ₦1 each.
(b) Stock on 31st December 20x4 was ₦27,280
(c) During the year, goods worth ₦6,500 were lost to theft. No entry had been made in the books to reflect this.
(d) Insurance prepaid was ₦200
(e) During the year a plant originally costing ₦50,000 and on which ₦30,000 depreciation had been provided was sold for ₦22,000. The proceeds were included in sales.
(f) Depreciation has been and is to be provided on plant and machinery at 10% on cost.
(g) Provision for bad debt is to be maintained at ₦2,500
(h) The directors wish to provide for (i) a final preference dividend (ii) a final ordinary dividend of 5%.

You are required to prepare:

(a) Statement of Profit and Loss and other comprehensive income.
(b) Appropriation accounts for the year ended 31st December 20x1
(c) Statement of financial position as at that date.

7.0 REFERENCES/FURTHER READING

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MODULE 4: INTRODUCTION TO INTERPRETATION OF ACCOUNTS AND FINANCIAL STATEMENT ANALYSIS

UNIT 1: FINANCIAL STATEMENT ANALYSIS

1.0 INTRODUCTION

This unit deals with financial statement analysis and interpretation.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Explain components of financial statement
2. State the objectives of financial statement
3. Identify different ratios and their application

3.0 MAIN CONTENT

3.1 FINANCIAL STATEMENT ANALYSIS

It is the process of providing information about the financial performance and position of an entity in terms of profitability, liquidity, growth and survival to users so as to enable them makes informed investment and other economic decisions. The rationale behind every financial statement analysis is for decision-making from the financial information that has been obtained. Financial information is needed to predict, compare and evaluate company performance and position so as to measure the level of quality management put into the business.

3.2 ACCOUNTING AS AN INFORMATION SYSTEM

Accounting can be seen as an important part of the total information system within a business.

Financial Accounts: geared toward external users of accounting information

Management Accounts: aimed more at internal users of accounting information

SELF ASSESSMENT EXERCISE

Describe accounting as an information system

3.3 THE PURPOSES OF ACCOUNTING INFORMATION

i. To determine performance of an entity over time.
ii. To determine the financial position of an enterprise at a particular point in time.
iii. To measure changes in cash flow over period.
iv. To evaluate management efficiency.
v. To assess the going concern status of an entity.
vi. To predict the collapse or corporate failure of an entity.
vii. To measure the entity's compliance to all relevant laws and regulation (e.g. IFRS).

Users of Accounting Information

Users	**Information needs**
1. Management	Planning, controlling and decision making
2. Shareholders	Investment decisions
3. Lenders	Liquidity position assessment
4. Employees	Profitability and welfare assessment
5. Suppliers	Liquidity position assessment
6. Competitors	Viability and competitiveness
7. Financial Analysts	Public education and records
8. Government agencies	Taxation assessment
9. General public	Social responsibility assessment

SELF ASSESSMENT EXERCISE

State the purposes of accounting information.

3.4 OBJECTIVES OF FINANCIAL STATEMENTS

Financial statements are usually produced out of the accounting records maintained by companies. Generally accepted accounting principles and procedure are followed to prepare these statements. The purpose of financial statement is for decision making majorly but among others, we have financial statement to

1. Know the earning potentials of an enterprise
2. To be provided with reliable facts & figures about economic resources and also the obligations that an enterprise has to undertake.
3. Financial statement are also needed to be able to disclose information related to the financial statement which may be of relevance to users of statements
4. Changes in noteworthy

They also provide reliable information about changes in the net-worthy of a company that has resulted from trading and other activities.

LIMITATIONS OF FINANCIAL STATEMENTS

1. Comparison of the financial statement of two or more companies may be difficult if the statement of accounting policies used for preparing the financial statements is known.
2. Financial statements are prepared to show true and fair view hence the actual figures may not be shown in the financial statements.
3. Financial statements are prepared on going concern basis while organization may even fold up few months after the financial statement date.
4. Application of accounting concepts and commenting may not be the same from company to company when compared.
5. Financial statements only ensure the disclosure of monetary facts. Non monetary facts can only be disclosed in note to the financial statements.

SELF ASSESSMENT EXERCISE

State the objectives and limitations of financial statements

3.5 SOURCES OF DOCUMENT FOR FINANCIAL RATIO COMPUTATION

A company annual report contains lot of useful financial information which are used by the financial analyst. A typical annual report of an organization should contain the following information:

1. Statement of financial position
2. Statement of profit or loss & other comprehensive income

3. Change in Equity account
4. Statement of cash flow
5. 5 years financial summary
6. Notes to the financial statement
7. Auditors Report
8. Directors Report
9. Audit Committee Report
10. Chairman’s statement
11. Results at a glance
12. Notice of annual general meeting
13. Chairman’s statement
14. Report of the audit committee
15. Performance charts (such as bar charts, pie charts etc)
16. Statement of unclaimed dividend warrants

Usually in the statement of financial analysis, focus is usually on the statement of financial position and also on the statement of profit or loss and other comprehensive income.

Also, other statement in an annual report should provide information that could ease the understanding of the financial statement analysis.

STATEMNT OF FINANCIAL POSITION

This is the most significant financial statement that usually indicates the state of affairs of the company on a particular date. Usually statement of financial position is to show the financial condition of a company. The statement of financial position gives

1. A concise and precise overview of the company assets and liabilities
2. Information about the company’s liquidity and solvency

STATEMENT OF PROFIT AND LOSS AND OTHER COMPREHENSIVE INCOME

This statement is a financial measure of the company’s performance during a particular period of time. The statement presents the summary of income, expenses and the net profit/loss of a company.

It also shows the profitability state of the company therefore the statement of profit or loss and other comprehensive income gives concise summary of the company's income and expenses for a given period of time.

SELF ASSESSMENT EXERCISE
Outline sources of document for the calculation pf financial ratios.

3.6 INTERPRETATION OF FINANCIAL STATEMENT

This is the in-depth analysis of financial statement using certain analytical instruments and techniques to enable users have a better understanding and gain insight into such financial statement with a view to making informed decisions. Interpretation of accounts helps in the appraisal of the component, of the capital structure and the lost associated to them.

Financial ratio shows the relationships between two or more financial data in a financial statement; it may be expressed as a percentage or fraction of another figure or group of figures in the same financial statement. The following are the varied types of comparison obtainable

1. Time sense Analysis: This involves company the calculated ratio, for the present with past ratio so as to be able to ascertain whether there has been an improvement or decline in the financial state of the company overtime.
2. Cross-sectional Analysis: This involves company the ratio of the one company with some other selected company in the same industry at the same point in time
3. Industry-Average Comparison: Here comparison between the company and the average ratio obtained from the industry is made.
4. Pro-Forma Analysis: Here, comparison between the computed ratio of the company and the future ratio is budgeted information is made

SELF ASSESSMENT EXERCISE
Identify four types of comparison obtainable in financial ratio

4.0 CONCLUSION
Clear understanding of the components of financial statement will aid its interpretation for potential users.

5.0 SUMMARY
In this unit, meaning of financial statement and analysis, objectives of financial statement and limitations of financial statement were discussed. Also, sources of document for the computation of financial ratios were identified.

6.0 TUTOR MARKED ASSIGNMENT

Question 1: The trial balance of Danladi Bako Limited as at December 31, 2014 is as follows:

	Debit	Credit
	₦	₦
Ordinary Share Capital		150,000
Purchases and Revenue	400,200	547,800
Inventory at January 1, 2014	35,100	
Returns	1,800	2,400
Wages	69,240	
Rent	19,500	
Motor expenses	5,580	
Insurance	1,140	
Irrecoverable debts	180	
Allowance for doubtful receivables January 1, 2014		882
Discounts	1,296	2,433
Light and cooling expenses	4,611	
Bank overdraft interest	111	
Motor vehicles at cost	36,000	
Accumulated depreciation Motor Van at January 1, 2014		18,360
Fixtures and fittings at cost	42,000	
Accumulated depreciation on fixtures and fitting at January 1, 2014		25,200
Land	150,000	
Receivables and payables	25,995	34,506
Bank	5,118	
Building at cost	150,000	
Aggregate depreciation on building at January 1, 2014		9,000
Retained earnings at January 1, 2014		157,200
	947,781	947,781

You are given the following additional information

i. Inventory as at December 31, 2014 was ₦38,520

ii. Rent prepaid was ₦1,500 and light and cooling expenses owed was ₦690 as at December 31, 2014.

iii. Land is to be revalued at ₦375,000 as at December 31, 2013

iv. Following a final review of the receivables as at December 31, 2014, Danladi Bako decides to write off another debt of ₦195. The company also wishes to maintain the allowance for doubtful receivables at 3% of the yearend balance.

v. Depreciation is to be provided on a straight line basis as follows:
- Building at 2%
- Fixtures and fittings, assuming a useful economic life of five years with no residual value.
- Motor vehicle at 25%

A full year's depreciation is charged in the year of acquisition and none in the year of disposal.

