NATIONAL OPEN UNIVERSITY OF NIGERIA
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FACULTY OF MANAGEMENT SCIENCES

ADVANCED FINANCIAL ACCOUNTING

ACC419

Course Guide

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1.0 INTRODUCTION

ACC419 is a first semester, three credit and 400 level core course. This course introduces learners to accounting and reporting concepts, analysis and interpretation as well as guide to preparation and presentation of accounts of group of companies.

2.0 COURSE AIMS

The aim of the course is to help the learner become reasonably well-informed about financial accounting. It will also enable you to have the knowledge and skill of analyzing, presenting and reporting financial statements in different organizations.

3.0 COURSE OBJECTIVES

The major objectives of this course, as designed, are to enable the students to know all the relevant enactments and legislations in relation to financial accounting in Nigeria and all over the world. As well, students should be able to:

- Explain Financial Statement and the underlying assumptions, elements, concepts, principles and standards ;
- State the legal and regulatory framework of group accounts, application of such framework to preparation of consolidated financial statements;
- Familiarize yourself with the disclosure requirements for banks and Insurance Companies;
- Make analysis based on the use of ratio analysis;
- Explain the accounting treatment for business combination reconstructions and reorganization;
- Explain accounting treatment of Insolvency and Bankruptcy;
- Understand concepts of valuation and various approaches to valuation of business and shares;
- Familiarize yourself with conversion of a foreign branch trial balance to head office trial balance;
- Prepare the accounts of specialized companies such as joint venture, hire purchase, goods on sale or return, containers account, consignment accounts, investments and securities, bill of exchange and pension ;

4.0 STUDY UNITS

The study units in this course are as follows:

MODULE 1

STUDY UNITS

The study units in this course are as follows:

MODULE 1
Unit 1: Review of Company Accounts

Unit 2: Legal and Regulatory Framework of Group Accounts
Unit 3: Consolidated Statement of Financial Position
Unit 4: Consolidated Income Statement
Unit 5: Associated Companies
Unit 6: Multiple Subsidiary and Vertical Structure

MODULE TWO

Unit 1: Ratio and Interpretation of Account
Unit 2: Business Combination (Takeover, Mergers and Acquisitions)
Unit 3: Reconstructions and Reorganization
Unit 4: Account for Banks (with special reference to relevant legislation)
Unit 5: Account for Insurance Companies (with special reference to relevant legislation)
Unit 6: Insolvency and Bankruptcy
Unit 7: Valuation of business and shares
Unit 8: Accounting for Foreign Branches

MODULE THREE
Unit 1: Joint Venture Account
Unit 2: Hire Purchase Account
Unit 3: Goods on Sale or Return
Unit 4: Containers Account
Unit 5: Consignment Account
Unit 6: Investment and Securities
Unit 7: bill of exchange
Unit 8: Pension Fund

5.0 ASSIGNMENT

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.

6.0 TUTOR-MARKED ASSIGNMENT (TMAs)

There is a Tutor Marked Assignment (TMA) at the end for every unit. You are required to attempt all the assignments. You will be assessed on all of them but the best three performances will be used for assessment. The assignment carries 10% each.

When you have completed each assignment, send it together with a (Tutor Marked Assignment) form, to your tutor. Make sure that teach assignment reaches your tutor on or before the deadline. If for any reason you cannot complete your work on time, contact your tutor before the assignment is due to discuss the possibility of an extension. Extensions will not be granted after the due date unless under exceptional circumstances.

7.0 FINAL EXAMINATION AND GRADING

The end of course examination carries 70% of the total score for the course. You will be notified of the time of the examination. You should prepare thoroughly for the examination by studying very hard. You should also submit yourself for the examination.

8.0 SUMMARY

The course ACC419 examines the contents of Financial Accounting. The course is designed and developed for your benefit as an accounting student.

We hope you enjoy your acquaintances with the National Open University of Nigeria (NOUN). We wish you success in this course. Success in this course will help you attain your life goals. Best wishes and regards.

MODULE ONE

Unit 1: Review of Company Accounts
Unit 2: Legal and Regulatory Framework of Group Accounts
Unit 3: Consolidated Statement of Financial Position
Unit 4: Consolidated Income Statement
Unit 5: Associated Companies
Unit 6: Multiple Subsidiary and Vertical Structure

UNIT ONE: REVIEW OF COMPANY ACCOUNTS

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1.0 Introduction

Topics covered in this unit include overview of components and elements of financial statements, characteristics, formats, and preparation of financial statements.

2.0 Objectives

After studying this unit, you should be able to:

1. State the elements and the components of financial statements.
2. Define and describe characteristics of financial statements.
3. Describe the formants of financial statements.
4. Prepare financial statements.

3.1 Elements of Financial statements

International Financial Reporting Standards (IFRS) set out the conceptual framework for financial Reporting in private business enterprises and public sector business enterprises. The conceptual framework form the basis for the preparation of General Purpose Financial Statement (GPFS)

Classification of elements of financial statements as stipulated in the conceptual framework.
The elements of financial statements consist of the following:

- Assets
- Liabilities
- Equity
- Revenue and
- Expenses

Assets

These are future economic benefits controlled by an entity as a result of past transactions or other past events. They are recognized in the Statement of Financial Position (SFP) when and only when:

(i) It is likely that the outflow of future economic benefits related thereto would arise and
(ii) The value of the assets can be reliably measured

Liabilities

These are the present obligation to pay arising from past transactions (or other past events) and are expected to result in outflow of future economic benefits. They are recognised in the SFP when:

i. It is likely that the outflow of future economic benefits related thereto would arise and
ii. The amount of the liability can be reliably measured

Equity

This is the residual interest in the assets of the entity after deducting liabilities. It is about the sum of share capital and reserves.

Revenue

Revenue is defined as the gross inflow of economic benefits (cash, receivables, other assets) during the report period arising from the ordinary operating activities of an entity when those inflows result in increases in equity other than increases relating to contributions from equity participants. Revenue is measured at the fair value of the consideration received or receivable.

Revenue is recognized in the income statement when:

- It is probable that any future economic benefits associated with the item of revenue will flow to the entity and
- The amount of revenue can be measured with reliability

Expenses

These are consumption of future economic benefits in the form of reductions in assets or increase in liabilities of the entity, other than those relating to distributions to owners that result in a decrease in equity. Expenses are recognized in the income statement when:

(i) It is probable that the consumption or loss of future economic benefits has/or would occur and
(ii) The consumption or loss of future economic benefits can be reliably measured.

3.2 Components of Financial Statements

The Framework is concerned with **'general purpose' financial statements** (i.e. a normal set of annual statements), but it can be applied to other types of accounts. A complete set of financial statements includes:

(a) A statement of financial position
(b) A statement of comprehensive income
(c) A statement of changes in Equity
(d) A statement of cash flows
(e) Notes, other statements and explanatory material
(f) Statement of accounting policies

Supplementary information may be included, but some items are not included in the financial statements themselves, namely, commentaries and reports by the directors, the chairman, management etc.

Note that before the adoption of International Reporting Standard in Nigeria, the standards that guided the preparation of accounts were Statement of Accounting Standards (SAS) issued by the then Nigeria Accounting Standard Board. Complete set of financial statements prescribed by SAS includes:

(a) Balance sheet
(b) Profit and loss account
(c) Cash flow statement
(d) Notes to the accounts
(e) Statement of accounting policies
(f) Value added statement
(g) Directors Report

3.3Qualitative Characteristics of Financial Statements

In order for the financial statements to be useful to the stakeholders of a business they must embody certain qualitative characteristics. They are defined as follows:

The fundamental qualitative characteristics:

Relevance – financial information is regarded as relevant if it is capable of influencing the decisions of users.Information is relevant to users if it can be used to assist in evaluating past, present, or future events or in confirming, or correcting, past evaluations. In order to be relevant, information must be timely.

Faithful representation – this means that financial information must be complete, neutral and free from error. For information to represent faithful transactions and other events, it should be presented in accordance with the substance of the transactions and other events, and not merely their legal form.

The enhancing qualitative characteristics:
Comparability – it should be possible to compare an entity over time and with similar information about other entities. Information in financial statements is comparable when users are able to identify similarities and differences between that information and information in other reports.

An important implication of the characteristic of comparability is that users need to be informed of the policies employed in the preparation of financial statements, changes to those policies, and the effects of those changes. Because users wish to compare the performance of an entity over time, it is important that financial statements show corresponding information for preceding periods.

Verifiability – if information can be verified (e.g. through an audit) this provides assurance to the users that it is both credible and reliable.

Timeliness – information should be provided to users within a timescale suitable for their decision making purposes.

Understandability – information should be understandable to those that might want to review and use it. This can be facilitated through appropriate classification, characterisation and presentation of information.Information is understandable when users might reasonably be expected to comprehend its meaning. For this purpose, users are assumed to have reasonable knowledge of the entity's activities and the environments in which it operates and to be willing to study the information. Information about complex matters should not be excluded from the financial statements merely on the grounds of possible difficulties for certain users to understand.

Materiality -The relevance of information is affected by its nature and materiality. Information is material if its omission or misstatement could influence the decisions of users or assessments made on the financial statements. Materiality depends on the nature or size of the item or error, judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut – off point rather than being a primary qualitative characteristic that information must have if it is to be useful

3.4 Format of the Statement of Financial Position is as follows:

The example given by IAS 1 (revised) is as follows.

	20X7	*20X6*
Assets	₦000	₦000
Non-current assets		
Property, plant and equipment	350,700	360,020
Goodwill	80,800	91,200
Other intangible assets	227,470	227,470
Investments in associates	100,150	110,770
Available-for-sale financial assets	142,500	156,000

	901,620	945,460
Current assets		
Inventories	135,230	132,500
Trade receivables	91,600	110,800
Other current assets	25,650	12,540
Cash and cash equivalents	312,400	322,900
	564,880	578,740
Total assets	1,466,500	1,524,200

Equity and liabilities		
Equity attributable to owners of the parent		
Share capital	650,000	600,000
Retained earnings	243,500	161,700
Other components of equity	10,200	21,200
	903,700	782,900
Non-controlling interest	70,050	48,600
Total equity	973,750	831,500
Non-current liabilities		
Long-term borrowings	120,000	160,000
Deferred tax	28,800	26,040
Long-term provisions	28,850	52,240
Total non-current liabilities	117,650	238,280
Current liabilities		
Trade and other payables	115,100	187,620
Short-term borrowings	150,000	200,000
Current portion of long-term borrowings	10,000	20,000
Current tax payable	35,000	42,000
Short-term provisions	5,000	4,800
Total current liabilities	315,100	454,420
Total liabilities	492,750	692,700
Total equity and liabilities	1,466,500	1,524,200

IAS 1 (revised) specifies various items which must appear on the **face of the statement of financial position** as a minimum disclosure.

(a) Property, plant and equipment
(b) Investment property
(c) Intangible assets
(d) Financial assets
(e) Investments accounted for using the equity method
(f) Biological assets (outside the scope of the syllabus)

(g) Inventories
(h) Trade and other receivables
(i) Cash and cash equivalents
(j) Assets classified as held for sale under IFRS 5
(k) Trade and other payables
(l) Provisions
(m) Financial liabilities
(n) Current tax liabilities and assets as in IAS 12
(o) Deferred tax liabilities and assets
(p) Liabilities included in disposal groups under IFRS 5
(q) Non-controlling interests Issued capital and reserves

Any other line items, headings or sub-totals should be shown on the face of the statement of financial position when it is necessary for an understanding of the entity's financial position.
Whether additional items are presented separately depends on judgments based on the assessment of the following factors.

(a) Nature and liquidity of assets and their materiality. Thus goodwill and assets arising from development expenditure will be presented separately, as will monetary/non-monetary assets and current/non-current assets.
(b) Function within the entity. Operating and financial assets, inventories, receivables and cash and cash equivalents are therefore shown separately.
(c) Amounts, nature and timing of liabilities. Interest-bearing and non-interest-bearing liabilities and provisions will be shown separately, classified as current or non-current as appropriate.

The standard also requires separate presentation where different measurement bases are used for assets and liabilities which differ in nature or function. According to IAS 16, for example, it is permitted to carry certain items of property, plant and equipment at cost or at a revalued amount.

STATEMENTS OF FINANCIAL POSITION

Statement of Financial Position is a Statement that shows Assets, Liabilities and Net Assets / Equity of the enterprise. Both Assets and Liabilities are categorized as Current and Non-Current.

1. CURRENT ASSETS

Current Assets are assets that can either be converted to cash or used to pay current liabilities within a short period of time (3months). Typical current assets include:

i. **Cash & Its Equivalent:**

- **Cash at Bank-** Money deposited in the bank, demand deposits and interest bearing bank accounts such as time deposits or certificates of deposits held by the bank.

- **Cash in Hand-** This account includes currency, coins, cheques, money orders, bankers' drafts not on deposit with a bank. This account also includes petty cash.

ii. Account Receivables

- Amounts due from private persons, firms or corporations for goods and services furnished by the enterprise. It also includes revenue receivables and short term loans / advances to employees etc.

iii. Inventories include

- Materials and supplies on hand for future consumption
- Goods held for resale, rather than for use in operations. This includes land and building intended for sale and not for use.

iv. Prepayments

These are payments made, which benefits are not yet taken by the organization (payments made in advance)

v. Other Current Asset

Assets, not previously classified that become due within one year.

2. NON-CURRENT ASSETS

Non-Current Assets are Assets that become due or can be converted to cash in over a year. These include:

(i) Property, Plant & Equipment(ii) Investment Property(iii) Intangible assets

(iv) Investments (Long Term)   (v) Long Term Loans Granted

i. **PROPERTY, PLANT AND EQUIPMENT (PPE)**

PPE are tangible assets that are held by the enterprise for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and are expected to be used during more than one reporting period. IAS 16 clearly provides definition, Measurement and Recognition of PPE. The Standard prescribes the principles for initial recognition and subsequent accounting (determination of carrying amount and the depreciation charges and impairment losses for property, plant and equipment so that users of financial statements can discern information about the Polytechnic's investment in its property, plant and equipment and the changes in such investment. An item of property, plant and equipment should be recognized as an asset when:

- It is probable that future economic benefits or service potential associated with the asset will flow to the entity
- The cost or fair value of the asset to the enterprise can be measured reliably.