You are required to:

Prepare a Statement of Profit or Loss and other Comprehensive Income for the year ended December 31, 2014.

Question 2

The Statement of Comprehensive Income and Statement of Financial Position of OLORUNNIWO NIGERIA PLC, as at 31st December, 2007 and 2008 are as follows:

	2008	2007
	₦'000	₦'000
Turnover	2,713,286	3,089,973
Cost of Sales	(1,907,419)	(1,954,626)
Gross Profit	805,866	1,135,347
Operating expenses	(664,738)	(553,645)
Trading Profit	141,128	581,702
Exceptional items	79,157	(5,848)
Other Income	72,859	37,085
Interest charges	(105,976)	(80,273)
Profit on ordinary activities before tax	284,168	532,666
Tax on profit on ordinary activities	(69,938)	(191,265)
Profit on ordinary activities after tax	214,230	341,401
Debenture Redemption Reserve	--	(10,000)
Dividend Proposed	(131,875)	(199,313)
Retained profit for the year	81,355	132,088
Reserve at the beginning of the year	464,434	332,346
Transfer from Redemption Reserve	40,000	---
Transfer to General Reserve	585,789	464,434

Statement of Financial Position as at 31st December

	2008	2007
	₦'000	₦'000
Non-Current Assets	260,739	248,609
Long-term investment	160	160
	260,899	248,769
Current Assets:		
Inventory	1,456,182	1,382,073
Receivables	579,876	310,322
Bank & Cash balances	525,574	792,059
	2,561,632	2,489,454
Payable: (Due within one year)	(1,479,217)	(1,557,347)
Net Current Assets	1,082,415	932,107
Payables (Due after one year)	(10,795)	(8,700)
Provision for liabilities & charges	(258,701)	(179,713)
	1,073,818	992,643
Equity & Reserves		
Called up share capital at 50k each	332,188	332,188
Reserves	741,630	660,275
	1,073,818	992,463
Market price of shares	45k/share	60k/share

You met the MD & Financial Controller of Olorunniwo Nigeria Plc to discuss the figures, and they explained that the reduction in trading profit was due to various adverse economic, infrastructural & socio-political factors prevalent in 2008.
You are required to:
(a) Compute the following ratios for 2007 and 2008
i. Gross Profit Margin
ii. Return on Capital employed
iii. Net Profit Margin
iv. Current Ratio
v. Liquid Ratio
vi. Receivables collection period
vii. Proprietary Ratio
viii. Earnings per share
ix. Dividend per share
x. Price Earning Ratio
(b) Based on the ratios computed in (a) above comment on the company's profitability and liquidity position over the two years period.
(c) Indicate the measures the company should take to improve the collection of debts and cash flow and set out the central and accounting information you would require for this purpose.

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UNIT 2: CLASSIFICATION OF FINANCIAL RATIO

1.0 INTRODUCTION

This unit deals with classification of ratios.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Explain different types of financial ratio
2. Interpret financial statement
3. Analyse financial statement of banks.

3.0 MAIN CONTENT

3.1 CLASSIFICATION OF FINANCIAL RATIO

1. Profitability Ratio/Returned ratio
2. Efficiency or statement ratio
3. Liquidity or short term financial stability ratio
4. Long term solvency or debt ratio
5. Investor or stock markets ratio

SELF ASSESSMENT EXERCISE

Classify financial ratio into five with one example

3.2 PROFITABILITY AND RETURNS RATIO

Profit is the difference between income and expenses over a period of time (usually one year). Profit is ultimate objective of a company and a company will have no future if it fails to make profit which is the primary purpose of being in business.

1. ***RETURN ON CAPITAL EMPLOYED (R.O.C.E)*** is an important means to measure the performance of a business. It measure the overall performance of a business by comparing inputs (capital invested) with output (profit)

1. ROCE $= \frac{Profit}{Capital\ employed} \quad \frac{100}{1}$

2. ROCE $= \frac{Profit\ before\ tax}{Capital + reserves} \quad \frac{100}{1}$

3. ROCE $= \frac{Profit\ before\ interest\ and\ tax}{Total\ asset\ (excluding\ deferred\ tax\ laibility)}$

2. GROSS PROFIT MARGIN

This relates the gross profit of the business to the revenue obtained that same period. It measure the percentage of sales revenue earned as profit after deducting cost of sale.

Gross Profit Margin = $\frac{Gross\ Profit}{Sales} \quad \frac{100}{1}$

3. NET PROFIT MARGIN

This relates the net profit (PBIT) of the business with the sales revenue of the same period. The operational performance of a business should be considered from the perspective of net profit and not just gross profit margin.

Net Profit Margin = $\frac{Profit\ before\ interest\ \&Tax}{Sales\ Revenue} \quad \frac{100}{1}$

4. RETURNS ON TOTAL ASSETS

This compares the profit for the period (PBIT) with the total assets employed by the entity in generating the profit during the same period.

Returns on Total Assets: = $\frac{Net\ Inocme}{Total\ Asset} \quad \frac{100}{1}$

5. RETURNS ON SHAREHOLDER FUND/ EQUITY

This compares the amount of profit for the period available to the owners with the owner's states.

ROSE/ROSF = $\frac{Net\ profit\ after\ Tax\ \&\ preference\ dividends}{Ordinary\ share\ capital+reserves}$

SELF ASSESSMENT EXERCISE

List five examples of profitability ratios

3.3 EFFICIENCY OR ACTIVITY RATIO

These are ratio that help to ascertain the efficiency of an entity in the utilization of their resources with the business.

1. INVENTORY HOLDING PERIOD

This measure the average period or length of time in which inventory are being held. It measure the average no of day or weeks that it takes to sell the finished product of an entity

Inventory holding period: $\frac{Average\ inventory}{Cost\ of\ Sales}$ x $\frac{365\ days}{}$

Average Inventory = $\frac{Opening\ Inventory+Closing\ inventory}{2}$

2. TRADE RECEIVABLE COLLECTION PERIOD

It measure on average, how long it takes a business, customer to pay the amount it owes its creditor. It measures the average no of days or weeks it takes to recap it money from debtors.

Trade Receivable Collection Period : $\frac{Average\ Trade\ Receivable}{Credit\ sales}$ x $\frac{365\ days}{}$

3. TRADE PAYABLE PAYMENTS PERIODS

It motivates how long it will take the business to settle its supplies after buying goods from them on credit. It also measure the average no of days or week it takes to pay its credit suppliers

Trade Payable Payment Period: $\frac{Average\ Trade\ Payble}{Credit\ Purchase}$ x $\frac{365}{}$ days

4. ASSET TURNOVER (SALES PERCENT TO CAPITAL EMPLOYED)

It measure the asset effectiveness in being able to generating sales revenue. It measure how well or efficient an entity is, on the use of their assets to generate sale revenue

Sales Revenue + Capital Employed (Assets Turnover): $\frac{Sales\ Revenue}{Capital+Reserves+long\ term\ loan}$ (No of Times)

5. INVENTORY TURNOVER

This measures how often the business turns its inventory into sales. It measures the rapidity with which a business is able to turn its inventory to sales.

Inventory Turnover: $\frac{Cost\ of\ Sales}{Average\ Inventory}$ x (No of times)

6. TRADE RECEIVABLE TURNOVER

It measures how often the business receives settlement on the average from its customers i.e. the rapidity of debt collections.

Trade Receivable Turnover : $\frac{Credit\ Sales}{Average\ Trade\ Receivable}$ > In number of time

7. TRADE PAYABLE TURNOVER

It measure how often the business makes settlement to its credit supplier. Here the lower the no of times, the better the business

Trade Receivable Turnover : $\frac{Credit\ Purchase}{Average\ Trade\ Receivable}$ = In number of time

SELF ASSESSMENT EXERCISE

List five efficiency ratios with appropriate formulas

3.4 LIQUIDITY OR SHORT TERM SOLVENCY RATIO

These ratio are used to judge the ability of enterprise to meet it short term maturing obligations

1. CURRENT RATIO

It indicates the extent to which assets that will be converted into cash within a year cover claims of short term payable or creditor. The current ratio measure the ability of business to settle its short term obligation at when due

Current ratio : $\frac{Current\ assets}{Current\ Laibilities}$:1

2. ACID TEST RATIO OR QUICK RATIO

This measures the ability of a business to settle its short term obligations as at when due using its liquid or quick asset (current assets- closing inventory). The most acceptable norm for quick ratio 1:1 meaning that for a business to be considered liquidity healthy, it liquid or quick asset should be equal to its current liabilities (short term obligation).

Acid Test Ratio or Quick Ratio: $\frac{Current\ assets - closing\ Inventory}{Current\ Laibilities}$: 1

3. CASH RATIO

This measure the ability of the business to settle its short term obligation as at when due using its highly liquid asset (i.e. cash and equivalents)

Cash ratio: $\frac{Cash\ \&Cash\ Equivalents}{Current\ Laibilities}$:1

SELF ASSESSMENT EXERCISE

Distinguish between current ratio and acid-test ratio

3.5 LONG TERM SOLVENCY/ GEARING RATIOS

These are ratio that assess what percentage of total funds used to finance operations is generated from outside source. This long term solvency also known as long term stability ratio measures the relationship between contribution to financing the business made by owners of the business and the amount contributed by other in form of loan

1. INTEREST COVER RATIO

It measures the ability of the business to pay its interest charges form the amount of profit available the higher the number of times, the better for the business.

In the interest cover ratio, a cover of about 3 times is normally considered sate.

Interest cover ratio : $\frac{Profit\ before\ interest\ \&\ taxation\ (PBIT)}{Interest\ Charge(Finance\ cash)}$ = No of times

2. *DEBT/EQUITY RATIO*

This ratio expresses total funds generated from outside source as a percentage of shareholders owner interest. This also measures the financial risk exposure level of the business. If the ratio is less than 100%, it mean the business is lowly geared

Debit/Equity ratio: $\frac{Long\ term\ loans\ including\ redeemable\ pref.share}{Equity\ share\ capital+reserves}\ x\ \frac{100}{1}$

3. *PROPRIETARY RATIO*

This ratio measures that proportion of the business assets that is financed with owner's funds and in effect measures the degree of protection to unsecured creditors in the events of liquidation.

Proprietary ratio : $\frac{Owner's\ fund}{Total\ Assets}\ x\ \frac{100}{1} = \frac{Equity\ share\ capital+reserves}{Total\ Asset}$ x 100

4. *GEARING RATIO*

This form of ratio shares the contribution to financing the business made by the owners of the business and the amount contributed in form of loans.

Gearing ratio : $\frac{Loans}{Capital+reserves+loans}\ x\ \frac{100}{1}$

Financial gearing measures the degree of financial risk exposed to a business as a result of how the business is financed. It relates the loan capital (borrowed fund) to owners' capital (owners' funds) to know the rate of financial risk associated with a business. It can also be described as a mixture of debt capital (borrowed fund) and equity capital (owners' funds) in the capital structure of a business.

SELF ASSESSMENT EXERCISE

What is gearing ratio?

3.6 INVESTMENT OR STOCK MARKET RATIOS

These are ratio concerned with returns that are attributable to each shares. They include

1. Earning per share: which relates the earnings generated by the business and available to ordinary shareholders during a period to the number of ordinary share in issue. It measures the amount of equity earnings i.e. the profit after tax attributable to a unit of ordinary share in issue

$$\text{EPS} : \frac{\text{Profit after tax and after preference dividends}}{\text{Number of ordinary share}}$$

2. Dividends per share: this measures the amount of current period dividends attributable to a unit of ordinary share

$$\text{DPS} : \frac{\text{Ordinary share dividends}}{\text{Number of ordinary shares}}$$

3. Price Earning Ratio: This reveals the number of times that the capital value of the business is higher than its current levels of earnings. It also measures the level of confidence that the market have in the future of the business

$$\text{P/E Ratio} : \frac{\text{Market price per share}}{\text{Earnings per share}}$$

4. Dividend cover ratio: It is used to indicate the number of time, the earnings per share (EPS) is able to cover the amount paid as dividends

$$\text{Dividend cover ratio} : \frac{\text{Earnings per share}}{\text{Dividends per share}} \text{ or } \frac{\text{Profit after tax \& preferred dividends}}{\text{ordinary dividends}}$$

5. Dividends Yield Ratio: It shows the net return in percentage earned by each holder of company ordinary shares i.e its measures the actual return on ordinary shareholders investments.

$$\text{Dividend Yield ratio} : \frac{\text{Dividends per share}}{\text{Market price per share}} \times 100$$

6. Dividend Payout Ratio: measures the proportion of current period earnings (profit) that is paid or distributed by the business to its shareholder in form of dividends.

DPR : $\frac{Ordinary\ dividend\ s}{Profit\ after\ tax\ \&\ after\ preference\ dividend} x \frac{100}{1}$

7. Retention Ratio: it measures the proportion of the current period earning (profit) that was returned or reinvested in the business for growth.

Retention ratio : $\frac{EPS-DPS}{EPS}$

SELF ASSESSMENT EXERCISE

List five stock market ratios

3.7 ANALYSIS OF BANKS' FINANCIAL STATEMENT

Idekwulim (2014) identified six ratios that can be used to analyse banks' financial statement. To analyse banks' financial statements, we use such tools as financial ratios, cash flow statement, common size financial statement, common sense, etc.

Financial Ratio:

This is the most common tools used in assessing the performance of a bank because of the sensitivity involved in banking. The stock in trade in banking industry is cash; this necessitates the consistent regulation of activities of banks. To analyse the banks' financial statements, we use the acronym 'CAMEL',

Where: C = Capital Adequacy

A = Asset Quality

M = Management Efficiency

E = Earnings growth or profitability

L = Liquidity

Capital Adequacy

This measures how adequate the capital of a bank is, that is, it measures the portion of the bank's asset that is financed by the owner (equity). Examples of ratios computed here are:

1. Equity to total assets = $\frac{\text{Equity}}{\text{Total assets}} \times 100\%$
2. Equity to loans and advances = $\frac{\text{Equity}}{\text{Loans and advances}} \times 100$
3. Permanent assets to equity = $\frac{\text{Permanent asset}}{\text{Equity}} \times 100$

Asset Quality

This ratio measures how quantitative the loans and advances of a bank is (credit facilities), that is, what is the portion of non-performing loans and advances to the total loans and advances of the bank. Examples of ratios computed here as:

1. Percentage of classified loans to total loan and advances =
$$\frac{\text{Classified loans}}{\text{Gross total loans and advances}} \times 100$$
2. Loan Loss reserves (statutory provision allowance; allowance for risk asset) to classified loans = $\frac{\text{Loans loss reserves}}{\text{Equity}} \times 100$

Management Efficiency

This is an assessment of the quality of a management team of a bank in terms of experience, qualification, exposure, competences, versatility, etc.

Earnings Growth or Profitability

This ratio measures the performance of a bank in terms of profit or loss. The ratios computed here are as follows:

1. Pre-tax margin (pre-tax profit margin) = $\frac{\text{PBT}}{\text{Revenue}} \times 100\%$

NB: Revenue = interest income

2. Return on total assets (ROTA) (same as ROCE) = $\frac{\text{PBIT}}{\text{Total assets}} \times 100$
3. Return on equity = $\frac{\text{PAT}}{\text{Equity}} \times 100\ \%$
4. Interest income to loans and advances = $\frac{\text{Interest income}}{\text{Loans and advances}} \times 100\ \%$
5. Interest paid to total deposits = $\frac{\text{interest paid}}{\text{Total deposit}} \text{ x } 100\%$
6. Operating expenses to total revenue = $\frac{\text{opening expenses}}{\text{Total revenue}} \text{ x } 100\%$
7. Non- interest income to total revenue = $\frac{\text{non-interest income}}{\text{Total revenue}} \text{ x } 100\%$
8. Staff income to revenue = $\frac{\text{Staff cost}}{\text{Revenue}} \text{ x } 100\%$

Liquidity

The ratio measure how liquid a bank is to meet customers demand as at when due. Example of ratios computed here are:

1. Loans and advances to total assets = $\frac{\text{loans and advances}}{\text{Total assets}} \text{ x } 100\%$
2. Cash and bank balances to total liabilities = $\frac{\text{cash and bank balances}}{\text{Total liabilities}} \text{ x } 100\%$
3. Loan and advances to total deposits = $\frac{\text{loans and advances}}{\text{Total deposit}} \text{ x } 100\%$

SELF ASSESSMENT EXERCISE

List and discuss five ratios that be used to analyse banks' financial statement.

Example 1

Goodman Plc

The following draft financial statements relates to princess plc.

Statement of Profit or Loss for the year ended 31st December, 20x5

	₦
Revenue (cash 20%)	8,500,000
Cost of sales	(4,950,000)
Gross Operating profit	3,550,000
Operating expenses	(2,154,500)
Other income	285,500
Finance costs	(216,000)
Profit before tax	1,464,970
Income tax expense	(454,500)
Profit for the year	1,010,470
Non-Current Assets:	
Property, plant and equipment	2,850,000
Investments	240,000
	3,090,000
Current Assets	
Inventory	950,000
Trade receivables	750,000
Other receivables	309,000
Cash	980,000
	2,989,000
Total assets	6,079,000
Equity and Liabilities:	
Equity:	
Ordinary shares of 50 cent each	500,000
Share premium	350,000
Revaluation surplus	155,000
Retained earnings	2,530,500
	3,535,000
Non-Current Liabilities	
18% loan notes	1,200,000
Deferred tax	178,000
	1,378,000
Current Liabilities	
Trade payables	850,500
Provisions	29,500
Income tax	285,500
	1,165,500
Total liabilities	2,543,500
Total equity and liabilities	6,079,000

Relevant notes:

1. Inventories as at 31st December 20x4 is valued at ₦650,000

2. The average market price during year ended is ₦3.25
3. Dividend paid amounted to ₦150,000
4. Operating expenses includes depreciation charges of ₦550,000 and provisions of N150,000
5. The business employed 1,500 staff during the period ended 31st December 20x5.
6. The other receivables represent prepaid expenses on insurance premium.