A class of property, plant and equipment is a grouping of assets of a similar nature or function in the Polytechnic's operations. The following are examples of separate classes:

(a). Land (b). Operational buildings (c). Roads (d). Machinery

(e). Electricity Transmission Network (f). Ships (g). Aircraft

(h). Specialist military equipment (i). Motor vehicles (j). Furniture and fixtures

(k). Office equipment (l). Oil rigs

a. **Land:** A fixed asset account, which reflects the acquisition cost of land owned by the Polytechnic. If land is purchased, this account includes the purchase price and costs such as legal fees, filling and excavation costs and the likes, which are incurred to put the land in condition for its intended use. If land is acquired by gift, the account reflects its appraised value at the time of acquisition.

b. **Operational Building:** A fixed asset account, which reflects the acquisition cost of permanent structures used to house persons and property owned by the enterprise. If buildings are purchased or constructed, this account includes the purchase or contract price of all permanent buildings and fixtures attached to and forming a permanent part of such buildings. If buildings are acquired by gift, the account reflects their appraised value at the time of acquisition.

c. **Infrastructure:** The acquisition cost of permanent improvements, other than buildings which add value to the land. These improvements consist of capital expenditure such as roads, bridges, streets, sidewalks, curbs, these assets are normally immovable and of value to the enterprise. Therefore, it is the enterprise's option whether such assets are recorded in the general fixed assets.

d. d. **Equipment and Furniture:** Equipment, Furniture, Fixtures and other tangible property of a non-consumable nature with a normal expected life of one year or more.

e. **Property under Capital Leases:** property acquired under a lease agreement that meets the requirements of capitalisation.

f. **INVESTMENT PROPERTY**

g. Investment property is land or buildings held (whether by the owner or under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

h. Use in the production or supply of goods or services or for administrative purposes;

i. Sale in the ordinary course of operations.

j. **IAS 40**prescribes the accounting treatment for investment property and related disclosures.

k. **INTANGIBLE ASSETS**

l. Intangible Assets that have no physical existence and the value are limited by rights and anticipative benefits that possession confers upon the owner (patent, copyright, etc.)

m. **INVESTMENT – NON – CURRENT**

n. Securities, including repurchase and reverse repurchase agreements held for the production of income in the form of interest and dividends e.g. bonds. These accounts do not include certificates of deposits or other interest bearing bank accounts.

o. gutters, drainage systems and outdoor lighting systems.

LONG TERM LOAN GRANTED

Loans granted by the enterprise to be repaid within a long period of time.

3. CURRENT LIABILITIES

Current Liabilities are Liabilities in existence at the date of the (balance sheet) Statement of Financial Position which is due for repayment with in shortest possible time. They include the following:

i. Deposits ii. Unremitted Deductions iii. Account Payables iv. Short Term Loans.

v. Current Portion of Borrowings.

i. **Deposits:** A Liability incurred for deposits received. They also represent funds held by the Polytechnic on behalf of third party or outsiders e.g. Retention Fees. They are treated as part of current liabilities because owners can demand for payment at any point in time.

ii. **Unremitted Deductions:** These are deductions made from payment by the Polytechnic but not remitted at the end of the reporting period. They include PAYE, WHT VAT, Union Dues, NHF, etc.

iii. **Account Payables:** Account Payables include:

- Liabilities due to private persons, firms or corporation for goods and services received by the enterprise, but not including amounts due to other funds of the Polytechnic.
- Judgments debts to be paid by the enterprise as a result of court decisions, including damages awarded for private property taken for public use.
- Annuities due and payable to retired employees in a public employees' retirement system.
- Amounts due on contracts for assets, goods and services received by the Polytechnic.
- **Current portion of borrowings**
- In the enterprise funds, the current portion would be used to record only that portion that was payable with current, available resources; the long-term portion would be recorded in the long term debt account group.
- **NON CURRENT LIABILITIES**
- Non Current Liabilitiesinclude Long Term Debts and borrowings.

3.5 Format of Income Statement

STATEMENT OF PROFIT OR LOSS

Statement of Profit or Loss is one of the Principal Statements included in GPFS. The Statement shows income accrued to the enterprise from all sources and Expenses incurred during the period. IAS 1 prescribes minimum requirements to be disclosed at the face of the Statement.

IAS 1 (revised) allows income and expense items to be presented either:

(a) in a single statement of comprehensive income (Statement of Profit or Loss); or
(b) in two statements: a separate income statement (Statement of Profit or Loss)and statement of other comprehensive income.

XYZ GROUP – STATEMENT OF COMPREHENSIVE INCOME (STATEMENT OF PROFIT OR LOSS) FOR THE YEAR ENDED 31 DECEMBER 20X7

	20X7	*20X6*
	₦'000	₦'000
Revenue	390,000	355,000
Cost of sales	(245,000)	(230,000)
Gross profit	145,000	125,000
Other income	20,667	11,300
Distribution costs	(9,000)	(8,700)
Administrative expenses	(20,000)	(21,000)
Other expenses	(2,100)	(1,200)
Finance costs	(8,000)	(7,500)
Share of profit of associates	35,100	30,100
Profit before tax	161,667	128,000
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operations		(30,500)
Profit for the year	121,250	65,500
Other comprehensive income:		
* Exchange differences on translating foreign operations	5,334	10,667
Available-for-sale financial assets	(24,000)	26,667
*Cash flow hedges	(667)	(4,000)
Gains on property revaluation	993	3,367
*Actuarial gains (losses) on defined benefit pension plans	(667)	1,333
Share of other comprehensive income of associates	400	(700)

SeparateIncome Statement

In other national published accounting standards it's referred to as the Profit and Loss Account.The standard distinguishes the function of expense ('by function') and nature of expense ('by nature') formats. The 'by function' format is also referred to as the cost of sales method.

The standard states that it "requires a choice between classifications based on that which most fairly presents the elements of the enterprise's performance"

IAS offers two possible formats for the income statement section or separate income statement-by function or by nature. Classification by function is more common.

Formant of separate income statements
Illustrating the classification of expenses by function
XYZ GROUP STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X8

	20X8	20X7
	N000	N000
Revenue	X	X

Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year	X	X
Attributable to:		
Owners of the parent	X	X
Non-controlling interest	X	X

Illustrating the classification of expenses by nature
XYZ GROUP STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X8

	20X8	20X7
	₦000	₦000
Revenue	X	X
Other operating income	X	X
Changes in inventories of finished goods and work in progress	(X)	X
Work performed by the entity and capitalised	X	X
Raw material and consumables used	(X)	(X)
Employee benefits expense	(X)	(X)
Depreciation and amortisation expense	(X)	(X)
Impairment of property, plant and equipment	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year	X	X

Attributed to:

Owners of the parent	X	X
Non-controlling interest	X	X
	X	X

Note: The usual method of presentation is expenses by function

The following example illustrates these two differing formats.

Illustration 1

The following is an extract of balances in the accounts of South Feeds and Fertilizers a limited company at 31 December 2010.

		₦m
Cost of sales		7.2
Sales revenue	18.2	
Distribution costs		2.6
Loan note interest		2.8
Admin expenses		4.2

An analysis of the costs other than interest; ie₦14m showed the following:

		₦m
Raw materials and consumables		4.2
Increase in inventories finished goods and work in progress		(0.4)
Depreciation		3.6
Staff costs		5.8
Other operating expenses		0.8
	14m	

The provision for income tax expense had been agreed at ₦0.4m. From this information we can now produce income statements in both formats.

'By Function' Format

South Feeds and Fertilizers Statement of Profit or Loss for Year Ended 31 December 2010

	₦m	₦m
Revenue		18.2
Cost of sales		7.2
Gross profit		11.0
Distribution costs	2.6	
Administration expenses	4.2	
		6.8
Profit from operations		4.2
Interest payable		2.8
Profit before tax		1.4
Income tax expense		0.4
Net profit for period		1.0

'By Nature' Format

	₦m	₦m
Revenue		18.2
Increase in inventories of finished goods and work in progress		0.4
		18.6
Raw materials and consumables	4.2	
Staff costs	5.8	

Depreciation	3.6	
Other operating expenses	0.8	
		14.4
Profit from operations		4.2
Interest payable		2.8
Profit before tax		1.4
Income tax expense		0.4
Net profit for period		1.0

3.6 Format of Statement of Changes in Equity

	Share Capital ₦m	**Share Premium ₦m**	**Revaluation Reserve ₦m**	**Retained earnings ₦m**	**Total ₦m**
Balance 31 December 2009	*	*	*	*	*
Surplus on revaluation of properties			*		*
Deficit on revaluation of investments			(*)		(*)
Net gains and losses not recognized in the income statement			*		*
Net profit for period				*	*
Dividends				(*)	(*)
Issue of Share Capital	*	*			*
Balance at 31 December 2010	*	*	*	*	*

Statement of changes in equity shows net assets for the year.Net Asset/Equity simply refers to Assets less Liabilities. Net Assets/Equity is financed by Reserves, Accumulated surpluses etc. The Statement is important in GPFS because it enables users to ascertain causes for movement in Net Worth of the enterprise. Vide the format of GPFS;

Changes in Net Assets /Equity are therefore normally caused by:

- *Significant changes in Accounting Policies*
- *Correction of prior year's errors*
- *Revaluation of the Assets*
- *Surplus or Deficit for the period*
- *Changes in Currency Translations etc.*

3.7*Statement of Cash flow*

Statement of Cash flow is one of the Statements required by IAS 7 to be presented in the GPFS. The cash flow statement identifies the sources of cash inflows and outflows: the items on which cash was expended during the reporting period, and the cash balance at the end of the reporting date. Cash flows are basically reported under three (3) separate activities as follows:

- ❑ OPERATING ACTIVITIES:

Cash flow from Operating Activities includes:

- Revenues or income from regular activities

- Payment to and on behalf of staff (personnel cost)
- Overheads
- Other charges etc.

- ❑ Investing Activities

Cash flow from investing activities includes acquisition and disposal of long term assets and other investments not included in cash equivalent.

- ❑ Financial Activities

These are activities that result in changes in the size and composition of the contributed capital and borrowings.

Method of Preparing Cash Flow

IAS 7 recognizes two methods of preparing cash flow; that is Direct and Indirect Method. Under direct method, major classes of gross cash receipts and gross cash payments are disclosed while under indirect method, net surplus / deficit is adjusted for the effect of, for instance transactions of non-cash nature like depreciation. Enterprise using direct method should provide a reconciliation of the surplus / deficit with the net cash from operating activities. Enterprises are however recommended to use direct method.

3.8 Notes to the financial statements

Notes and other disclosures in GPFS are additional information presented in the GPFS to enable users understand the financial statements better and compare them with those of other entities.

Notes include narrative description or more detailed schedules or analyses of amounts shown on the face of the statement of financial performance, statements of financial position, cash flow statement and statement of changes in net assets / equity, as well as additional information such as contingent liabilities and commitments.

T FORWARD

Contents of Notes

The notes to the financial statements will amplify the information given in the statement of financial position, statement of comprehensive income and statement of changes in equity. We have already noted above the

information which the IAS allows to be shown by note rather than in the statements. To some extent, then, the contents of the notes will be determined by the level of detail shown on the face of the statements.

Structure

No Standard specifically provides format for preparation of notes and other disclosures to the financial statements but as a minimum requirement, notes to the financial statements should perform the following functions.

(a) Provide information about the basis on which the financial statements were prepared and which specific accounting policies were chosen and applied to significant transactions/events

(b) Disclose any information, not shown elsewhere in the financial statements, which is required by IFRSs

(c) Show any additional information that is relevant to understanding which is not shown elsewhere in the financial statements he way the notes are presented is important. They should be given in a systematic manner and cross referenced back to the related figure(s) in the statement of financial position, statement of comprehensive income or statement of cash flows.

Notes to the financial statements will amplify the information shown therein by giving the following.

(a) More detailed analysis or breakdowns of figures in the statements
(b) Narrative information explaining figures in the statements
(c) Additional information, e.g., contingent liabilities and commitments

IAS 1 suggests a certain order for notes to the financial statements. This will assist users when comparing the statements of different entities.

(a) Statement of compliance with IFRSs

(b) Statement of the measurement basis (bases) and accounting policies applied

(c) Supporting information for items presented in each financial statement in the same order as each line item and each financial statement is presented

(d) (d) Other disclosures, e.g.:

(i) Contingent liabilities, commitments and other financial disclosures

(ii) Non-financial disclosures

The order of specific items may have to be varied occasionally, but a systematic structure is still required.

3.9 Presentation of accounting policies

Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements. They are part of the financial statements.

Enterprise should select and apply accounting policies so that the financial statements comply with all the requirements of each applicable International Financial Reporting Standard.

The accounting policies section should describe the following.

(a) The measurement basis (or bases) used in preparing the financial statements
(b) The other accounting policies used, as required for a proper understanding of the financial statements

This information may be shown in the notes or sometimes as a separate component of the financial statements. The information on measurement bases used is obviously fundamental to an understanding of the financial statements. Where more than one basis is used, it should be stated to which assets or liabilities each basis has been applied.

3.10 Other disclosures

An entity must disclose in the notes:

(a) The amount of dividends proposed or declared before the financial statements were authorised for issue but not recognised as a distribution to owners during the period, and the amount per share

(b) The amount of any cumulative preference dividends not recognised

IAS 1 ends by listing some specific disclosures which will always be required if they are not shown elsewhere in the financial statements.

(a) The domicile and legal form of the entity, its country of incorporation and the address of the registered office (or, if different, principal place of business)

(b) A description of the nature of the entity's operations and its principal activities

The name of the parent entity and the ultimate parent entity of the group

Illustration 2

The following balances remained in the books of Lagbaja Plc at December 31, 2014 after determining the gross profit:

	₦"000
Share capital, authorised and issued:	
200,000,000 ordinary shares of ₦1 each	200,000
Cash at bank and in hand	500
Inventory at December 31, 2014	61,200
Trade receivables	18,005
Trade payables	15,009
Gross profit at December 31, 2014	128,942
Retained earnings	25,000
Salaries & Wages	28,430
Prepayments	600
Bad debts	500
Accrued expenses	526
Director's account (credit)	2,500
Finance cost on loan note (½ year to June 30, 2014)	600
Sundry expenses	4,100
Rates & insurance	1,520
6% Loan notes	20,000
Lighting & cooling	1,310
Postage, telephone and telegrams	800
Motor vehicle (cost ₦25million)	15,000
Office fittings and equipment (cost ₦65.5million)	42,350
Profit at January 1, 2014	22,300
Land and buildings at Cost	239,362

The following additional information is relevant:

(i) Office fittings and equipment are to be depreciated at 15% of cost, and Motor vehicle at 20% of cost.

(ii) Provisions are to be made for:

Directors" Fees	₦6,000,000
Audit Fees	₦2,500,000

(iii) The amount of insurance includes a premium of ₦600,000 paid in September 2014 to cover the company against fire for the period September 1, 2014 to August 31, 2015.