Required:
Compute five ratios under each of the following:

a. Returns and profitability ratios
b. Liquidity (Short term solvency) ratio
c. Efficiency (activity) ratios
d. Investors/investments ratios
e. Long term solvency (gearing or stability) ratios

Solution to Example 1

Computation of financial ratios

A. PROFITABILITY AND RETURNS RATIOS:

1. Return on capital employed

$$= \frac{profit}{capital\ employed} \times 100 = \frac{profit\ before\ interest\ and\ tax}{capital + reserves + long\ term\ loans}$$

$$= \frac{1{,}464{,}970 + 216{,}000}{3{,}535{,}500 + 1{,}200{,}000} \times 100 = \frac{1{,}680{,}970}{4{,}735{,}500} = 35.5\%$$

NB: PBIT + finance costs.

ROCE is a fundamental measures of business performance. That is, it measures the overall performance of a business by comparing inputs (capital invested) with outputs (profit). In a nut shell, ROCE measures the overall returns from all investments. ROCE is a vital tool in assessing the effectiveness with which funds have been used or managed by managers.
ROCE is popularly referred to as PRIMARY RATIO. From the ratio computed above, a ROCE of about 35.5% indicates that princess plc earns a return of about 35.5 cent for every N1 invested. This equally means that if the company employs or invests N20m, it will earn a return of about (35.5% x N20m). = N7.1m. Though the above formula is more acceptable to users (as it is the most appropriate), ROCE can equally be calculated using either of formula below:

a. ROCE = $\frac{profit\ before\ interest\ and\ tax}{total\ assets\ (excluding\ deferred\ tax\ liability}$ x 100

b. ROCE = $\frac{profit\ before\ tax}{capital\ reserves}$ x 100

2. Gross Profit Margin

$$= \frac{Gross\ profit}{sales} \times 100 \qquad = \frac{3{,}550{,}000}{8{,}500{,}000} \times 100 = 41.8\%$$

Gross profit margin relates to the gross profit of the business to the revenue of the same period. That is, it measures the proportion or percentage of sales revenue earned as a profit after deducting only cost of sales.
From the ratio computed above, gross profit margin of about 41.8% indicates that princess Plc will earn a profit about 41.8cent for every N1 revenue after deducting only cost of sales.j

3. Net Profit Margin

$$= \frac{profit\ before\ interest\ and\ tax}{sales} \text{ x } 100$$

$$= \frac{1{,}464{,}970+216{,}000}{8{,}500{,}000} \text{ x } 100 \quad = \frac{1{,}680{,}970}{8{,}500{,}000} \text{ x } 100 = 19.8\%$$

Net Profit Margin relates the net profit (PBIT) of the business to the sales revenue of the same period. That is, it measures the proportion or percentage of sales revenue earned as profit after deducting all expenses (except interest and tax). The operational performance of a business should be considered from the perspective of net profit and not gross profit margin.
A net profit margin of about 19.8% indicates that princess Plc will earn a profit of about 19.8cent for every N1 sales revenue after deducting all expenses (excluding interest expense and tax).
Though the above formula is the most appropriate measure of operational performance but net profit margin can equally be calculated using the formula below:

$$\text{Net Profit Margin} = \frac{profit\ before\ tax}{sales\ revenue} \text{ x } 100$$

4. Return on shareholders equity/funds (ROSE/ROSF)

$$= \frac{net\ profit\ after\ taxation\ and\ preference\ dividend}{ordinary\ share\ capital + reserves}$$

$$= \frac{1{,}010{,}470}{3{,}535{,}500} \text{ x } 100 = 28.6\%$$

The ROSF compares the amount of profit for the period available to the owners with the owner's stake in the business during the same period. That is, it measures the amount of return on ordinary shareholder's investment based on current period performance.
A ROSF (or ROSE) of about 28.6% indicates that the ordinary shareholders in princess plc will earn about 28.6cent on every N1 of their investment based on current year performance.

5. Return on Total Assets

$$= \frac{net\ income}{total\ assets} \text{ x } 100 = \frac{net\ profit\ before\ interest\ \&\ tax}{total\ assets} \text{ x } 100$$

$$= \frac{1{,}464{,}970+216{,}000}{6{,}079{,}000} \text{ x } 100 \quad = \frac{1{,}680{,}970}{6{,}079{,}000} \text{ x } 100 \quad = 27.7\%$$

This compares the profit of the period (PBIT) with the total assets employed by the entity in generating the profit during the same period. That is, it measures the amount of return earned on every invested on assets.
A return on total assets of about 27.7% indicates that princess plc will earn about 27.7cent for every ₦1 invested on assets.

B. EFFICIENCY OR ACTIVITY RATIOS

These are ratios that the efficiency of an entity in the utilization of their resources within the business.

1. Inventory holding period

$$= \frac{average\ inventory}{cost\ of\ sales} \text{ x 365 days}$$

Average inventory = (N950,000 + N650,000)/2 = N800,000

$$= \frac{800,000}{950,000} \text{x 365 days = 60 days}$$

Inventory holding period measures the average period in which inventory are being held. That is, it measures the average number of days or weeks it takes an entity to sell its finished products. Simply put, it measures the average number of days or weeks that an entity's finished products stayed in the warehouse or store before being sold to customers. The shorter the period, the better it is for the business.

An inventory holding period of about 60days indicates that it will take princess plc about 60 days to sell its goods to customers after production or purchases.
This shows that the finished product of princess plc will remain the warehouse or store for about 60 days (0ver two months) before being sold to customers.
NB: Average inventory = (opening inventory + closing inventory) / 2
However, if opening inventory is not available, then the closing inventory will be used as the average inventory.

2. Trade Receivable Collection Period

$$= \frac{average\ trade\ receivable}{credit\ sales} \text{ x 365 days } = \frac{750,000}{80\% \ x\ 8,500,000}$$

$$= \frac{750,000}{6,800,000}\ x\ 365\ days \text{ = 40 days.}$$

This ratio measures on the average, how long it takes the business customers to pay the amount they are owing. That is, it measures the average number of days or weeks that it takes an entity to collect money from their customers after selling goods to them on credit. The shorter the period, the better for the business (but it should not be extremely too short as it may affect the business performance negatively through reduction in turnover.

A trade receivables period of about 40 days indicates that it will take princess Plc about 40 days to collect money from its customers after selling goods to them on credit. That is, the credit customers will owe the money for an average of about 40days before making settlement.
Note: If the proportion of sales on credit is not available then it will be assumed that all sales were on credit.

Average trade receivables = $\frac{opening\ trade\ receivables+closing\ trade}{2}$

However, if opening trade receivables is not available, then the closing receivables (i.e. SOFP value will be used as average trade receivables.

3. Trade Payables payment period

$$= \frac{average\ trade\ payables}{credit\ purchases} \times 365 \text{ days}$$

Purchase = cost of sales + closing inventory – opening inventory

= 4,950,0000 + 950,000 – 650,000 = 5,250,000

Average trade payables period = $\frac{850{,}500}{5{,}250{,}000}$ x 365 days = 59 days

This ratio measures on the average, how long it takes the business to settle its suppliers after buying goods from them on credit. That is, it measures the average number of days or weeks that the credit suppliers remained unsettled. The longer the period, the better for the business but it should not be unreasonably too long.

A trade payables period of about 59 days indicates that it will take the business about 59 days to settle its suppliers after buying goods from them on credit. That is, princess plc will owe their credit suppliers for an average of about 59 days before settlements.

Notes: If the proportion of purchase on credit is not available, then it will be assumed that all the purchases were on credit.

i. Average trade payables = $\frac{opening\ trade\ payables+closng\ trade\ payables}{2}$

But if opening payables is not available, then the closing trade payables (i.e. SOFP value) will be used as average trade payable.

If opening inventory is not available, then cost of sales will be used as purchases.

However, if opening inventory is available, then purchases will be derived as

Purchases = Cost of sales + closing inventory – opening inventory

4. Sales Revenue to Capital Employed (Asset turnover)

$$= \frac{sales\ revenue}{capital+reserves+long\ term\ loans}$$

$$= \frac{8{,}500{,}000}{3{,}535{,}500+1{,}200{,}000} = \frac{8{,}500{,}000}{4{,}735{,}500} = 1.79\text{times}$$

This ratio examines how effectively the assets of the business are being used to generate sales revenue. That is, it measures how well or efficient an entity is, on the use of their assets to generate sales revenue. The higher the asset turnover, the more productive or efficient the business is in the use of assets to generate sales revenue and vice versa.

An assets turnover of about 1.79 times indicates that a sales revenue of about N1.79 will be generated for every N1 of capital employed.

Notes: An asset turnover of less than one time may indicates that the business is less productive while an asset turnover of more than one time may indicates that the business is productive (or more productive).
A very high or extremely high assets turnover may suggest that the business is over trading on its assets, that is, has insufficient assets to sustain the level of sales revenue achieved. In analyzing assets turnover ratio, the age and conditions of assets as well as the valuation bases for the assets should be taken into consideration.

5. Sales revenue per employee

$$= \frac{sales\ revenue}{number\ of\ employees}$$

$$= \frac{8{,}500{,}000}{1500} = \text{N}5{,}667.$$

This ratio relates sales revenue generated by a business to the number of employees employed by the business for the same period. That is, it measures how productive the work force of the business is in generating sales revenue.

From the ratio computed above, sales revenue per employee of N5,667 indicates that an average employee in the company contributed or improved revenue generation by N5,667 during the accounting period.

6. Inventory Turnover

$$= \frac{cost\ of\ sales}{average\ inventory} = \text{in numbers of times}$$

$$= \frac{4{,}950{,}000}{800{,}000} = 6.19 \text{ times}$$

This ratio measures how often the business turns its inventory into sales. That is it measures the rapidly with which a business is able to turn its inventory into sales. The higher the number of times, the more efficient the inventory managements of the business are.

7. Trade Receivables Turnover

$$= \frac{credit\ sales}{average\ trade\ receivables} = \text{in numbers of times}$$

$$= \frac{(80\%\ x\ 8{,}500{,}000}{750{,}000} = \frac{6{,}800{,}000}{750{,}000} = 9.07\text{times}$$

This ratio measures on the average how often the business receives settlement from credit customers. That is, it measures the rapidity of debt collection.
The higher the number of times, the better for the business but it should not be extremely too high.
A trade receivables turnover of about 9.07 times means that on the average, the business will receive settlement from their credit customers for about 9times during the accounting period.

8.Trade Payables Turnover

$$= \frac{credit\ purchases}{average\ trade\ payables} = \text{in numbers of times}$$

$= \frac{5,250,000}{850,500}$ = 6.17 times

This ratio measures on the average how often the business makes settlement to its credit suppliers. The lower the number of times, the better of the business but it should be extremely too low.

A trade payable turnover of about 6.17times indicates that on the average, the business will make settlement to its credit supplier for an average of about 6.17 times during period.

C. LIQUIDITY OR SHORT TERM SOLVENCY RATIO

1. Current Ratio

$= \frac{current\ ratio}{current\ liabilities}: = \frac{2,989,000}{1,165,500}:1 = 2.56:1$

Current ratio measures the ability of the business to settle its short term obligation as and when due using its current assets. The acceptance norm for current ratio is 2:1, meaning for a business to be considered liquidity healthy, its current assets should doubles its current liabilities.

A current ratio of about 2.56:1 means that the business will be able to settle its short term obligation as and when due provided all the current assets items (especially inventory and receivables) will be realized in cash.

2. Acid Test Ratio or Quick Ratio

$$= \frac{current\ assets - closing\ inventory}{current\ liabilities}:1$$

$$= \frac{2,989,000 - 950,000}{1,165,000}:1 = 1.67:1$$

Acid test ratio measures the ability of a business to settle its short term obligations as at when due using its liquid or quick assets (i.e. current assets – closing inventory). The acceptance norm for quick ratio is 1:1, meaning that for a business to be considered liquidity healthy, its liquid or quick assets (i.e. current assets less closing inventory) should be equal to its current liabilities (short term obligations).

An acid test ratio of about 1.67:1 measures that the business will be able to settle its short term obligations as at when due.

NB: Quick ratio gives better liquidity position of a business than the current ratio.

3. Cash Ratio

$= \frac{cash\ and\ cash\ equivalent}{current\ liabilities}: 1$

$= \frac{cash + bank\ balance + short\ term\ investments\ \ (i.e\ marketable\ securities)}{current\ liabiities}$

$= \frac{980,000}{1,165,000}:1 = 0.84:1$ or 84% or 0.84

Cash ratio measures the ability of the business to settle its short term obligations as and when due using its highly liquid assets (i.e. cash and equivalents).

Cash ratio of about 0.84 means that the business will be able to settle about 84% of its short term obligations (current liabilities) as and when due using its cash balance.
NOTE: That all the ratios considered under efficiency or activity ratios are also part of liquidity ratios apart from assets turnover and sales revenue per employee.

D. INVESTMENT OR STOCK MARKET RATIOS

These are ratios concerned with assessing the returns and performance of shares held in a particular businesses from the perspective of shareholders who are not involved with the management of the business. The following are widely used:

1. Earnings per share (EPS)

$$= \frac{profit\ after\ tax\ and\ after\ preferred\ dividend}{number\ of\ ordinary\ shares}$$

$$= \frac{1{,}010{,}470}{500{,}000 \div 0.5} = \frac{1{,}010{,}470}{1{,}000{,}000\ shares} = \text{N1.01 or 101cent}$$

EPS relates the earnings generated by the business and available to ordinary shareholders during a period to the number of ordinary shares in issue. That is, it measures the amount of equity earnings (profit after tax and after preference dividends) attributes to a unit of ordinary shares in issues. The trend in earnings per share over time is used to assess the investment potential of a business shares.

Earnings per share of about 101cent indicates that about 101 cent of the current period equity earning is attributable to a unit of ordinary shares in issue.

2. Dividends per share (DPS)

$$= \frac{ordinary\ share\ dividend}{number\ of\ ordinary\ shares} = \frac{150{,}000}{(500{,}000 \div 0.5\ shares)} = \frac{150{,}000}{1{,}000{,}000\ shares} = \text{N0.15 or 15 cent}$$

Dividend per share (DPS) measures the amount of current period dividend attributable to a unit of ordinary shares in issue. That is, it shows the actual returns that will be received or was received by ordinary shareholders on a unit of its shares.

A dividend per share of about 15cent means that an ordinary shareholder in the business will receive a dividend of about 15cent on a unit of its shares.

3. Price Earning Ratio (P/E ratio)

$$= \frac{N3.25}{N1.01} \text{ or } \frac{325cent}{101cent} = \text{3.22 times}$$

Price earnings ratio relates the market value of a business's share to its earnings per share. The price earnings ratio reveals the number of times by which the capital value of the business is higher than its current levels of earnings. P/E ratio is a major performance indicator ratio because it measures the level of confidence the market (or public) have in the future of the business. The higher have the number of times, the greater the confidence. A higher P/E ratio means that investor will pay no more to acquire the business shares in the future.

A price earnings ratio of about 3.22 times reveals that the capital value of the business's share is about 3.22 times higher than its current level of earnings.

4. Dividend Payout Ratio

$$= \frac{DPS}{EPS} \text{ x } 100 \text{ or } \frac{Ordinary\ dividend}{profit\ after\ tax\ and\ after\ preference\ dividend} \text{x } 100$$

$$= \frac{15cent}{101\ cents} \text{ x } 100 \text{ or } \frac{150{,}000}{N1{,}101{,}40 - 0} \text{ x } 100 = 14.85\%$$

NB: Preference dividend is zero because there is no preference shares.
Dividend pay-out ratio measures the proportion of the current period earnings (profit) that is paid or distributed by the business to its shareholders inform of dividends.

Dividend pay-out ratio of about 14.85% means that about 14.85% of the business current period earnings was distributed to the shareholders in form of dividend. This implies that about 85% of the current period earnings was not distributed as dividend but was reinvested into the business for future growth and expansion.

5. Dividend Cover Ratio

$$= \frac{EPS}{DPS} \text{ or } \frac{profit\ after\ tax\ and\ preference\ dividends}{ordinary\ dividends} = \text{Number of times}$$

$$= \frac{101\ cent}{15\ cent} \text{ or } \frac{N1{,}010.470}{N150{,}000} = 6.74 \text{ times}$$

Dividend cover ratio measures the number of times that dividend of the current period is covered by the earnings of the same period.

A dividend cover of about 6.74 times shows that the current period earnings will cover the actual dividend by about 7times.

6. Earning Yield Ratio

$$= \frac{EPS}{MPS} \text{ x } 100$$

$$= \frac{101cent}{325cent} \text{ x } 100 = \frac{N101}{N325} \text{ x } 100 = 31.02\%$$

Earnings yield measures the potential returns on ordinary shareholder's investment. That is, it measures the amount of return due to the ordinary shareholders and not necessarily their actual returns. If none of the current profit is retained, then earning yield and dividend yield will be the same.