(iv) A bill for ₦548,000 in respect of electricity consumed up to December 31, 2014 has not been posted to the ledger.

Required:

a. Prepare the Statement of profit or loss for the year ended December 31, 2014; and

b. The Statement of financial position as at December 31, 2014.

a.

LAGBAJA PLC

Statement of Profit or Loss for the year ended 31 December, 2014

	₦'000	₦'000
Gross profit		128,942
Operating expenses:		
Salaries and wages	28,430	
Bad debts	500	
Sundry expenses	4,100	
Rates & Insurance (N1,520 - (8/12*N600)	1,120	
Lighting & cooling (N1,310+N548)	1,858	
Postage, telephone & telegrams	800	
Directors fees	6,000	
Audit fees	2,500	
Depr. Of Office fitting & equip (15% x N65.5million)	9,825	
Depr. Of motor vehicles (20% x N25million)	5,000	
Total operating expenses		(60,133)
Profit from operation		68,809
Finance cost (6% x N20,000,000)		(1,200)
Profit before taxation		67,609
Income tax expenses		-
Profit for the year		67,609

Statement of changes in equity for the year ended 31 December, 2014

	Ordinary Shares	Retained Earnings	Total
	₦'000	₦'000	₦'000
Profit as at January 1, 2014	200,000	22,300	222,300

Retained earnings brought forward	-	25,000	25,000
Profit for the period	-	67,609	67,609
Balance as at December 31, 2014	200,000	114,909	314,909

b.

LAGBAJA PLC

Statement of financial position as at 31 December, 2014

Assets		
Non-Current Assets:	₦'000	₦'000
Property, Plant and Equipment		
Land and buildings		239,362
Motor vehicles		10,000
Fittings and equipment		32,525
Total Non-Current Assets		281,887
CurrentAssets:		
Inventory	61,200	
Trade Receivables	18,005	
Prepayment (600 + 400)	1,000	
Cash at bank and in hand	500	
Total Current Assets		80,755
TOTAL ASSETS		362,592
Equity and Liabilities:		
Share capital 200,000,000 ordinary shares of N1 each		200,000
Retained Earnings		114,909
Total Equity		314,909
Non-Current Liabilities:		
6% Loan notes		20,000
Current Liabilities:		
Accrued audit Fees	2,500	
Trade Payables	15,009	
Director's account (2500 + 6000)	8,500	
Accrued expenses (548 + 526)	1,074	
Accrued finance cost on loan notes	600	
		27,683

362,592

Workings:

1.All the figures in bracket in the solution above are in ₦'000

2.Non-current assets : Property, Plant and Equipment

	Land & building	Motor Vehicle	Fittings & equipment
	₦"000	₦"000	₦"000
Cost b/f	239,362	25,000	65,500
Depreciation:			
Bal b/f	-	10,000	23,150
Charge for the year		5,000	9,825
Bal c/f		15,000	32,975
Carrying amount 31/12/2014	239,362	10,000	32,525

4.0 Conclusion

IAS 1 suggests formats for the statement of financial position and statement of comprehensive income, but these are not rigid. Certain items are specified, however, for disclosure on the face of the financial statements.

5.0 Summary

IAS 1 covers the form and content of financial statements. The main components are:

1. Statement of financial position
2. Income Statement
3. Statement of changes in equity
4. Statement of cash flows
5. Notes to the financial statements

Each component must be identified clearly.

6.0Tutor mark assessment

HK Ltd has prepared its draft trial balance to 30 June 20X1, which is shown below.

Trial balance at 30 June 20X1

	₦000	*₦000*
Freehold land	2,100	
Freehold buildings (cost ₦4,680)	4,126	
Plant and machinery (cost ₦3,096)	1,858	
Fixtures and fittings (cost ₦864)	691	
Goodwill	480	
Trade receivables	7,263	
Trade payables		2,591

Inventory	11,794	
Bank balance	11,561	
Development grant received		85
Profit on sale of freehold land		536
Sales		381,600
Cost of sales	318,979	
Administration expenses	9,000	
Distribution costs	35,100	
Directors' emoluments	562	
Bad debts	157	
Auditors' remuneration	112	
Hire of plant and machinery	2,400	
Loan interest	605	
Dividends paid during the year – preference	162	
Dividends paid during the year – ordinary	426	
9% loan		7,200
Share capital – preference shares (treated as equity)		3,600
Share capital – ordinary shares		5,400
Retained earnings		6,364
	407,376	407,376

The following information is available:

(a) The authorized share capital is 4,000,000 9% preference shares of ₦1 each and 18,000,000 ordinary shares of 50k each.

(b) Provide for depreciation at the following rates:

(i) Plant and machinery 20% on cost

(ii) Fixtures and fittings 10% on cost

(iii) Buildings 2% on cost

Charge all depreciation to cost of sales.

(c) Provide ₦5,348,000 for income tax.

(d) The loan was raised during the year and there is no outstanding interest accrued at the year-end.

(e) Government grants of ₦85,000 have been received in respect of plant purchased during the year and are shown in the trial balance. One-fifth is to be taken into profit in the current year.

(f) During the year a fire took place at one of the company's depots, involving losses of ₦200,000. These losses have already been written off to cost of sales shown in the trial balance. Since the end of the financial year a settlement of ₦150,000 has been agreed with the company's insurers.

(g) ₦500,000 of the inventory is obsolete. This has a realizable value of ₦250,000.

(h) Acquisitions of property, plant and equipment during the year were:

Plant ₦173,000 Fixtures ₦144,000

(i) During the year, freehold land which cost ₦720,000 was sold for ₦1,316,000.

(j) A final ordinary dividend of 3k per share is declared and was an obligation before the year-end, together with the balance of the preference dividend. Neither dividend was paid at the year-end.

(k) The goodwill has not been impaired.

(l) The land was revalued at the year end at ₦2,500,000.

Required:

(a) Prepare the company's statement of comprehensive income for the year to 30 June 20X1 and a statement of financial position as at that date, complying with the relevant accounting standards in so far as the information given permits. (All calculations to nearest ₦000.)

7.0 References/Further Readings

Adebayo, P.A.(2011). Financial Accounting and Reporting Standards for Students and Professionals, Abuja: Rainbow Graphic Printers and Publishers

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UNIT TWO: LEGAL AND REGULATORY FRAMEWORK OF GROUP ACCOUNTS

1.0 Introduction

2.0 objectives

3.0 Main Content

3.1 Law and Accounting Standards that Regulates Operations of Group Account

3.2 Group Financial Statements

3.3 Parent/Holding Company and Subsidiaries

3.4 Methods of Preparing Consolidated Accounts

3.5 Exemption of Subsidiaries from Consolidation

3.6 Explanation of terms under Group Account

4.0 Conclusion

5.0 Summary

6.0 Tutor-Marked Assignment

7.0 References/Further Readings

1.0 INTRODUCTION

A company may own a relatively large number of shares in another company; usually in excess of 50 per cent of the other company's issued equity share capital, or even all its shares of one company. Combinations based on the ownership of controlling shares by one company in another company, directly or indirectly, give rise to a group of companies. Though, the combinations of this nature do not affect the existence of the combined companies, as separate legal entities. However, this transfer of control from one group of owners to another affects the economic substance of members of the group which requires special accounting treatment.

2.0 OBJECTIVES

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

- Explain the theoretical background and regulatory documents for the preparation and presentation consolidation of financial statements.
- Describe the conditions required for an enterprise to be a subsidiary, an associate of a group or a joint entity.
- Understand consolidation procedures and key terms.
- Understand some terms in group account

3.0 MAIN CONTENT

3.1 Law and accounting standards that regulate the operations of Group Accounts

The regulatory documents for the preparing of group accounts are as follows:

(a) The Companies and Allied Matters Act Cap.C20 LFN 2004, later called the Act;

(b) IAS 27 Consolidated and Separate Financial Statements

(c) IAS 28 Investment in Associates

(d) IAS 31 Interests in Joint Ventures

(e) IFRS 3 Business Combinations

(f) IFRS 10 Consolidated Financial Statements.
IFRS 10 replaces the portion of IAS 27 Consolidated and Separate Financial Statements that addresses the accounting for consolidated financial statements.

(g) IFRS 11 Joint Arrangements, IFRS 11 replaces IAS 31 Interests in Joint Ventures and SIC-13 Jointly-controlled Entities—Non-monetary Contributions by Venturers.

(h) SIC-12 Consolidation — Special Purpose Entities

(i) IFRS 12 Disclosure of Interests in other Entities.

IFRS 12 includes all of the disclosures that were previously in IAS 27 related to consolidated financial statements, as well as all of the disclosures that were previously included in IAS 31 and IAS 28 Investment in Associates.

3.2 Group Financial Statements

A group is defined as a parent company and its subsidiaries, group financial statements are the financial statements of the parent company and its subsidiaries combined to form a set of consolidated financial statements.

Consolidated financial statements are the financial statements of a group presented as those of a single enterprise. In accordance with the Act, the group's financial statements shall consist of three statements, as follows:

(a) Consolidated statement of financial position dealing with the state of affairs of the company and all the subsidiaries of the company;

(b) Consolidated income statement/ comprehensive income statement of the company and its subsidiaries; and

(c) Consolidated statement of cash flows of the company and its subsidiaries.

(d) Consolidated statement of changes in equity of the company and its subsidiaries.

(e) Notes to the consolidated statement of financial position.

3.3 Parent/Holding Company and Subsidiaries

A holding company is one that has one or more subsidiaries. A subsidiary is an enterprise that is controlled by another enterprise known as the parent.

Under Section 338 of the Act, a company (say company A) shall be deemed to be the subsidiary of another company (say company B) if:

(a) the company (company B) is a member of it and controls the composition of its board of directors; or

(b) holds more than half the nominal value of its equity share capital; or

(c) the first mentioned company (company A) is a subsidiary of any company which is a subsidiary of company B.

For the purpose of the Act, the composition of the board of directors of a company shall be deemed to be controlled by another company if that other company has the power to remove all or a majority of the directors without the consent or concurrence of another party.

IFRS 10 establishes a single control model that applies to all entities (including 'special purpose entities,' or 'structured entities' or 'variable interest entities'. The changes introduced by IFRS 10 will require management to exercise significant judgment to determine which entities are controlled, and therefore are required to be consolidated by a parent, compared with the requirements that were in IAS 27. Therefore, IFRS 10 may change which entities are within a group. These changes were made by the IASB, in part, in response to the financial crisis, when there was heavy criticism of accounting rules that permitted certain entities to remain off-balance sheet.

Generally, control is also presumed to exist when the parent has:

1. Power over more than half the voting right by virtue of agreement with other investors.

2. Power to govern the financial and operating policies of the enterprise under a statute or agreement.
3. Power to appoint or remove the majority of the members of the board of directors.
4. Power to cast the majority of votes at a meeting of board of directors or equivalent governing body and control of the entity is by that board or body.

Illustration 1

Green Co owns the following investments in other companies:

	Equity shares held	Non-equity shares held
Violet Co	80%	Nil
Amber Co	25%	80%
Black Co	45%	25%

Green Co also has appointed five of the seven directors of Black Co.
Which of the following investments are accounted for as subsidiaries in the consolidated accounts of Green Co Group?

A Violet only
B Amber only
C Violet and Black
D All of them

Answer

Let's consider each of the investments in turn to determine if control exists and therefore, if they should be accounted for as a subsidiary.
Violet Co – by looking at the equity shares, Green Co has more than 50% of the voting shares – i.e. an 80% equity holding. This gives them control and, therefore, Violet Co is a subsidiary.
Amber Co – you must remember to look at the equity shares, as despite having the majority of the non-equity shares, these do not give voting power. As Green Co only has 25% of the equity shares, they do not have control and, therefore, Amber Co is not a subsidiary.

Black Co – by looking at the percentage of equity shares, you may incorrectly conclude that Black Co is not a subsidiary, as Green Co has less than half of the voting rights. However, by looking at the fact that Green Co has appointed five of the seven directors, effectively they have control over the decision making in the company. This control should make you conclude that Black Co is a subsidiary.

Therefore the correct answer is C.

3.4 Methods of preparing consolidated accounts

Before IFRS 3, there were two main methods of preparing consolidated statements, the purchase method and the pooling of interests method. The former method was the more common and was used in all cases where one company was seen as acquiring another. IFRS 3 now allows only the purchase method.

The purchase method has the following features:
(i) Assets and liabilities of the subsidiaries are measured at fair market value at the date of acquisition;
(ii) Shares purchased and issued in settlement of the purchase are valued by the parent company at fair value.
(iii) The profits of the subsidiary are divided into pre-acquisition and post-acquisition periods. Only the post-acquisition profits are consolidated.

(iv) Goodwill arises on consolidation when the fair value of the consideration is different from the fair value of the net asset acquired.

Requirements of IFRS 3 in relation to Acquisition Method

(i) All business combinations must be accounted for using acquisition method.

(ii) Identify the acquirer – one of the combining entities must be identified as the acquirer.

(iii) Determine the acquisition date – this is generally the date on which the acquirer obtains control of the 'acquiree' and this would usually be the closing date or sometimes a date earlier or later than the closing date.

(iv) Determine the acquisition date – this is generally the date on which the acquirer obtains control of the 'acquiree' and this would usually be the closing date or sometimes a date earlier or later than the closing date.

(v) Recognise and measure the identifiable assets acquired and the liabilities assumed at fair value on the acquisition date.

(vi)NCI in an 'acquiree' should be measured at fair value or at the NCI's proportionate share of the 'acquiree's' identifiable net assets at acquisition.

(vii)Recognise and measure goodwill or gain from a bargain purchase and test goodwill for impairment periodically.

3.5 Exemption of Subsidiaries from Consolidation

Under theCompanies and Allied Matters Act (CAP C20 LFR 2004):

(a) Under Section 336(2) of the Act, group accounts need not be prepared where the parent company itself is at the end of its financial year, a wholly owned subsidiary of another company incorporated in Nigeria. However, w here the ultimate parent company is incorporated overseas; the group accounts should be prepared.

(b) Under Section 336(3) of the Act, a subsidiary may be omitted from the group accounts if:

(i) it is impracticable or would be of no real value to members because of the insignificant amount involved;

(ii) it would involve expenses or delay out of proportion to its value to members of the company;

(iii) the result would be misleading or harmful to the business of the company or any of its subsidiaries. For instance, it may be harmful to consolidate the result of a subsidiary with operating losses, poor liquidity position and massive borrowing; or

(iv) the business of the parent company and that of the subsidiary are so different that they cannot reasonably be treated as a single undertaking.