An earnings yields of about 31.02% means that a returns of about 31.02 cent is due on every ₦1 investment of the ordinary shareholders based on current period performance.

7. Dividend Yield Ratio

$$= \frac{DPS}{MPS} \text{ x } 100$$

$$= \frac{N0.15}{N3.25} \text{ x } 100 \text{ or } \frac{15cent}{325cent} \text{ x } 100 = 4.62\%$$

Dividend yield ratio relates the cash returns from share to its current market value. That is, it measures the actual return on ordinary shareholders investments.
Dividend yield ratio can help investors to assess the cash return on their investment in a business.

A dividend yield of about 4.62% indicates that ordinary shareholder's in the business will be entitled to an actual return of about 4.62% on their investment.

8. Retention Ratio

$$= \frac{EPS-DPS}{EPS} \text{ x } 100 \text{ or } \frac{retained\ profit\ for\ the\ period}{profit\ after\ tax\ and\ preferred\ dividend}$$

$$= \frac{101cent-15cent}{101\ cent} \text{ x } 100 = \frac{86cent}{101cent} \text{ x } 100 = 85.15\%$$

Retention ratio measures the proportion of the current period earnings (profit) that was retained or re-invested in the business for growth and expansion.
That is, it measures the proportion of the current year profit that was not paid to the ordinary shareholders inform of dividend but was re-invested into the business for future growth and expansion.

A retention ratio of about 85.15% implies that the business retained and re-invested about 85% of its current profit into the business.

E. STABILITY OR LONG TERM SOLVENCY RATIOS

This measures or shows the relationship between contribution to financing the business made by the owners of the business and the amount contributed by others in the form of loans. It is also known as financial gearing ratio. The main ratio here is gearing ratio thought not only that will be considered.

1. Gearing Ratio

$$= \frac{loans}{capital+reserves+loans} \text{ x } 100$$

$$= \frac{1,200,000}{1,200,000+3,535,500} \text{ x } 100 = \frac{1,200,000}{4,735,000} \text{ x } 100 = 25.34\%$$

As stated earlier gearing ratio tends to highlight the extent to which the business uses loans finance.

A gearing ratio of about 25.34% indicates that the business is lowly geared since only about 25% its long term capital was borrowed. This shows that the going concern status of the business secured since about 75% of its long term capital is provided by owners.
2. Interest Cover Ratio

$$= \frac{profit\ before\ interest\ and\ taxation}{interest\ charges\ (or\ finance\ cost)}$$

$$= \frac{1,464,970+216,000}{216,000} = \frac{1,680,970}{216,000} = 7.78\text{times}$$

It measures the number of times the amount of profit available cover interest charges or finance cost. That is, it measures the ability of the business to pay its interest charges from the amount of profit available the higher the number of times, the better for the business.

An interest cover of about 7.78times shows that the available profit (PBIT) is considerably higher than the level of interest charges or finance cost (since the profit is about 8 times of the interest payable).
This means that there must be a significant fall in profit before the business profit will fall to cover interest payables or charges.

3. Debt to Equity Ratio

$$= \frac{loans}{capital+reserves} \times 100$$

$$= \frac{1,200,000}{3,535,500} \times 100 = 33.94\%$$

This also measures the risk exposure level of the business since the computed ratio is less 100%, it means the business is lowly geared.
The calculated ratio also shows that the borrowed fund of the business is just about 34% of the fund provided by the owners.

4. Proprietary Ratio

$$= \frac{owners\ fund}{total\ assets} \times 100$$

$$= \frac{share\ capital+reserve}{total\ assets} \times 100 \quad = \frac{3,535,500}{6,079,000} \times 100 = 58.16\%$$

This ratio measures the proportion of the business assets that is financed with owner's funds. The higher the ratio, the higher the margin of safety of the unsecured creditors or payables at the events of liquidation.

A proprietary ratio of about 58.16% means that about 58% of the total assets are financed by funds provided by the owners of the business.

5. Total debts Ratio

$$= \frac{total\ debts}{total\ assets} \times 100$$

$$= \frac{current\ liabilities+long\ term\ loans\ including\ redeemable\ preference\ shares}{total\ assets} \times 100$$

$$= \frac{1,165,500 + 1,200,000}{6,079,000} \times 100 = 38.9\%$$

This ratio measures the proportion of the business assets that is financed with debts and in effect also measures the degree of protection to unsecured creditors in the events of liquidation.

A debt ratio of about 38.9% means that about 38.9% of the total assets are financed by debts or borrowings.

4.0 CONCLUSION

The units examine various classification of financial ratios that are applicable to the interpretation of financial statement.

5.0 SUMMARY

This unit examined financial ratios application to the interpretation of financial statement.

6.0 TUTOR MARKED ASSIGNMENT

Question 1: The summarized Statement of Financial Position and operating results of Wellington Limited for the two years ended 30th September, 19x8 were as follows:

Statement of Financial Position as at 30th September

	20x1	20x0
	₦'000	₦'000
Non-Current Asset (net)	16,222	6,941
Current Assets		
Stock	62,294	52,196
Debtors	54,859	50,052
Bank	7,234	14,565
	124,387	116,813
Current Liabilities		
Creditors	47,055	42,885
Taxation	4,154	3,219
Dividends	2,500	2,250
	53,709	48,354
Net current assets	70,678	68,459
10% Debentures 20x7-9		
Net assets	25,000	25,000
Financed by		
Ordinary shares of ₦1 each	12,500	12,500
Revenue reserves	35,874	29,787
Deferred taxation	13,526	8,113
	61,900	50,400

Operating results for the year ended 30th September

	20x1	20x0
	₦'000	₦'000
Sales	672,944	559,071
Profit before interest and taxation	23,412	20,882
Interest payable	2,500	2,500
Taxation	100,506	8,747
Dividend	3,750	3,500

The shares of the company were quoted at ₦1.20 at 30th September, 19x1.

You are required:

a. Calculate from the balance sheet and operating results:

i. two ratios of interest to creditors;

ii. two ratios of interest to management; and

iii. two ratios of interest to shareholders.

b. Comment briefly upon the changes between 20x0 and 20x1

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UNIT 3: CASHFLOW STATEMENT

1.0 INTRODUCTION

This unit deals with classification of ratios.

2.0 OBJECTIVES

After studying this unit, you should be able to:
1. Explain
2. Explain

3.0 MAIN CONTENT

3.1 CASH FLOW STATEMENT

Cash is the residual balance from cash inflows less cash outflow for all poor periods of a company. Cash flow refers to the current period cash inflows less cash outflows. Cash flows statements are used to show the enterprise financial strengths and flexibility by indicating the pattern of cash generation and utilization. This is done by showing how cash is generated firm operations or through new capital raised and how payments are made for taxes, dividends, new investment of debt.

Cash flows statement records inflows when cash is received and outflows when cash is paid out. The statement of cash flow reports cash flows measure for 3 primary business activities operating, investing and financing. Statement of cash flow provides information on cash flow and outflows for a particular period. It also distinguishes among the source and uses of cash flow by separating them into operating, investing and financing activities.

Definitions of Terminologies

Cash: This comprises of cash on hand, demand deposits, in N and also foreign currencies

Cash Equivalents: are short terms, highly liquid investments that are readily convertible to known amount of cash and will be subject to an insignificant risk of changes in value.

Cashflows: They are inflows and outflow of cash and cash equivalent.

SELF ASSESSMENT EXERCISE

Explain cashflow statement

3.2 ADVANTAGES OF CASH FLOW STATEMENT

1. It provides a better platform to compare the result of different companies
2. It can be audited more easily than accounts based on the account concepts
3. The cash flow statement is more comprehensive in nature than when "profit" is being used
4. Journal of a company depends on its ability to generate cash
5. Forecasts can be monitored using variance statement which companies actual cash flow against the forecast.

SELF ASSESSMENT EXERCISE

State the merits of cash flow statement

3.3 LIMITATIONS OF CASH FLOW STATEMENT

A statement of cash flow on its own will not provide all the information required by investor to assess the profitability, liquidity, financial flexibility and risk of a particular enterprise.

Much information can be obtained by the combination of statement of financial position statement of profit or loss and other comprehensive income and the statement of cash flow

SELF ASSESSMENT EXERCISE

Discuss the limitation of cash flow statement

3.4 METHODS OF PREPARING STATEMENTS OF CASHFLOW

Basically, there are 2 methods of preparing a statement of cash flows

1. Direct method
2. Indirect method

DIRECT METHOD

The method also known as (inflow-outflow) method reports gross cash receipts cash disbursements related to operations- essentially adjusting each income statement item from account to cash flow basis. The direct method reports total amount of cash flowing in from a company's operating activities, investing activities and financing activities.