Under IFRS 10

Consolidated Financial Statements, a parent entity is allowed not to present or prepare consolidated financial statements if certain conditions prevail.

(i) it is a wholly-owned subsidiary or is a partially-owned subsidiary of another entity and

all its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;

(ii)its debt or equity instruments are not traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets);

(iii) it did not file, nor is it in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market; and its ultimate or any intermediate parent produces consolidated financial statements that are available for public use and comply with IFRSs.

3.6 Explanation of Concepts under Group Accounts

(a) Equity share capital

This comprises any equity share capital which carries the right to participate beyond a specified amount in either a capital or revenue distribution. Therefore, it includes all share capital other than non-participating preference shares.

In the absence of information to the contrary, ordinary shares are summed to be equity while preference shares are not.

(b) Equity method of accounting

This is a method of accounting where the investment in a company is shown in the consolidated statement of financial position at:

(i) the cost of the investment; plus
(ii) the investing company or group's share of the post-acquisition retained profits and reserves of the company; less
(iii) any amount written off in respect of (i) and (ii) above. The investing company should account separately in the profit and loss account for its share of the profit before tax, taxation and extraordinary items of the acquired company.

This method is usually applied to associated companies.

(c) Related company

The Act defines a related company as anybody corporate (other than that which is a group company in relation to that company) in which that company holds on a long-term basis, a qualifying capital interest for the purpose of securing a contribution to that company's own activities by exercising control or influence arising from that interest.

(d) Associated companies

This is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.

Significant influence is the power to participate in the financial and operating policy decisions of the investee but does not have control over those policies. A holding of 20 percent but less than 50% of the equity voting rights is regarded as the ability to exercise significant influence (though not in all circumstances).

(e) Fellow subsidiaries

A body corporate is treated as a fellow subsidiary of another body corporate, if both are subsidiaries of the same company, but neither is the other's subsidiary.

(f) Cost of control account

It is described as an account opened to record the purchase of a business so as to determine whether the business is being purchased 'at a profit or at a loss'. In other words, it is a goodwill account. A debit balance on

the Cost of Control Account is regarded as a loss on purchase because the cost of shares acquired is greater than the net assets acquired while a Credit balance on the Cost of Control is regarded as a gain (i.e. Negative Goodwill). In the cost of control account, the cost of investment is cancelled against the net assets are acquired to determine goodwill.

(g) Goodwill on consolidation

Goodwill is the difference between the price paid by the parent company and the fair value of the subsidiary's net assets at the date of acquisition. Included in the definition of net assets are identifiable assets, liabilities and contingent liabilities of the subsidiaries.

IFRS 3 business combinations states the positive purchased goodwill must be capitalised upon consolidation and reviewed for impaired at least annually under IAS 36 impairment of assets. The impairment goes through the consolidated income statement. Negative goodwill is investigated and is taken to the consolidated income statement immediately as a credit. Negative goodwill is also known as "bargain purchase"

The new revised IFRS 3 method of calculating goodwill now gives the parent company a choice between 2 methods of calculating goodwill and dealing with NCI:

(i) NCI's share of net assets - this is the old method (also known as the partial goodwill). Here, the goodwill is calculated in the traditional way. The NCI are basically ignored in the goodwill calculation and just the parent's share is shown.

(ii) Fair value – this is the new method (also known as the full goodwill). Both the parent's and the NCI's goodwill is established and shown in the consolidated financial statements.

(h) Fair value of net assets

The fair value of an asset and a liability is defined as the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length (IFRS 3). If additional evidence of the fair values of acquired assets and liabilities becomes available after the acquisition, the consolidated financial statements should be adjusted to reflect this development.

(i) Non -controlling interest (Formerly called Minority interest)

When the parent company owns less than 100% equity shares in the subsidiary, say 70%, the remaining 30% is attributable to the non-controlling interest (NCI). Non-controlling interest is "the equity in a subsidiary not attributable, directly or indirectly, to a parent."

(j) Pre-acquisition and post-acquisition profits

The profits of a subsidiary company are distinguished between pre-acquisition and post-acquisition for the purpose of preparing consolidated accounts.
Pre-acquisition reserves are the accumulated reserves earned by the subsidiary prior to its acquisition by the parent company. They are credited to cost of control account as part of the process required to arrive at goodwill arising on consolidation.

Post-acquisition reserves are the accumulated retained profits since the date of acquisition. The proportion of these reserves earned by the parent company is credited to the consolidated accounts. To the extent that post-acquisition profits earned by the subsidiary are transferred to the parent company

by w ay of dividends, the amount to be aggregated when consolidation takes place will be reduced correspondingly.

(l) Other reserves of a subsidiary

Other reserves of a subsidiary may include share premium account, revaluation surplus on fixed assets and other reserves. The principle of dividing them between pre-acquisition and post-acquisition reserves will apply.

4.0 CONCLUSION

Knowledge of the theoretical background for consolidation of financial statements and the regulatory documents is very necessary for the preparation and presentation of consolidated financial statements.

5.0 SUMMARY

This unit explained the legal and regulatory framework in the presentation of group accounts with particular reference to the detailed provisions of CAMA 2004 and IFRS.

In the next unit, we shall discuss consolidated statement of financial position.

6.0 TUTOR-MARKED ASSIGNMENT

Discuss the reasons for exempting a subsidiary from consolidation procedure.

7.0 REFERENCES/FURTHER READINGS

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UNIT THREE: **CONSOLIDATED STATEMENT OF FINANCIAL POSITION**

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
- 3.1 Consolidation Procedures
- 3.2 Group Structure
- 3.3 Cancellation and Part Cancellation
- 3.4 Consolidation Schedule
- 3.5 Non-Controlling Interest
- 3.6 Preferred Shares
- 3.7 Deferred Consideration
- 3.8 Fair Value Adjustment Calculation
- 3.9 Inter-Company Sales of Fixed Assets

4.0 Conclusion
5.0 Summary
6.0 Tutor-Marked Assignment
7.0 References/Further Readings

1.0 INTRODUCTION

The main objective of consolidated statements of financial position is to provide information about the group's financial position to the equity shareholders of the parent company. The consolidated statement of financial position is prepared by aggregating on a line-by-line basis all the assets and liabilities of the parent company with those of its subsidiary. The result is a statement of financial position containing the assets and liabilities of the two entities as if they were owned by a 'single economic entity'.

2.0 OBJECTIVES

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

- Apply the basic principles and procedures involved in consolidation.
- Calculate goodwill, unrealised profit, fixed assets;
- Account for inter-company items.
- Determine goodwill, pre-acquisition, profit and NCI

3.0 MAIN CONTENT

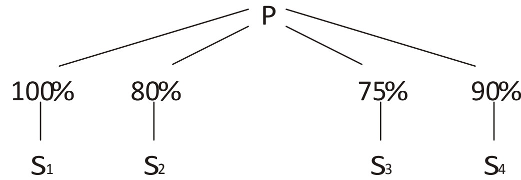
3.1 Consolidation Procedures

The process of consolidating financial statements can be broken down into the following steps:

- Step 1 Determine group structure
- Step 2 Layout the pro-forma
- Step 3 Consider the adjustments
- Step 4 the carrying amount of the holding company's investment as well as its share of the net assets of the subsidiary are eliminated;
- Step 5 balances and transactions between the holding and subsidiary are eliminated in full
- Step 6 Calculate goodwill
- Step 7 Calculate non-controlling interest (NCI) for subsidiary
- Step 8 Combine the financial statements

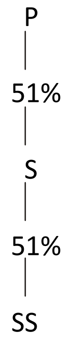
3.2 Group structure

The simplest are those in which a parent company has only a **direct interest** in the shares of its subsidiary companies. For example:



S_1 Co is a wholly owned subsidiary of P Co. S_2 Co, S_3 Co and S_4 Co are partly owned subsidiaries; a proportion of the shares in these companies is held by outside investors.

Often a parent will have indirect holdings in its subsidiary companies. This can lead to more complex group structures.



P Co owns 51% of the equity shares in S Co, which is therefore its subsidiary. S Co in its turn owns 51% of the equity shares in SS Co. SS Co is therefore a subsidiary of S Co and consequently a subsidiary of P Co. SS Co would describe S Co as its parent (or holding) company and P Co as its ultimate parent company.

3.3 Cancellation and part cancellation

The preparation of a consolidated statement of financial position, in a very simple form, consists of two procedures.

(i) Take the individual accounts of the parent company and each subsidiary and cancel out items which appear as an asset in one company and a liability in another.

(ii) Add together all the uncancelled assets and liabilities throughout the group.

Items requiring cancellation may include the following.

(a) The asset 'shares in subsidiary companies' which appears in the parent company's accounts will be matched with the liability 'share capital' in the subsidiaries' accounts.

There may be intra-group trading within the group; as receivable in account of one company and payable in the accounts of another company, but not at the same amounts. This is applicable to dividend (dividend receivable and dividend payable), interest (interest receivable and interest payable), trade (trade payable and trade receivable), and bill (bill receivable and bills payable)

(b) The parent company may have acquired shares in the subsidiary at a price greater or less than their par value. The asset will appear in the parent company's accounts at cost, while the liability will appear in the subsidiary's accounts at par value. This raises the issue of goodwill, which is dealt with later in this chapter.

(c) Even if the parent company acquired shares at par value, it may not have acquired all the shares of the subsidiary (so the subsidiary may be only partly owned). This raises the issue of non-controlling interests,

(d) The inter-company trading balances may be out of step because of goods or cash in transit.

(e) One company may have issued loan stock of which a proportion only is taken up by the other company.

Pre and post-acquisition profits

When a subsidiary is acquired, it will already have accumulated profits, these are known as pre-acquisition profits. These profits are not part of the group, and therefore are not shown in the consolidated reserves. All the profits earned after the subsidiary was acquired will belong to the group, but only to the extent of the share ownership. These are known as post acquisition retained reserves (PARR).

Therefore the pre-acquisition profits are included in the goodwill calculation, and the share of post-acquisition profits is shown in the consolidated reserves. Post-acquisition profits are easily established as profits at the balance sheet less profits at date of acquisition.

Pre-acquisition reserves are *all reserves* whether capital or revenue in nature, existing on the date of acquisition of the interest of the parent company in the subsidiary company. If a subsidiary has already been trading before it is acquired by a parent company, it will already have reserves (share premium account, capital redemption reserve, revaluation reserve, income statement etc) in its statement of financial position. The reserves which are built up before the date of acquisition are known collectively as pre- acquisition profits.

Post-acquisition reserves on the other hand, refer to *all reserves* that are generated after the acquisition date. These are not capital investment (in fact, they represent a return on the investment in subsidiary).In this context, post-acquisition profits include any increase in reserves owned by the share after the date of acquisition. This includes, not just profits in the subsidiaries' income statement, but also increase in other reserves such as the revaluation reserve (i.e. when a subsidiary's fixed assets are revalued). The group's share of post-acquisition profits should be included in the group's reserves in the consolidated statement of financial position.

Non Controlling Interest

The Non-controlling interest in a subsidiary consists of shareholders who are not part of the parent company and they are totally unaffected by any distinction between pre- and post- acquisition profits. In other words, the Non-controlling interest (in a subsidiary's ordinary shares) in the consolidated statement of financial position will be the appropriate percentage of the subsidiary's net assets.

Goodwill

When a premium is paid above the fair value of the net assets acquired over a subsidiary, it results in goodwill. IFRS 3 business combinations states the positive purchased goodwill must be capitalised upon consolidation and reviewed for impaired at least annually under IAS 36 impairment of assets. The impairment goes through the consolidated income statement.

Negative goodwill is investigated and is taken to the consolidated income statement immediately as a credit. Negative goodwill is also known as "bargain purchase".

The new revised IFRS 3 method of calculating goodwill now gives the parent company a choice between 2 methods of calculating goodwill and dealing with NCI:

(i) **NCI's share of net assets** - this is the old method (also known as the **partial goodwill**). Here the goodwill is calculated in the traditional way. The NCI are basically ignored in the goodwill calculation and just the parent's share is shown.

(ii) **Fair value** – this is the new method (also known as the **full goodwill**). Both the parent's and the NCI's goodwill is established and shown in the consolidated financial statements.

Illustration 1

Extracts from the Statement of Financial Position of Holiva Plc and Long Gear Plc as at 31/12/2010 are as follows:

	Holiva Plc	Long Gear Plc
	₦'000	₦'000
Share Capital		
Ordinary share at ₦1.00 each	180,000	60,000
Accumulated Reserves	48,000	24,000
	228,000	84,000

The entire share capital of Long Gear Plc was acquired when the accumulated reserves was ₦18 million. Cost of acquisition was ₦88 million.

Required: Calculate the goodwill

SOLUTION

Net Assets	₦'000
Ordinary Share Capital	50,000
Pre-Acquisition Reserves	18,000
	68,000
Cost	88,000
Goodwill	**20,000**

Illustration 2

On 1 January 20X0 Rose plc acquired 100% of the 10,000 ₦1 common shares in Tulip plc for ₦1.50 per share in cash and gained control. The fair value of the net assets of Tulip plc at that date was the same as the book value. The statements of financial position at the date of acquisition were as follows:

	Rose plc	*Tulip plc*
	₦	₦
ASSETS		
Non-current assets	20,000	11,000
Investment in Tulip	15,000	—
Net current assets	8,00	3,000
Net assets	43,000	14,000
Share capital	16,000	10,000
Retained earnings	27,000	4,000
	43,0000	14,000

Required: Prepare the group accounts immediately after the acquisition.

SOLUTION

	Rose plc	*Tulip plc*	*Group*
	₦	₦	₦
ASSETS			
Non-current assets	20,000	11,000	31,000
Goodwill	—	—	1,000
Investment in Tulip	15,000	—	—
Net current assets	8,000	3,000	11,000
Net assets	43,000	14,000	43,000
Share capital	16,000	10,000	16,000
Retained earnings	27,000	4,000	27,000
	43,000	14,000	43,000

Note 1

Net Assets Acquired	14,000
Cost of Acquisition (10,000x1.50)	15,000
Goodwill	1,000

Note 2

		₦
Non-current assets other than goodwill (20,000 + 11,000)		31,000
Goodwill	(as calculated in Note 1)	1,000
Net current assets	(8,000 + 3,000)	11,000
		43,000

Note 3. Calculate the consolidated share capital and reserves for the group accounts:

		₦
Share capital	(The parent company only)	16,000
Retained earnings	(The parent company only)	27,000
		43,000

Note that:

In Note 1 the investment in the subsidiary (₦15,000) has been set off against the parent company's share of the subsidiary's share capital and reserves (₦14,000) and these cancelled inter-company balances do not, therefore, appear in the consolidated accounts.