The system of reporting cash flows for an entity reports gross cash receipts of gross cash payment which when aggregated makeup the net operating cash flow.

INDIRECT METHODS

This describes the system of cash flow reporting where an enterprise reports the same net operating cash flow as under the direct method but produces that figure by reporting adjustment to net profit for the effects of any deferrals or accruals of operating cash receipts and payments and for any whole case effects and related to investing or financing activities or which are items of an non-cash nature such as Depreciation.

This method is a much easier approach to the preparation of the cash flow statement. The net profit or loss for the period is adjusted for

1. Changes during the period in investment, trade payable and receivable
2. Non-cash items e.g. depreciation, provision, profit/ losses on the sales of asset
3. Other items, the cash flow from which should be classified under investing or financing activity

SELF ASSESSMENT EXERCISE

List and discuss two methods of preparing cash flow statement

3.5 GROUPING/CLASSIFICATION OF CASH FLOW

Activities of reporting entity can be classified into the following

1. Operating activities
2. Investing activities
3. Financing activities

3.5.1 OPERATING ACTIVITIES

This is an integral part of the statement of cash flow because it shows whether and to what extent, companies can generate cash from their operations

Operating activities of an organization are the activities undertaken by organization in pursuant to its objectives as indicated in the Memorandum of Association and Articles of Association.

The amount of cash flow arising from operating activities is a key indicator to the extent to which the business operations have generated sufficient cash flow to repay loans, maintain the operating capability of the enterprise, pay dividends and make new investment without recourse to extend sources of financing.

The following are examples of cash flow operating activities

Cash Receipts

1. From sales of goods and rendering of services
2. From royalties, fees, commission and other revenue
3. And cash payment from contracts held by dealing or trading purpose

Cash payments

1. To suppliers for goods and services
2. To and on behalf of employees salaries, wages and other staff cost
3. For rent, rates, levies, duties and tax related to normal operations of the business
4. For income taxes, net amount paid or received in respect of VAT and other sales taxes
5. Any other cash outflow other than investing or financing activities

3.5.2 INVESTING ACTIVITIES

The cash flows classified under this heading relates to financial transaction that involves acquisition and disposal of fixed assets investment properties and other productive assets needed or used in producing the enterprise usual goods and services other than stock held for processing or resale.

The following are examples of cash flow from investing activities

1. Cash payment to acquire property, plant and equipment, intangibles & other long term assets including those relating to capitalized development costs and self cash invented property, plant and equipment
2. Cash receipts from sales of property, plant and equipment, intangibles and other long term assets
3. Cash payments to acquire share or debentures of other entities (i.e purchase of investment).
4. Cash receipts from sales of shares and debentures of other entities i.e sales of investment
5. Cash receipts from the repayment of advances and loans made to other parties,
6. Cash payments for or receipts from future/ forward/ option/ swaps contracts excepts where the contract are held for dealing purpose or the payment/ receipts are classified as financing activities.

3.5.3 FINANCING ACTIVITIES

This sections of the statement of cash flow shows the share of cash which the entity's capital providers have claimed during the period.

Financial transaction include such transactions as borrowing, repayment amount borrowed raising equity capital or making distribution to the owner.

The importance of the separate disclosure of cash flows from financing activities lie in the fact of its usefulness in predicting claimed on future cash flow by provides of capital to the enterprise.

Cash Flow from Financing Activities Include

1. Cash proceeds from the issue of equity investment
2. Cash proceeds from the use of debentures, bonds, loan stock, commercial papers and other debt securities
3. Repayments of principal on all form of borrowing
4. Payments of interest and dividends
5. Receipts & payments relating to obtaining and repayment long term credit
6. Payment relating to the acquisition of the enterprise own equity investment

SELF ASSESSMENT EXERCISE

Explain the components of cash flow statement

3.6 COMPARISION BETWEEN DIRECT METHOD AND THE INDIRECT METHOD

From practical experience obtained so far, the direct method is rarely used except when the information to be obtained for it is not too costly to obtain where the IASF (Statement of cash flow) turnover the indirect method.

FORMAT OF CASHFLOW STATEMENT USING THE DIRECT METHOD

Operating Activities	₦	₦
Cash receipts from customers	xx	
Cash paid to suppliers	xx	
Cash paid to employees	xx	
Cash paid to other operating expenses	xx	
Cash receipts from debtors	<u>xx</u>	
Cash flows generated from operations		xx
Tax paid		<u>(xx)</u>
Net cash flows from operating Activities (A)		xx
Investing Activities		
Sales/(Purchase) of PPE (Property, Plant and Equipment	±xx	
Sales/(Purchases) of Investments	±xx	
Dividend Received	xx	
Interests Received	<u>xx</u>	
Net Cash flows from Investing Activities (B)		xx
Financing Activities		
Issue/(Redemption) of shares	±xx	
Issues/(Redemption) of Debentures	±xx	
Dividend paid	(xx)	
Interest paid	<u>(xx)</u>	
Net Cash Flows from financing activities (C)		<u>xx</u>
Increase/Decrease in Cash & Cash Equivalent (D)		xx
Cash & Cash Equivalent b/f (E)		<u>xx</u>
Cash & Cash Equivalent c/f (F)		<u>xx</u>

Please Note: $A + B + C \rightarrow D$

$D + E \rightarrow F$

FORMAT OF CASHFLOW STATEMENT USING INDIRECT METHOD

Cash flow from Operating Activities		
Profit before tax	₦	₦
Adjustments		
Depreciation charges, Amortization cash		
Loss on Disposal of Non-Current Asset		xx
Loss on Disposal of Investment		xx
Goodwill written off (current year charge)		xx
Interest Expenses (in the income statement)		xx
Profit on Disposal of Non-Current Asset/Investment		(xx)
Dividends/interest income (in the income statement)		(xx)
Operating cashflows before changes in working capital		xxx
Changes in Operating/Working Capital		
Add Decrease in Inventory/Trade Receivable/Prepayment		xx
Less Decrease in Inventory/Trade Receivable/Prepayment		(xx)
Add Increase in Trade Payables & Accruals		xx
Less Decrease in Trade Payables & Accruals		(xx)
Operating cashflows after changes in working capital		xx
Tax paid		(xx)
Net cash flows from operating activities (A)		xx
Cashflows from Investing Activities		
Proceeds on disposal of non-current assets/	xx	
Dividends/Interest received	xx	
Cash paid for Acquisition of NCA (Non-Current Assets/Investment)	(xx)	
Net Cash flows from Investing Activities (B)		xxx
Cashflows from Financing Activities		
Cash received from issue of shares	xx	
Cash received from issue of debentures	xx	
Cash received on Bank loans/other borrowings	xx	
Cash paid on repayment of debentures/pref. shares	xx	
Cash paid on repayment of Bank Loans	xx	
Interest/Dividend paid	xx	
Net cashflows from financing activities		xxx
Increase/Decrease in cash & cash equivalent		xxx
Cash & cash equivalent b/f		xx
Cash & Cash Equivalent c/f		xxx

CALCULATION OF CASH & CASH EQUIVALENT

	Previous Year	**Current Year**
	20x1	**20x2**
Cash in Hand	xx	xx
Cash at Bank/Bank Balance	xx	xx
Short term Investment (Treasury Bills)	xx	xx
Bank overdraft	(xx)	(xx)
Cash & Cash Equivalent	xxx	xxx

3.7 TREATMENTS OF INTEREST AND DIVIDEND

Cashflows from interest and dividend received or paid should each be disclosed separately.

Dividend Receivable

The actual amount of interest received should be recognized as an inflow under investing activities, alternatively, it can be subtracted from each generated from operating after changes in operating/working capital.

Interest Received

The actual amount of interest received should be recognized as an inflow under investing activities. Alternatively, it can be added to cash generated from operation after changes in operating/working capital.

Interest Paid

The actual amount of interest paid should be recognized as an outflow under the financing activities.

Dividends Paid

The actual amount of dividend paid should be recognized as an outflow under financing activities.

Tax Paid

Cashflow arising from taxes on income should be separately disclosed and should be classified as cash outflow under operating activities. (note that, this is usually the last item under operating activities).