In Note 2 the total of the net assets in the group account is the same as the net assets in the individual statement of financial position but the Tulip plc investment in Rose plc's accounts has been replaced by the net assets of Tulip plc of ₦14,000 **plus** the previously unrecorded ₦1,000 goodwill.

In Note 3 the consolidated statement of financial position only includes the share capital and retained earnings

of the parent company, because the subsidiary's share capital and retained earnings have been used in the calculation of goodwill.

3.4 Consolidation Schedule

The adjustments are often set out in a schedule format as follows:

	Rose plc	*Tulip plc*	*Adjustments*	*Group*
	₦	₦		₦
ASSETS				
Non-current assets	20,000	11,000		31,000
Goodwill	—	—	1,000	1,000
Investment in Tulip	15,000	—	(10,000)	—
			(4,000)	
			(1,000)	
Net current assets	8,000	3,000		11,000
Net assets	43,000	14,000		43,000
Share capital	6,000	10,000	(10,000)	16,000
Retained earnings	27,000	4,000	(4,000)	27,000
	43,000	14,000		43,000

Supported by the same notes (Notes 1–3) shown above.

Note

i. Only the assets and liabilities of each entity are aggregated.

The share capital and retained earnings are not aggregated. The share capital and retained earnings of the subsidiary do not appear on the consolidated statement of financial position.

3.5 Non-controllinginterests

It was mentioned earlier that the total assets and liabilities of subsidiary companies are included in the consolidated statement of financial position, even in the case of subsidiaries which are only partly owned. A proportion of the net assets of such subsidiaries, in fact,belongs to investors from outside the group (**non-controllinginterests**).

IFRS 3 allows two alternative ways of calculating non-controlling interest in the group statement of financial position. Non-controlling interest can be valued at:

(a) Its proportionate share of the fair value of the subsidiary's net assets; or

(b) Full (or fair) value (usually based on the market value of the shares held by the non-controlling interest).

The exam question will tell you which method to use. If you are required to use the 'full (or fair) value' method, then you will be given the share price, told what the fair value of the non-controlling interest is or given the goodwill attributable to the non-controlling interest.

Illustration 3

Abba Plc. acquired 75% of the shares in Bello Plc. for ₦68,000 on 1 January 2011 when, Bello Plc. had retained earnings of ₦15,000.

The market price of Bello Plc.'s shares before the date of acquisition was ₦1.60.
Abba Plc. values non-controlling interest at fair value. Goodwill is not impaired.

The statement of financial position of Bello Plc. at 31 December 2011 is as follows:

		₦'000
Property, Plant & Equipment		50
Current Assets		35
		85
Ordinary share capital of ₦1.00 each		50
Retained earnings	25	
Current liabilities		10
		85

Calculate the amount of non-controlling interest.
SOLUTION
Non-controlling Interest (NCI) fair value 25%

(50,000 shares x ₦1.60)	20,000	
25% (₦25,000 – ₦15,000)		2,500
22,500		

Illustration 4
P Co has owned 75% of the share capital of S Co since the date of S Co's incorporation. Their latest statement of financial position are given below.
P CO STATEMENT OF FINANCIAL POSITION

	₦	₦
Assets		
Non-current assets		
Property, plant and equipment	50,000	
30,000 ₦1 ordinary shares in S Co at cost	30,000	
		80,000
Current assets		45,000
Total assets		125,000
Equity and liabilities		
Equity		
80,000 ₦1 ordinary shares	80,000	

Retained earnings	25,000	
		105,000
Current liabilities		20,000
Total equity and liabilities		125,000

S CO STATEMENT OF FINANCIAL POSITION

	₦	₦
Assets		
Property, plant and equipment		35,000
Current assets		35,000
		70,000
Total assets		
	₦	
Equity and liabilities		
Equity		
40,000 ₦1 ordinary shares	40,000	20000
Retained earnings	10,000	
	50,000	50,000
Current liabilities		
		70,000
Total equity and liabilities		

Required Prepare the consolidated statement of financial position.

Solution

All of S Co's net assets are consolidated despite the fact that the company is only 75% owned. The amount of net assets attributable to non-controlling interests is calculated as follows.

Non-controlling share of share capital (25% ×₦40,000) 10,000 Non-controlling share of retained earnings (25% ×₦10,000) 2,500 12,500

Of S Co's share capital of ₦40,000, ₦10,000 is included in the figure for non-controlling interest, while ₦30,000 is cancelled with P Co's asset 'investment in S Co'.

The consolidated statement of financial position can now be prepared.

P GROUP CONSOLIDATED STATEMENT OF FINANCIAL POSITION		
	₦	₦
Assets		
Property, plant and equipment		85,000
Current assets		80,000
Total assets *Equity and liabilities* Equity attributable to owners of the parent		165,000
Share capital	80,000	

Retained earnings ₦(25,000 + (75% ×₦10,000))	32,500	112,500
Non-controlling interest		12,500
		125,000
Current liabilities		40,000
Total equity and liabilities		165,000

Illustration 5. Preand Post-Acquisition Profits

The statement of financial position of Peter ltd. and Paul ltd as at 31dec 2015 were as follows:

	Peter ltd	**Silas ltd**
	₦'000	**₦'000**
Non Current Assets	40,000	32,000
Investment at cost	76,000	-
Current assets:	60,000	48,000
	176,000	80,000
Share capital		
Ordinary shares of ₦1.00 per share	120,000	40,000
Accumulated reserves	32,000	16,000
	152,000	56,000
Current liability	24,000	24,000
	176,000	80,000

The entire share capital of Paul ltd was acquired when the accumulated reserves was ₦12million.

You are required to show the consolidated reserve of the group at 31 Dec.2015.

Solution

Consolidated schedule

Equity of Paul ltd.	Total	Pre-acquisition 100%	Post-acquisition
	₦'000	₦'000	₦'000
Ordinary share Capital	40,000	40,000	
Accumulated Reserves	16,000	12,000	4,000
	56,000	52,000	
Cost of investment		(76,000)	
Goodwill		24,000	
Accumulated reserves of peter			32,000
Consolidated Reserves			36,000

3.6 Preference Shares

Preference shares are non-equity shares. The parent company may own all or part of the total preference shares issued by the subsidiary. There may be goodwill associated with the preference shares, which is just the difference between the value of the preference shares and the price paid.

If the preference shares are not 100% owned by the parent company, there will be NCI. The preference share owned by the parent company will be cancelled upon consolidation, and the remaining preference shares will be shown under NCI as non-equity NCI.

It is important to note that the ownership in preference shares does not determine the group structure; this is only with ordinary equity shares (which give voting rights). Preference shares do not give

3.6 Forms of consideration

The consideration paid by the parent for the shares in the subsidiary can take different forms and this will affect the calculation of goodwill. Examples of various forms are given below:

Contingent consideration

IFRS 3 requires the acquisition-date **fair value** of contingent consideration to be recognised as part of the consideration for the 'acquiree'.

The acquirer may be required to pay contingent consideration in the form of equity or of a debt instrument or cash. A debt instrument should be presented as under IAS 32. Contingent consideration can also be an asset, if the consideration has already been transferred and the acquirer has the right to return of some of it, if certain considerations are met.

Note: The previous version of IFRS 3 only required contingent consideration to be recognised if it was probable that it would become payable. IFRS 3 revised dispenses with this requirement – all contingent consideration is now recognised. It is possible that the fair value of the contingent consideration may change after the acquisition date. If this is due to additional information obtained that affects the position at acquisition date goodwill should be re-measured. If the change is due to events after the acquisition date (such as a higher earnings target has been met, so more is payable) it should be accounted for under IAS 39 if the consideration is in the form of a financial instrument (such as loan notes) or under IAS 37 as an increase in a provision if it is cash. Any equity instrument is not re-measured.

3.7 Deferred consideration

An agreement may be made that part of the consideration for the combination will be paid at a future date. This consideration will therefore be discounted to its present value using the acquiring entity's cost of capital.

The parent acquired 75% of the subsidiary's 80m ₦1 shares on 1 Jan 2016. It paid ₦3.50 per share and agreed to pay a further ₦108m on 1 Jan 2018.

The parent company's cost of capital is 8%.

In the financial statements for the year to 31 December 2016 the cost of the combination will be as follows:

80m shares × 75% ×₦3.50	210
Deferred consideration:	100
₦108m × 1/1.08	310

Total consideration

At 31 December 20X7, the cost of the combination will be unchanged but ₦8M will be charged to finance costs, being the unwinding of the discount on the deferred consideration.

Share exchange

The parent has acquired 12,000 ₦1 shares in the subsidiary by issuing 5 of its own ₦1 shares for every 4 shares in the subsidiary. The market value of the parent company's shares is ₦6.

Cost of the combination:

	₦
12,000 × 5/4 ×₦6	90,000

Note that this is credited to the share capital and share premium of the parent company as follows:

	DR	*CR*
Investment in subsidiary 90,000		
Share capital (₦12,000× 5/4)	15,000	
Share premium (₦12,000× 5/4 × 5)	75,000	

3.8 Fair value adjustment calculations

Until now we have calculated goodwill as the difference between the consideration transferred and the book value of net assets acquired by the group. If this calculation is to comply with the definition above we must ensure that the book value of the subsidiary's net assets is the same as their fair value.

There are two possible ways of achieving this.

(a) The subsidiary company might incorporate any necessary revaluations in its own books of account. In this case, we can proceed directly to the consolidation, taking asset values and reserves figures straight from the subsidiary company's statement of financial position.

(b) The revaluations may be made as a consolidation adjustment without being incorporated in the subsidiary company's books. In this case, we must make the necessary adjustments to the subsidiary's statement of financial position as a working. Only then can we proceed to the consolidation.

Note. Remember that when depreciating assets are revalued there may be a corresponding alteration in the amount of depreciation charged and accumulated.

Illustration 6

P Co acquired 75% of the ordinary shares of S Co on 1 September 2015. At that date the fair value of S Co's non-current assets was ₦23,000 greater than their net book value, and the balance of retained earnings was ₦21,000. The statements of financial position of both companies at 31 August 2016 are given below. S Co has not incorporated any revaluation in its books of account. Non-controlling interest is valued at full fair value which was deemed to be ₦18,000 at the acquisition date.

P CO STATEMENT OF FINANCIAL POSITION AS AT 31 AUGUST 2016	₦	₦
Assets		
Non-current assets		
Property, plant and equipment	63,000	
Investment in S Coat cost	51,000	
		114,000
Current assets		82,000
Total assets		196,000

Equity and liabilities		
Equity		
Ordinary shares of ₦1 each	80,000	
Retained earnings	96,000	
		176,000
Current liabilities		20,000
Total equity and liabilities		196,000

S CO STATEMENT OF FINANCIAL POSITION AS AT 31 AUGUST 2016

Assets₦		
Property, plant and equipment		28,000
Current assets	43,000	
Total assets	71,000	
Equity and liabilities		
Equity		
Ordinary shares of ₦1 each		20,000
Retained earnings		41,000
Current liabilities		10,000
Total equity and liabilities		*71,000*

If S Co had revalued its non-current assets at 1 September 2015, an addition of ₦3,000 would have been made to the depreciation charged for 2015/16.

Required

Prepare P Co's consolidated statement of financial position as at 31 August 2016.

Solution

P CO CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 AUGUST 2016

	₦	₦
Non-current assets		
Property, plant and equipment ₦(63,000 + 48,000)*	111,000	
Goodwill (W1)	5,000	
		116,000
Current assets		125,000
		241,000
Equity and liabilities		
Equity		
Ordinary shares of $1 each	80,000	
Retained earnings (W2)	108,750	
		188,750
Non-controlling interest (W3)		22,250
		211,000

Current liabilities			30,000
			241,000

* (28,000 + 23,000 – 3,000)

1 *Goodwill*

		Group	*NCI*
		₦	₦
Consideration transferred/fair value of NCI		51,000	18,000
Net assets acquired as represented by			
Ordinary share capital	20,000		
Retained earnings	21,000		
Fair value adjustment	23,000		
	64,000		
Group/NCI share		(48,000)	(16,000)
Goodwill		3,000	2,000

108,750

Adjustments should be made for these items of differences, as follows:

(a) If the goods or cash are in transit between the parent company and the subsidiary, the adjusting entry should be made in the balance sheet of the parent company, no matter the direction of the transfer.

(b) If the items are in transit between fellow subsidiaries, the adjusting entry should be made in the books of the company to which the items are in transit; that is, recipient company.

Illustration 7

At the year end, the current accounts in the books of Hoo plc and Sho plc show the following balances; Hoo plc being the parent company.

Book of Hoo plc- Account with Sho plc ₦68,000

Book of Sho plc- Account with Hoo plc ₦59,000

The difference is due to goods in transit from Sho plc to Hoo plc.

Explain the accounting treatment of the goods in transit.

Suggested Solution

Step 1: Adjustment for items in transit	₦	₦
Dr Stock in transit	9,000	

Cr Sho current account (in Hoo SFP) 9,000

Step 2: cancel the current accounts which are now in agreement

Step 3: include the stock in transit as part of the current assets in the consolidated statement of financial position.

Unrealised Profit on Stock

Where sales have been made between two companies within the group, there may be an element of profit that has not been realised by the group if the goods have not then been sold on to a third party before the year-end.From a group point of view, this profit is unrealised, it will only become realized once the goods are sold to third parties. In many instances, you will be expected to calculate the profits made by using margins or mark-ups. Where a subsidiary with a non-controlling interest sells goods to a parent company at a mark-up, the non-controlling interest must be charged with their share of any provision for unrealized profit.

Illustration 8

Goods were invoiced by parent to subsidiary company at cost plus mark-up of 25%. At the end of the year, included in the stock of the subsidiary was this inter-company sales of ₦24,000,000 at invoiced price.

Calculate the unrealised profit on stock.

Suggested Solution

Price structure:	
Cost	100%
Mark up	25%
Invoiced price	125%
Unrealized profit	=25x ₦24,000,000
	125

3.9Inter-Company Sales of Fixed Assets

Fixed assets are transferred from one group entity to another, adjustments may be required so that any profit or loss arising on the transfer is eliminated and the depreciation charge is adjusted so that it is based on the cost of the asset to the group or its valuation (if a valuation policy is adopted).

The over-charge of depreciation arising from the unrealised profit must be removed by applying the rate of depreciation on the unrealized profit.

Illustration 9

KeffiOlu plc, sold a plant with a net book value of ₦6,000,000 to Abuja plc for ₦9,000,000. The policy of the group is to charge depreciation on plant at 10% on cost per annum.
Required: Calculate the amount to be included in the fixed asset account and depreciation account and show the journal entries.

Suggested Solution	₦
Unrealised profit ₦(9,000,000 – 6,000,000)	3,000,000
Less: over –charged depreciation (10%)	300,000
	2,700,000

Illustration 10

ShitandaPlc's purchased 960 million shares in Karatandi Plc a year ago when Karatandi had a credit balance of ₦190million in retained earnings. The fair value of the non-controlling interest at the date of acquisition was ₦330million. At the date of acquisition, the freehold land of Karatandi Plc was valued at ₦140million in excess of its carrying value. The revaluation has not been recorded in the accounts of Karatandi.

The financial statements comprising Statement of Financial Position of Shitanda Plc and Karatandi Plc as at 31 December 2012 are as follows:

Shitanda Plc Karatandi Plc

	₦m	₦m	₦m	₦m
Non-Current Assets				
Land and building	630		556	
Machinery and equipment	570		440	
Investment in Karatandi Plc.		1,320		-
		2,520		996
Current Assets				
Inventories	714		504	
Trade receivables	1,050		252	
Cash/bank	316	2,080	60	816
		4,600		1,812
Ordinary Shares at ₦1 each		3,000		1,200

Retained Earnings	1,160	424
Shareholders fund	4,160	1,624
Current Liabilities		
Trade payables	440	188
	4,600	1,812

Karatandi Plc owes Shitanda Plc ₦50million for goods purchased during theyear.
Inventory of Karatandi Plc includes goods bought from Shitanda Plc at the price that includes a profit to Shitanda Plc of ₦24million.

The management of Shitanda Plc wants the financial statements to be consolidated using the acquisition method and wishes to know whether there is goodwill on acquisition of Karatandi Plc and the amount involved.
You are required to:

Prepare the Consolidated Statement of Financial Position as at 31 December 2012.

Solution

Shitanda Plc
Consolidated Statement of Financial Position as at 31 December 2012

	₦'Million	₦'Million
Non Current Assets		
Goodwill (working 1)		120
Land & building (630 + 556 + 140)		1,326
Machinery & Equipment (570 + 440)		1,010
		2,456
Current Assets		
Inventory (714 +504 – 24)	1,194	
Trade receivables (1,050 + 252 – 50)	1,252	
Cash/Bank (316 + 60)	376	2,822
		5,278
Ordinary shares of ₦1 each		3,000
Retained earnings (Working 3)		1,323.2
Non-controlling Int. (Working 4)		376.8
		4,700
Current Liabilities		

Trade Payables (440 + 188 - 50)	578
	5,278

Workings:

1. Calculation of goodwill:

	₦'Million	₦'Million
Fair value of consideration		1,320
Plus fair value of NCI at acquisition		330
Less net acquisition – fair value of Assets acquired & liability:		
Share capital	1,200	
Retained Earning	190	
Fair value adj. at acquisition	140	(1,530)
Goodwill		120

2. Group structure

960 million x 100 1,200 million	80%

3. Retained earnings:

	Shitanda ₦ million	Karatand ₦ million
As per question	1,160	424
Adjustment (unrealised profit)	(24)	
Pre-acquisition retained earnings		(190)
		234
Group share of post-acquisition retained earnings:		
(80% x 234)	187.2	
	1,323.2	

4. Non-controlling interest:

	₦ million
Fair value of NCI at acquisition	330
Plus NCI's share of post-acquisition	
Retained earnings (20% x 234)	46.8
	376.8

Consolidation Schedule

Karatandi Plc	₦ 'M	Shitanda in Karatandi 80% (W3) ₦ 'M	NCI 40% ₦'M	Post – Acq ₦ 'M
Ordinary share capital	1,200	960	240	
Revaluation Res. (W1)	140	112	28	
Retained earnings	424	152	84.8	187
Net assets acquired		1,224		
Cost of acquisition		(1,320)		
Goodwill (partial value)		(96)		
Goodwill attribute to NCI (W5)		(24)	24	
Goodwill (fair value)		(120)		
Unrealised profit on inventory			_____	(24)
NCI (fair value)			376.8	
Retained earnings of Shitanda Plc				1,160
Consolidated retained earnings				1,323

Dividends payable by the subsidiary

Dividends paid by the subsidiary will be received by their shareholders, which mean the parent company and non-controlling interest (NCI).

At the year end, the subsidiary may have proposed dividends but the financial statements may not have been adjusted to reflect this. Always read the question carefully and establish whether the financial statements reflect the dividends proposed. If they don't, then they need to be accrued manually. Remember under IAS 10 only dividends declared by the balance sheet date can be accrued.

The parent company will also need to account for their share of the dividends payable by the subsidiary. Again read the question and establish whether the parent's individual financial statements include the dividends receivable.

At the yearend, any inter-company dividends payable and receivable will be cancelled upon consolidation. Remember the consolidated statement of financial position must only show liabilities which are owed to third parties. So the only dividends payable in the consolidated balance sheet will be the parent's and dividends payable to the NCI from the subsidiary shares.

The treatment is the same for preference share dividends and interest on debentures and loan stock.

4.0 CONCLUSION

Take the individual accounts of the parent company and each subsidiary and cancel out items which appear as an asset in one company and a liability in another. All the uncancelled assets and liabilities throughout the group form part of consolidated statement of financial position and only show liabilities which are owed to third parties.

5.0 SUMMARY

The basic procedure for consolidation is:

- Aggregate the assets and liabilities in the statement of financial position i.e. 100% P + 100% S irrespective of how much P actually owns.
- This shows the amount of net assets **controlled** by the group.
- Share capital is that of the parent only.
- Balance of subsidiary's reserves is consolidated (after cancelling any intra-group items).
- Calculate the non-controlling interest share of the subsidiary's net assets (share capital plus reserves).

6.0 TUTOR-MARKED ASSIGNMENT

1. A subsidiary's fixed assets were re-valued at a surplus on the date it was acquired by the parent company. What will be the effect of this surplus on pre-acquisition profits and post-acquisition profits of the subsidiary?
2. On 2 January, 2011 Paddy Plc acquired 80% of the voting shares in Giddy Limited for ₦48million.

3. The following information is relevant:

	Paddy Plc	Giddy Ltd
	₦' million	₦' million
Non-Current Assets	192	54
Current Assets	108	36
Investment in Giddy Ltd	48	-
Total Assets	348	90
Non-Current Liabilities	102	42
Current Liabilities	72	18
Ordinary Share Capital	120	18
Retained Earnings	54	12
Total Equity & Liabilities	348	90

Fair value of Giddy Limited's net identifiable assets was equal to its book value.

The non-controlling interest is measured at its proportionate share of Giddy Limited's net assets. Paddy Plc accounts for its investment in Giddy Limited at cost in its separate financial statements.

You are required to:
Prepare Paddy's Consolidated Statement of Financial Position as at 31 December 2011.

7.0 REFERENCES/FURTHER READINGS

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UNIT FOUR: **CONSOLIDATED INCOME STATEMENT**

CONTENTS

1.0 Introduction
2.0 Objectives

3.0 Main Content
- 3.1 Consolidation Procedures
- 3.2 Format of the Consolidated Profit and Loss Account
- 3.3 Consolidation Adjustment
- 3.4 Non-Controlling Interest
- **3.5** Acquisition of a Subsidiary during the Year

4.0 Conclusion
5.0 Summary
6.0 Tutor-Marked Assignment
7.0 References/Further Readings

1.0 INTRODUCTION

The consolidated income statement shows all the revenue and expenses of the parent and subsidiaries during the accounting period. The workings on the consolidated income statement are very similar to consolidated statement of financial position.

2.0 OBJECTIVES

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

- Explain the procedures involved in the consolidation of income statement of a parent company and its subsidiaries.
- Eliminate inter-company sales and unrealized profits on consolidation
- Adjust for the effect of inter-company dividends and interest on loan and account for non-controlling interest.

3.0 MAIN CONTENT

3.1 Consolidation Procedures

Consolidated profit and loss account is prepared by adding together the results of trading in the year of the parent company and its subsidiaries after making adjustments that are necessary to exclude inter-company items.

3.2 Formats of the consolidated income statement (revised IAS 1)

FORMAT:

Consolidated profit and loss account for the year ended 31 December, 2007

Turnover	X	
Cost of sales		(X)
Gross profit		X
Distribution cost		(X)
Administration costs /and any impairment loss		(X)
Profit from main business	X	
Other operating income	X	
Other interest receivable and similar income	X	
Interest payable and similar charges		(X)
Profit on ordinary activities before tax	X	
Taxation		(X)
Profit on ordinary activities after tax	X	
Non-controlling interest		(X)
Profit attributable to group members	X	
Extra ordinary profit / (loss)		X
Profit/ (Loss) for the year		X

The revised IAS 1 allows 2 formats to be adopted showing all income and expenses.

- In a single statement called "statement of comprehensive income": or

- In two separate statements called "income statement" and "statement of other comprehensive income".

The income statement will show the realised profit and loss for the period. Other comprehensive income is income and expenses that are not recognised in the realized profit and loss but would normally appear in the reserves. These would now appear on the face of the "statement of comprehensive income" or "statement of other comprehensive income".

Examples of other comprehensive income include:

- Revaluation gains (IAS 16 and IAS 38)
- Exchange differences on translation of foreign operations (IAS 21)

- Gains or losses on re-measuring available for sale financial assets (IAS 39)
- Actuarial gains or losses on defined pension schemes (IAS 19)

- Gains / losses on hedging instruments in a cash flow hedge (IAS 39)

Basically all the above items would normally have appeared in the statement of changes in equity before IAS 1 was revised in 2007. They will now be shown on the face of the comprehensive income statements as either part 1 or 2 formats detailed above.

The above shows that all the non-owner changes in equity are presented in the comprehensive income statements (part 1 or part 2 formats).

3.3 Consolidation adjustments

1 Turnover to total comprehensive income

The statement of comprehensive income (income statement) is added together 100% line by line from turnover to total comprehensive income. If the subsidiary was acquired part way through the accounting year, the items are pro-rated.

2 Inter-company sales

Like the consolidated statement of financial position, the consolidated income statement should deal with the results of the group as those of a single entity. When one company in a group sells goods to another an identical amount is added to the sales revenue of the first company and to the cost of sales of the second. Yet as far as the entity's dealings with outsiders are concerned no sale has taken place. The consolidated figures for sales revenue and cost of sales should represent **sales to**, **purchases from** and **outsiders**. An adjustment is therefore necessary to reduce the sales revenue and cost of sales figures by the value of intra-group sales during the year.

Illustration 1

Purple Co acquired 70% of the voting share capital of Silver Co on 1 October 2011.

The following extracts are from the individual income statements of the two companies for the year ended 30 September 2012:

	Purple Co	**Silver Co**
	₦	₦
Revenue	79,300	29,900
Cost of sales	(54,990)	(17,940)
Gross Profit	24,310	11,960

Purple Co had made sales to Silver Co during the year of ₦5,000. Purple Co had originally purchased the goods at a cost of ₦4,000. Half of these items remained in inventory at the year end.

What should be the consolidated revenue for the year ended 30 September 2012?

Therefore, the consolidated revenue is calculated as: ₦79,300 + ₦29,900 – ₦5000 = ₦104,200
The consolidated cost of sales figure is calculated as:
₦54,990 + ₦17,940 + ₦500 – ₦5,000 = ₦68,430

Rules for removing Unrealized Profit

a. If the sales were made by the parent company, there would be no adjustment to non-controlling interest;
b. If the unrealised profit originally arose in the subsidiary (that is, the sale is from the subsidiary to the parent company) the non-controlling interest should be adjusted for its share in the unrealised profits;
    c. Notwithstanding this second rule, all the unrealised profit should be eliminated from cost of sales to determine the correct amount of gross profit earned by the group as if they are trading as a single entity.

Transfer of Fixed Assets between Group Companies

(a) If the fixed assets are transferred at a value other than the net book value, the profit or loss arising on the transfer is eliminated.

(b) The depreciation charge based on the cost of the asset to the group will be used to reduce the amount of profit or loss to be eliminated.

Intra-Group Interest on Loan

If the parent company owns a loan stock in the subsidiary, it will receive interest from such subsidiary. Therefore,

part of the total interest paid or payable by the subsidiary will be treated as investment income in the parent company's book.

On consolidation, both entries should be eliminated. Only the interest payable or receivable from parties outside the group should be consolidated.

Investment income

The consolidated income statement must only show investment income from other investments and not from subsidiaries, associate and joint ventures. This is because the actual returns from the investment companies are being replaced with individual items.

Intra-Group Interest on Loan

If the parent company owns a loan stock in the subsidiary, it will receive interest from such subsidiary. Therefore, part of the total interest paid or payable by the subsidiary will be treated as investment income in the parent company's book.

On consolidation, both entries should be eliminated. Only the interest payable or receivable from parties outside the group should be consolidated.

Dividend on Preference Shares in the Subsidiary and Non-Controlling Interest

The non-controlling interest in the profit and loss account will be calculated in two parts, viz: Share of the non-controlling interest in the preference dividend; plus Share of the non-controlling interest in the profits attributable to ordinary shareholders.

3.4 Non-controlling interest (NCI)

The non-controlling interest is deducted from profit after tax to arrive at the profits attributable to group members and only the post-acquisition retained profit of the subsidiary brought forward will be consolidated.

The dividends paid and proposed will only be of the parent company which is shown in the consolidated statement of changes in equity under the reserves column.

The consolidated reserves bought forward will be the parent's bought forward reserves plus share of post-acquisition retained reserves (PARR) of subsidiary bought forward.

Illustration 2

P Co acquired 75% of the ordinary shares of S Co on that company's incorporation in 20X3. The summarized income statements and movement on retained earnings of the two companies for the year ending 31 December 20X6 are set out below.

		P Co	*S Co*
		₦	₦
Sales revenue	75000		*38,000*
Less: Cost of sales	30,000		20,000 18,000
Gross profit	45,000		
Administrative expenses	(14,000)		8,000)
Profit before tax	31,000		10,000
Income tax expense	(10,000)		2,000
	21,000	8,000	
Profit for the year			8,000

Note: Movement on retained earnings

Retained earnings brought forward	87,000	17,000
Profit for the year	21,000	8,000
Retained earnings carried forward	108,000	25,000

Required

Prepare the consolidated income statement and extract from the statement of changes in equity showing retained earnings and non-controlling interest.