Example 1

KELE-KELE PLC

The following relates to Kele-Kele Plc for the year ended 31st December 20x9

Cash Account for 20x9

	₦'000		₦'000
Balance c/d	65,000	Supplied (goods)	687,380
Receipts:		Wages and salaries	80,500
Customers (goods)	889,540	Other operating expenses	105,230
Commissioners	50,000	Interests	46,000
Investments	28,000	Dividends	27,000
Equity shares	95,000	Plants	36,770
Equipment	25,000	Properties	21,000
8% loans	22,000	10% Debentures	10,000
Dividends	39,500	6% redeemable pref. shares	27,500
Interests	22,800	Taxation	48,760
		Balance c/d	146,700
	1,236,840		1,236,840

Statement of Profit or Loss for the year ended 31st December 20x9

	₦'000
Revenue	700,000
Cost of sales	(390,980)
Gross profit	309,020
Other income	58,000
Dividends and interest received	62,300
Distribution costs	(96,350)
Administrative expenses	(128,480)
Finance cost	(46,000)
Profit before tax	158,490
Income tax expense	(52,410)
Profit for the year	106,080

Statement of Financial Position as at 31st December,

	20x9	**20x8**
	₦'000	**₦'000**
Non-Current Assets		
Freehold properties	153,660	140,160
Plant and equipment	106,720	109,750
Investments	58,500	78,500
	318,880	328,410
Current Assets:		
Inventories	290,500	250,100
Trade receivables	267,900	457,440
Prepaid expenses	13,500	28,000
Cash	146,700	65,000
	718,600	800,540
Total Assets	1,037,480	1,128,950
Equity and Liabilities		
Equity:		
Ordinary shares of N1 each	200,000	140,000
Share premium	95,000	60,000
Retained earnings	308,680	229,600
	603,680	429,600
Non-Current Liabilities:		
6% redeemable preference shares	-	27,500
10% debentures stock	45,000	55,000
Loan notes	82,000	60,000
	127,000	142,500
Current Liabilities:		
Trade payable	234,000	490,000
Accrued expenses	10,500	8,200
Income tax payable	62,300	58,650
	306,800	556,850
Total liabilities	433,800	699,350
Total equity & Liabilities	1,037,480	1,128,950

Relevant Notes:

i. During the year, the directors disposed equipment that cost ₦38m for ₦25m. The accumulated depreciation on the equipment as at the date of disposal was ₦13m.

ii. The administrative expenses includes the following depreciation charges:

	₦'000
Freehold properties	7,500
Plant and equipment	14,800

iii. Dividends paid during the year to equity shareholders amounted to N27m.

iv. During the year investments with a carrying amount of N20m were sold for N28m, the other income includes profit from sale of investment.

Required:

Prepare statement of cash flow for the year ended 31st December 20x9 using:

ii. Direct method ii. Indirect Method

Solution to Example 1

a. Using the direct method

Since cash amount is available, only the cash amount should be used in preparing the statement cashflows while all other information should be ignored.

Procedures for the use of cash account in preparing statement of cash flows

1) The balance b/d in the cash account represents cash and cash equivalent at the beginning and should be subtracted if it is on the credit side of the cash account.
2) The balance c/d in the cash account represents cash and cash equivalent at the end and should be subtracted it if is on the debit side of the cash account.
3) All items on the debit side of the cash account apart from bal b/d or bal c/d represents cash inflows and should be added under their respective activities.
4) All items on the credit side of the cash account apart from bal c/d or bal b/d represents outflows of cash and should be subtracted under their respective activities.

KELE-KELE PLC

Statement of cash flows for the year ended 31 December, 20x9

	₦	₦
Operating activities		
Customers		889,540
Commission received		50,000
Payment suppliers		(687,380)
Wages and salaries paid		(80,500)
Other operating expenses paid		(105,230)
Tax paid		(48,760)
Net cash flows from operating activities		17,670
Investing activities		
Proceeds from sale of investments	28,000	
Proceeds from sale of equipment	25,000	
Dividend received	39,500	
Interest received	22,800	
Purchase of plant	(36,770)	
Purchase of properties	(21,000)	
Net cash flows from investing activities		57,530
Financing Activities		

Proceeds from issue of equity shares	95,000	
8% loan received	22,000	
Interest paid	(46,000)	
Dividend paid	(27,000)	
10% Debenture repaid	(10,000)	
6% Redeemable pref. shares repaid	(27,500)	
Net cash flows from financing activities		6,500
Increase/Decrease in cash and cash equivalent		***81,700
Cash and cash equivalent at the beginning		65,000
Cash and cash equivalent at the end		146,900

***Represents the addition of net from operation + net from investing + net from financing.

b. Using the indirect method

KELE-KELE PLC

Statement of cash flows for the year ended 31 December, 20x3

	₦	₦
Operating activities		
Profit before tax		158,490
Adjustments		
Add depreciation charges on PPE (7,500 + 14,800)		22,300
Add finance cost		46,000
Less interest and dividends received		(62,300)
Less profit/loss on disposal of plant (NBV=sales proceeds)		(8,000)
Changes in working/operating capital:		
Less increase in inventory (290,500 – 250,100)		(40,400)
Add decrease in receivables (457,440 – 267,900)		189,540
Add decrease in prepaid expenses (28,000 – 13,500)		14,500
Add increase in accrued expenses (10,500 – 8,200)		2,300
Less decrease in trade payables (490,000 - 234,000)		(256,000)
Cash flows generated from operation after changes in WC		66,430
Taxation paid (wk9)		(48,760)
Net cash flows from operating activities		17,670
Investing activities		
Proceeds from sale of investments	28,000	
Proceeds from sale of equipment	25,000	
Dividend received and interest received	62,300	
Purchas of plant (wk10)	(36,770)	
Purchas of properties (wk11)	(21,000)	
Net cash flows from investing activities		57,530
Financing activities		
Issue of shares (200,000 + 95,000) – (160,000 + 40,000)	95,000	
8% Loan received (82,000 – 60,000)	22,000	
Interest paid	(46,000)	
Dividend paid	(27,000)	
10% Debenture repaid (55,000 – 45,000)	(10,000)	
6% Redeemable pref. share repaid (27,500 – 0)	(27,500)	
Net cash flows from financial activities		6,500
Increase/(Decrease) in cash and Cash equivalent)		***81,700
Cash and cash equivalent at the beginning		65,000
Cash and cash equivalent at the end		146,900

Tutorial notes/workings:

1. The operating activities should start with profit before tax
2. Since depreciation charge is a non-cash expense, it should be added back to profit before tax under operating activities
3. Finance cost should be added back to PBT under operating activities (because it is not an operating expenses) and recognized as cash outflow under financing activities (i.e. finance cost paid).
4. Interest and dividends received should be deducted from PBT under operating activities and recognized as cash inflows under investing activities (because it is not an operating income but investing item).

5. Increase in inventory (i.e. excess of current year value over the previous year value) should be deducted from PBT under changes in working capital.
6. Decrease in receivables (i.e. excess of previous year value over the current year value) should be added to PBT under changes in working capital.
7. Increase in accrued expenses (i.e. excess of current year value over previous year value) should be added back to PBT under changes in working capital.
8. Decrease in trade payables (i.e. excess of previous year value over current year value) should be deducted back to PBT under changes in working capital.

4.0 CONCLUSION

Adequate knowledge of cash flow statement assist accountants in the analysis and interpretation of financial statement

5.0 SUMMARY

The unit enumerates the components, methods of preparation and accounting treatment involve in the preparation of cash flow statement.

6.0 TUTOR MARKED ASSIGNMENT

Question 1

The following information relate to the affairs of DERICA Plc for the period ended 31st December:

Statement of financial position as at 31 December:

	20x9	**20x8**
	₦'000	**₦'000**
Non-Current assets	321,000	340,000
Long-Term Investment	50,000	30,000
	371,000	370,000
Current Assets:		
Inventories	200,000	90,000
Trade Receivables	82,000	60,000
Cash and bank balances	62,000	50,000
	344,000	**200,000**
TOTAL ASSETS	**715,000**	**570,000**
Equity and Liabilities		
EQUITY		
Issued share capital	200,000	160,000
Share Premium	56,000	40,000
Retained Earnings	273,000	243,000
	529,000	**443,000**
Non-Current Liability		
Long-Term Loan	40,000	22,000
Current Liabilities		
Trade payables	62,000	30,000
Bank overdraft	28,000	15,000
Income tax payable	24,000	20,000
Other payables	32,000	40,000
	146,000	**105,000**

Total Liabilities	**186,000**	**127,000**
Total equity and liabilities	**715,000**	**570,000**

Statement of Profit or Loss for the year ended 31st December 20x9

	₦'000
Revenue	488,000
Cost of sales	(285,000)
Gross profit	**203,000**
Distribution costs	(44,000)
Administrative expenses	(81,000)
Interest and dividends received	3,000
Finance cost	(1,000)
Profit before tax	**80,000**
Income tax expense	(24,000)
Profit for the period	**56,000**

Additional Information:

1. Depreciation charge for the year was ₦8million on land and building and ₦22 million on plant and machinery.
2. During the year a plant with a carrying amount of ₦35million was sold for ₦42million.
3. During the year, an investment that had cost ₦8million some years earlier was sold for ₦13million.
4. Dividend paid in the year amounted ₦26million.

Required: Prepare statement of cash flows of Derica Plc for the period ended 31st December 20x9.

(a) Indirect Method (b) Direct Method

2. Distinguish between direct and indirect methods of preparing cash flow statement.

7.0 REFERENCES/FURTHER READING

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