Solution

P CO CONSOLIDATED INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2016

	₦
Sales revenue (75 + 38)	113,000
Cost of sales (30 + 20)	50,000
Gross profit	63,000
Administrative expenses (14 + 8)	22,000
Profit before tax	41,000
Income tax expense (12,000)	
Profit for the year	29,000

Profit attributable to:

Owners of the parent 27,000

Non-controlling interest (₦8,000× 25%)2,000

29,000

STATEMENT OF CHANGES IN EQUITY (EXTRACT)

	Retained Earnings	*Non-controlling Interest*	*Total Equity*
	₦	₦	₦
Balance at 1 January 20X6	99,750	4,250	104,000
Total comprehensive income for the year	27,000	2,000	29,000
Balance at 31 December 20X6	126,750	6,250	133,000

Notice how the non-controlling interest is dealt with.

(a) Down to the line 'profit for the year' the whole of S Co.'s results is included without reference to group share or non-controlling share. A one-line adjustment is then inserted to deduct the non-controlling share of S Co.'s profit.

(b) The non-controlling share (₦4,250) of S Co.'s retained earnings brought forward (17,000 × 25%) is excluded from group retained earnings. This means that the carried forward figure of ₦126,750 is the figure which would appear in the statement of financial position for group retained earnings.

3.5 Acquisition of a Subsidiary during the Year

The figure for retained earnings carried forward must be the same as the figure for retained earnings in the consolidated statement of financial position. We have seen in previous units that retained earnings in the consolidated statement of financial position comprise:

(a) The whole of the parent company's retained earnings

(b) A proportion of the subsidiary company's retained earnings. The proportion is the group's share of post-acquisition retained earnings in the subsidiary. From the total retained earnings of the subsidiary we must therefore exclude both the non-controlling share of total retained earnings and the group's share of pre-acquisition retained earnings.

A similar procedure is necessary in the consolidated income statement if it is to link up with the consolidated statement of financial position. Previous examples have shown how the non-controlling share of profits is excluded in the income statement. Their share of profits for the year is deducted from profit after tax, while the figure for profits brought forward in the consolidation schedule includes only the group's proportion of the subsidiary's profits.

In the same way, when considering examples which include pre-acquisition profits in a subsidiary, the figure for profits brought forward should include only the group's share of the post-acquisition retained profits. If the subsidiary is acquired during the accounting year, it is therefore necessary to apportion its profit for the year between pre-acquisition and post-acquisition elements. The part year method is used.

With the part-year method, the entire income statement of the subsidiary is split between pre-acquisition and post-acquisition proportions. Only the post-acquisition figures are included in the consolidated income statement.

Illustration 3

The summarized Profit and Loss account of ODEJAY Plc and its subsidiary COMFORT Ltd for the year ended 31 March 2011 are as stated below:

	ODEJAYPLC	**COMFORT LTD**
	₦'000	₦'000

Turnover	968,500	524,600
Cost of Sales	(486,000)	(253,400)
Trading Profit	482,500	271,200
Debenture interest received	26,000	-
Extra ordinary income	42,600	18,000
Dividend received from COMFORT Ltd	18,000	
	569,100	289,200
Directors' Remuneration	(56,000)	15,600)
Audit fees	(28,000)	(10,000)
Depreciation	(52,600)	(16,800)
Sundry Administrative Expenses	(124,420)	(49,680)
Profit before tax	308,080	197,120
Taxation	(90,400)	(58,700)
Appropriations:		
General Reserve	(40,000)	(12,000)
Profit after tax	(65,000)	(30,000)
Retained profit for the year	112,680	96,420
Retained profit b/f	596,440	305,180
Retained profit c/f	709,120	401,600

Additional information (All figures are in ₦'000)

1. ODEJAY Plc acquired its 70% interest in COMFORT Ltd on 1 July 2010.
2. During the year ended 31 March 2011, ODEJAY Plc invoiced goods worth ₦200,000 to COMFORT Ltd. The goods were invoiced at cost plus 25%. A quarter of the goods had been sold by year end.
3. The extra ordinary income earned by COMFORT Ltd is in respect of a transaction carried out in December 2010.
4. ODEJAY Plc has accounted for the interim dividend received from COMFORT Ltd.

Required:

Prepare the Consolidated Profit and Loss Account of ODEJAY Plc for the year ended 31 March 2011 using the part year method.

ODEJAY Plc

Consolidated Profit and Loss Account of ODEJAY Plc for the year ended 31 March 2011

	₦'000	₦'000
Turnover		1,361,750
Cost of sales		(675,880)
Trading profit		685,870
Debenture interest received		26,000
		711,870
Director's Remuneration	67,700	
Audit fees	35,500	
Depreciation	65,200	
Sundry Admin expenses	161,680	(330,080)
Profit before tax		381,790
Taxation		(134,425)
Profit after tax		247,365
Non-Controlling interest 30%		(27,095)
		220,270
Extraordinary Income		55,200
Profit for the year		275,470
Appropriation:		
General Reserve	46,300	
Interim dividend	65,000	(111,300)
Retained profit for the year		164,170
Retained profit b/f		596,440
		₦760,610

Consolidation Schedule	Odejay Plc	Comfort Ltd	Adjustm ent	Group
	₦'000	₦'000	₦'000	₦'000
Turnover	968,500	393,450	(200)	1,361,750
Cost of sales less UPS	(468,030)	(190,050)	200	675,880
Trading Profit	482,470	203,400	-	685,870
Debenture interest received	26,000	-	-	26,000
	508,470	203,400	-	711,870
Directors Remuneration	(56,000)	(11700)	-	(67,700)
Audit fees	(28,000)	(7,500)	-	(35,500)
Depreciation	(52,600)	(12,600)	-	(65,200)
Sundry Administrative expenses	(124,420)	(37,260)	-	(161,680)
Profit before the tax	247,452	134,340		381,790
Taxation	(90,400)	(44,025)	-	(134,425)
Profit after Tax	157,050	90,315		247,365
Non controlling interest 30% (Wk3)	-	(27,095)	-	(27,095)
	157,050	63,220	-	220,270
Intercompany dividend	18,000	(18,000)	-	-

Group profit	175,050	45,220	-	220,270
Extra Ordinary Income (Wk 4)	42,600	12,600	-	52,200
Profit for the year	217,650	57,820	-	275,470
Appropriation:				
General Reserve (Wk 5)	(40,000)	(6,300)	-	(46,300)
Interim dividend	(65,000)	-	-	(65,000)
Retained profit for the year	112,650	51,520	-	164,170
Retained profit before	596,440	0	-	596,440
	709,090	51,520	-	760,610

Wk2) Unrealised profit (UPS) $= \frac{2}{125} x \frac{200,000}{1} x \frac{3}{4} =$ ₦30,000

Wk3) Non-Controlling interest $= \frac{30}{100} x \frac{90,315}{1} =$ ₦27,095 (Approx.)

Wk4) Extraordinary income $\frac{70}{100} x \frac{18,000}{1} =$ ₦12,600

Wk5) General Reserve $\frac{70}{100} x \frac{12,000}{1} x \frac{9}{12} =$ ₦6,300

4.0 CONCLUSION

The principle for consolidation of profit and loss account is the same for consolidated balance sheet. That is, the results of all the group companies should be presented in one profit and loss account.

5.0 SUMMARY

This unit explained the procedures involved in the consolidation of the profit and loss account of a parent company, and its subsidiaries, demonstrates how to eliminate inter-company sales and unrealised profit on consolidation and also how to account for non-controlling interest.

In the next unit, you will learn about the principles governing the accounts of associated companies.

6.0 TUTOR-MARKED ASSIGNMENT

1. Tobias Plc purchased 70% of the issued share capital of Brandon Ltd. and 40% of the issued share capital of Emma Ltd. on 1 May 2010. Details of the purchase consideration at that date are as follows:

Brandon Ltd.: a share exchange of two shares in Tobias Plc for every three shares in Brandon Ltd. plus an issue to the shareholders of Brandon Ltd. of 7% loan stock redeemable at par on 30 April 2014, on the basis of ₦ 100 loan note for every 500 shares held in Brandon Ltd.

Emma Ltd.: a share exchange of one share in Tobias Plc for every five shares in Emma Ltd. plus ₦1 cash per share.

The market value of a share in Tobias Plc at 1 May 2010 was ₦5 per share.

The draft Statements of Comprehensive Income for the three companies for the year ended 31

December 2010 are as follows:

	Tobias Plc	**Brandon Ltd.**	**Emma Ltd.**
	₦000's	**₦000's**	**₦000's**
Revenue	42,000	30,000	25,000
Cost of sales	(10,000)	(14,000)	(14,000)
Gross profit	32,000	16,000	11,000
Operating expenses	(14,000)	(8,500)	(7,270)
Operating profit	18,000	7,500	3,730
Finance costs	(4,000)	-	-
Profit on ordinary activities	14,000	7,500	3,730
Taxation	(3,200)	(3,000)	(1,400)
Profit on ordinary activities after taxation	10,800	4,500	2,330

The following information is relevant:

1. The fair value of the land and buildings of Brandon Ltd. at the date of acquisition showed the following:

	Book Value	**Fair Value**
	₦000's	**₦000's**
Land	8,000	9,000
Building	4,000	5,000

The fair values have not been reflected in the financial statements. The increase in the fair value would create additional depreciation of ₦100, 000 in the post-acquisition period, in the consolidated financial statements to 31 December 2010.

2. Details of the capital and reserves at 1 January 2010 are as follows:

	Tobias Plc	**Brandon Ltd.**	**Emma Ltd.**
	₦000's	**₦000's**	**₦000's**
Equity ₦1	20,000	15,000	10,000
Share premium	10,000	5,000	2,000
Retained earnings	28,000	9,000	6,000

3. In the post-acquisition period sales by Tobias Plc to Brandon Ltd. amounted to ₦2 million. Tobias Plc made a profit of ₦400,000 on this sale. Half of these goods were still in BrandonLtd's inventory at 31 December 2010.

4. On 31 December 2010, Tobias Plc. and Brandon Ltd. paid dividends of ₦6,000,000 and ₦2,400,000 respectively. Neither company has accounted for dividends paid or dividends received.

5. Tobias Plc.'s policy is to value the non-controlling interest at fair value at the date of acquisition. At the date of acquisition, the goodwill attributable to the non-controlling interest was ₦4,500,000.

6. All profits and losses are deemed to accrue evenly throughout the year.

REQUIRED:

(a) Calculate the goodwill arising on the acquisitions of both companies.

(b) Prepare a consolidated statement of comprehensive income for the Tobias group for the year ended 31 December 2010.

(c) Calculate the consolidated retained profits that will be carried forward at 31 December 2010.

2. The income statement of Abuja Ltd and Lagos Ltd for the year ended September 30, 2004 disclosed

	Abuja Ltd	Lagos Ltd
	₦'000	₦'000
Turnover	240,000	120,000
Cost of sales	(170,800)	(92,800)
Gross profit	69,200	27,200
Distribution costs	(16 400)	(5,600)
Admin. Expenses	(20,800)	(12,400)
Operating Profit	32,000	9,200
Income from shares in Group companies	3,000	-
Income from other fixed Asset investment	1,200	1,400
Interest Receivable	1,400	
Interest Payable	-	(1,200)
Profit on ordinary activities before tax	37,600	9,400
Tax on profit on ordinary activities	(11,200)	(2,800)
Profit on ordinary activity after tax	26,400	6,600
Dividend proposed	(12,000)	(4,000)
Retained profit for the year	14,400	2,600

Retained profit b/fwd 12,000 4,800
Retained profit c/ fwd 26,400 7,400
Additional information
i. On 1st October 2000, Abuja Ltd acquired ex dividend 30,000 ordinary shares 15,000 preference shares and ₦4,000, 12½% Debenture in Lagos Ltd. At that date the income statement of Lagos Ltd showed a credit balance of ₦2,000.
ii. The issued share capital of Lagos Ltd is 20,000 5% preference share and 40,000 ordinary shares of ₦1 each and it had N9,600, 12½% debenture outstanding on September 30, 2004.
iii. During the year Abuja Ltd sold goods to S lid fur ₦10,000at a gross margin of 20%. None is included in Lagos Ltd stock as at September 10, 2004,
All the figures in notes (i) - (iii) are in thousand.
You are required to prepare the Consolidated Income statement for the year ended 30th September, 2004.

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UNIT FIVE: ASSOCIATED COMPANIES

CONTENTS

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 3.2 'Upstream' and 'downstream' transactions
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1.0 INTRODUCTION

Accounting for investments in associates is governed by the provisions of CAMA 2004 and the requirements IAS 28.

2.0 Objective

- Define an associate.
- Explain the principles for the use of equity accounting.
- Prepare a consolidated statement of financial position to include a single subsidiary and an associate.
- Prepare a consolidated income statement to include a single subsidiary and an associate.

3.1 Definitions

Associate: The Act describes an associate as a related company.

Schedule 2, part V, paragraph 68 of the Act describes a related company as anybody corporate in which the investor (company) holds, on a long term basis, the equity voting rights for the purpose of securing a contribution to the investor's own activities by exercise of any control or influence arising from it.

The Act further states that in a related company, the investor is deemed to:

- Hold a qualifying capital interest in the body corporate.
- Exercise material influence in matter relating to dividends, commercial and financial policy of the body corporate.
- Hold 20% or more of all the relevant shares held in that body corporate
- Hold the interest on a long term basis.

3.2 Significant Influence

Significant influence is the power to participate in the financial and operating policies of the investee but not control or joint control over those policies. A holding of 20% or more of the voting power is presumed to amount to significant influence. A voting of less than 20% will not give significant influence, unless it can be clearly demonstrated that such an influence exists.

3.2.1 Evidence of Significant Influence

Significant influence is usually evidenced in one or more of the following ways.

(a) Representations on the board of directors or equivalent governing body of the investee;
(b) Participation in policy making processes, including dividend decisions;
(c) Material transactions between the investor and the investee;
(d) Interchange of managerial personnel;
(e) Provision of essential technical information.

Whether or not a significant influence exists also depends on the distribution of shareholdings. For instance where the distribution is highly dispersed, a holding of less than 20% may give significant influence whereas a majority holding by one investor may prevent the other from exercising significant influence even if it holds more than 20% equity.

2.0 OBJECTIVES

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

- Explain the basic principles and philosophy of accounting for associated company;
- Distinguish and apply the equity and proportionate consolidation methods of accounting;
- Prepare financial statements for associated companies.

3.0 MAIN CONTENT

3.1 Associated Companies Methods of Accounting for Associates

Associate. An entity, including an unincorporated entity such as a partnership, over which an investor has significant influence and which is neither a subsidiary nor an interest in a joint venture.

Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies.

Equity method. A method of accounting whereby the investment is initially recorded at cost and adjusted thereafter for the post-acquisition change in the investor's share of net assets of the investee. The profit or loss of the investor includes the investor's share of the profit or loss of the investee.

Consolidation procedures

- Investments in Associates to be recorded in CFS using equity method
- Investment to be initially recorded as cost, identifying goodwill / capital reserve arising at the time of acquisition.
- Carrying amount of investment is adjusted thereafter for the post acquisition change in investor’s share of net assets of the investee.
- Investor’s share of results of operations of investee to be included in Consolidated profit & loss account
- Goodwill/capital reserve arising on the acquisition of an associate included in the carrying amount of investment in the associate but should be disclosed separately.
- The investment in the associate is disclosed separately as a non-current asset.
- Unrealised profits and losses resulting from transactions between investor (or its consolidated subsidiaries) and the associate should be eliminated to the extent of the investor’s interest in the associate.
- Unrealised losses should not be eliminated if and to the extent the cost of the transferred asset cannot be recovered.
- Carrying amount of investment in an associate should be reduced to recognise a permanent decline in the value of investment. Such recognition should be determined and made for each and every individual investment.

- Equity method is not applied when investment is acquired and held for subsequent disposal in near future; or there are severe long-term restrictions that significantly impair associate's ability to transfer funds to its investors.
- Transactions between the Investor and the Associate-Since an associate is not consolidated, these inter-company transactions will not be cancelled out.
- Loan between associate and investor-The loan should be disclosed separately in the balance sheet as investment in the associate. Loans to and from the associated company should not be netted off.
- Receivables and payables arising between the associate and the- investor-The receivable and payables should not be netted off. Rather they should be included under respective current asset or liabilities. Such receivables and payables should be disclosed separately, if material.

Illustration 1

Johnson paid ₦1·2 million for a 30% investment in Treem's equity shares on 1 August 2014.

Treem's profit after tax for the year ended 31 March 2015 was ₦750,000. On 31 March 2015, Treem had ₦300,000 goods in its inventory which it had bought from Johnson in March 2015. These had been sold by Johnson at a mark-up on cost of 20%. Treem has not paid any dividends.

On the assumption that Treem is an associate of Johnson, what would be the carrying amount of the investment in Treem in the consolidated statement of financial position of Johnson as at 31 March 2015?

	₦'000	
Investment at cost	1,200	
Share of post-acq. profit	150	(750 x 8/12 x 30%)
URP in inventory	(15)	(300 x 20/120 x 30%)
	1,335	

Illustration 2

On 31/12/2008, Abu Plc. acquired 40% of the 2,000,000 ordinary share capital of ₦1 each of BarllettPlc. for ₦1,700,000 when the reserves of the company stood at ₦1,200,000. On the same date, Abu Plc. acquired 60% of the ordinary share capital of Dan Plc. when the reserve of Dan Plc. was ₦ 2,000,000.

The profit and loss accounts of the three companies for the year ended 31 December 2008 were as follows:

	Abu Plc.		Dan Plc.		BarllettPlc.
	₦'000		₦'000		₦'000
Profit before tax	10,400		5,400		4,000
Company income tax	(4,200)		(1,400)		(1,400)
Profit after tax	6,200		4,000		2,600
Extra-ordinary loss after tax					(1,600)
Proposed dividend	(2,000)		(800)		(200)
Retained profit for the year	4,200		3,200		800
Retained profit b/f	3,000		2,400		2,000
Retained profit c/f	7,200		5,600		2,800

Required: prepare the profit and loss account of Abu Plc. and its subsidiary including the group share of associated company.

Suggested Solution

Abu group consolidated profit and loss account for the year ended 31/12/08

	₦'000		₦'000
Turnover			Xx
Group profit before tax (P+S)	-		15,800
Group share of associate profit ₦4,000 x 40%			1,600
Profit before tax			17,400
Taxation: group (P+S)	5,600		-
Associate (₦ 1,400+40%)	560		(6,160)
Profit after tax	-		11,240
Non-controlling interest ₦ 4,000+40%	-		(1,600)
Net profit for the period	-		9,640
Extra ordinary loss ₦ 1,600x40%	-		(640)
Net profit for the period	-		9,000
Dividend proposed	-		(2,000)
Retained profit for the year	-		7,000
Retained profit b/f (w2)	-		3,560
Retained profit c/d	-		10,560
Movement on reserves			
Retained profit b/f			3,560
Retained profit for the year			7,000
Retained profit c/f			10,560

Statement of reserves for the year ended 31 December 2008
(Disclosing associate reserve separately)

	Parent	Associate	Group
	₦'000	₦'000	₦'000
Brought forward (w2)	3,240	320	3,560
Retained for the year (w3)	6,680	320	7,000
	9,920	640	10,560
Workings			
(a) Goodwill in associate			₦'000
Cost of shares acquired			1,700
Share of net assets 40% ₦(2,000+1,200)			1,280
Goodwill			420
(b) Retained profits brought forward			
Group ₦3,000 + 60% (₦2,400-2,000)			3,240
Associate 40% (₦2,000-1,200)			320
			3,560
(c) Profit for the year			

Retained profit ₦4,200+ 60% ₦3,200			6,120
Add dividend receivable			
From Barllett 60% x ₦800			480
From Dan 40% x ₦200			80
			6,680
Associate ₦800x 40%			320

Tutorial notes

(a) The associate profit before tax is not aggregated with the group profit. It is disclosed separately. The associate tax is also disclosed separately from the group tax.

(b) Extra ordinary items (losses in this case) are shown below profit after tax and minority interest. The share of associates gains or losses should be disclosed separately.

Though not compulsory, it helps to approach this question by preparing working schedule first.

	Abu Plc.		Dan Plc.		Consolidated	BarllettPlc.
	₦'000		₦'000		₦'000	₦'000
Profit before tax	10,400		5,400		15,800	4,000
Associated profit 40%					1,600	1,600
Profit before tax	10,400		5,400		17,400	
Taxation	(4,200)		(1,400)		(5,600)	
Associate tax	-		-		(560)	(560)
Profit after tax	6,200		4,000		11,240	1,040
Non contr. Interest	-		(1,600)		(1,600)	
Extra ordinary loss					(640)	(640)
Profit for the period	6,200		2,400		9,000	400
Inter-company dividend						
Group 60%	480		(480)		-	-
Associate 40%	80					(80)
Proposed dividend	(2,000)		-		(2,000)	-
Retained profit for the year	4,760		1,920		7,000	320
Retained profit b/f	3,000		240		3,560	320
Retained profit c/f	7,760		2,160		10,560	640

The profit b/fis₦3,000,000

3.2 Upstream' and 'downstream' transactions

'Upstream' transactions are, for example, sales of assets from an associate to the investor. 'Downstream' transactions are, for example, sales of assets from the investor to an associate.

Profits and losses resulting from 'upstream' and 'downstream' transactions between an investor (including its consolidated subsidiaries) and an associate are eliminated to the extent of the investor's interest in the associate. This is very similar to the procedure for eliminating intra-group transactions between a parent and a subsidiary. The important thing to remember is that **only the group's share is eliminated**.

Illustration 3

A Co, a parent with subsidiaries, holds 25% of the equity shares in B Co. During the year, A Co makes sales of ₦1,000,000 to B Co at cost plus a 25% mark-up. At the year-end, B Co has all these goods still in inventories.

Solution

A Co has made an unrealised profit of ₦200,000 (1,000,000 × 25/125) on its sales to the associate. The group's share (25%) of this must be eliminated:

DEBIT Cost of sales (consolidated income statement) ₦50,000

CREDIT Investment in associate (consolidated statement of financial position) ₦50,000

Because the sale was made to the associate, the group's share of the unsold inventory forms part of the investment in the associate at the year-end. If the associate had made the sale to the parent, the adjustment would have been:

DEBIT Cost of sales (consolidated income statement) ₦50,000

CREDIT Inventories (consolidated statement of financial position) ₦50,000

3.3 Associate's losses

When the equity method is being used and the investor's share of losses of the associate equals or exceeds its interest in the associate, the investor should discontinue including its share of further losses. The investment is reported at nil value. The interest in the associate is normally the carrying amount of the investment in the associate, but it also includes any other long-term interests, for example, long term receivables or loans.

After the investor's interest is reduced to nil, additional losses should only be recognised where the investor has incurred obligations or made payments on behalf of the associate (for example, if it has guaranteed amounts owed to third parties by the associate).

3.4 Impairment losses

IAS 39 sets out a list of indications that a financial asset (including an associate) may have become impaired. Any impairment loss is recognised in accordance with IAS 36 *Impairment of assets* for each associate individually.

In the case of an associate, any impairment loss will be deducted from the carrying value in the statement of financial position.

The working would be as follows.

	₦
Cost of investment	X
Share of post-acquisition retained earnings	X
	X
Impairment loss	(X)
Investment in associate	X

Illustration 4

Below are the statements of financial position of three companies as at 31 December 2010.

	H Ltd	S Ltd	A Ltd
Non-current assets	₦000	₦000	₦000
Property, plant and equipment	1,120	980	840
Investments			
672,000 shares in S Ltd	644	-	-
168,000 shares in A Ltd	224	-	-
	1,988	980	840
Current Assets			
Inventory	380	640	190
Receivables	190	310	100
Bank	35	58	46
	605	1,008	336
Total assets	2,593	1,988	1,176
Equity and liabilities			
Equity			
₦1 Ordinary shares	1,120	840	560
Retained earnings	1,232	602	448
	2,352	1,442	1,008
Current liabilities			
Trade payables	150	480	136
Taxation	91	66	32
	241	546	168
Total equity and liabilities	2,593	1,988	1,176

You are also given the following information:

1. H Ltd acquired its shares in S Ltd on 1 January 2010 when S Ltd had retained losses of ₦56,000.
2. H Ltd acquired its shares in A Ltd on 1 January 2010 when A Ltd had retained earnings of ₦140,000.
3. An impairment test at the year end shows that goodwill for S Ltd remains unimpaired but the investment in A Ltd has impaired by ₦2,800.
4. The H Group values the non-controlling interest using the fair value method. The fair value on 1 January 2010 was ₦160,000.

Required:

Prepare the consolidated statement of financial position as at 31 December 2010.

Suggested Solution:

W1 Shareholdings

	S Ltd	A Ltd
Group	80%	30%
Non-controlling interest	20%	-

	100%

W2 Net asset of S Ltd

	At date of acquisition	At the reporting date
	₦000	₦000
Share capital	840	840
Retained earnings	(56)	602
	784	1,442

W3 Calculation of Goodwill

	₦000
Cost of investment	644
Fair value of NCI	160
	804
Less: 100% net assets at acquisition	(784)
Goodwill	20

W4 Non-controlling interest

	₦000
Fair value of NCI	160
20% post-acquisition profit [20% x (56 + 602)]	131.6
	291.6

W5 Group retained earnings

	₦000
H Ltd	1,232
S Ltd [80% x (56 + 602)]	526.4
A Ltd [30% x (448 – 140)]	92.4
Less: Impairment of associate	(2.8)
	1,848

W6 Investment in associate

	₦000
Cost of investment	224
Post-acquisitionprofits (W5)	92.4
Less: Impairment	(2.8)
	313.6

Suggested Solution

Consolidated statement of financial position as at 31 December 2010

Non-current assets	₦000	₦000
Goodwill (W3)		20
Property, plant and equipment (1,120 + 980)		2,100
Investment in associate (W6)		313.6
		2,433.6
Current assets		
Inventory (380 + 640)	1,020	

Receivables (190 + 310)	500	
Cash (35 + 58)	93	1,613
Total assets		4,046.6
Equity and liabilities		
Equity		
₦1 ordinary shares		1,120
Retained earnings (W5)		1,848
		2,968
Non-controlling interest (W4)		291.6
		3,259.6
Current liabilities		
Trade payables (150 + 480)	630	
Taxation (91 + 66)	157	787
Total equity and liabilities		4,046.6

4.0 Conclusion

Associate – An entity, including an unincorporated entity such as a partnership, over which an investor has significant influence and which is neither a subsidiary nor an interest in a joint venture.

Equity method – A method of accounting whereby the investment is initially recorded at cost and adjusted thereafter for the post-acquisition change in the investor's share of net assets of the investee. The profit or loss of the investor includes the investor's share of the profit or loss of the investee.

5.0 Summary

- Investments in Associates to be recorded in CFS using equity method
- Investment to be initially recorded as cost, identifying goodwill / capital reserve arising at the time of acquisition.
- Carrying amount of investment is adjusted thereafter for the post acquisition change in investor's share of net assets of the investee.
- Investor's share of results of operations of investee to be included in Consolidated profit & loss account
- Goodwill/capital reserve arising on the acquisition of an associate included in the carrying amount of investment in the associate but should be disclosed separately.
- The investment in the associate is disclosed separately as a non-current asset.

6.0 Tutor Marked Assessment

1. Below are the income statements H Ltd, S Ltd and A Ltdfor the year ended 31 December 2010.

	H Ltd	S Ltd	A Ltd
	₦000	₦000	₦000
Revenue	8,000	4,500	3,000
Operating expenses	(4,750)	(2,700)	(2,050)
Profit from operations	3,250	1,800	950
Finance costs	(750)	(100)	(50)
Profit before tax	2,500	1,700	900
Tax	(700)	(500)	(300)

Profit for the year	1,800	1,200	600

You are also given the following information:

1. H Ltdacquired 80% of S several years ago.
2. H Ltd acquired 30% of the equity share capital of A Ltd on 1 January 2009.
3. During the year, H Ltd sold goods to A for ₦1 million at a mark-up of 25%. At the year-end, A Ltdstill held one quarter of these goods in inventory.
4. At 31 December 2010, it was determined that the investment in the associate was impaired by ₦35,000, of which ₦20,000 related to the current year.

Required:
Prepare the consolidated income statement for the group for the year ended 31 December 2010.

2. You are required to prepare the consolidated income statement and consolidated statement of financial position ofOlu Plc. and its subsidiary companies as at 31 December 2013.

Statement of financial position as at 31 December, 2013

	Olu Plc.	**Sule Ltd**	**Oye Ltd**
	₦	₦	₦
Ordinary shares of ₦1 each	200,000	40,000	10,000
General reserve	60,000		
Revenue reserve	37,000	27,000	13,000
	297,000	67,000	23,000
Payables	20,000	32,000	6,000
Company tax	9,000	11,000	7,000
Proposed dividends	10,000		4,000
	336,000	110,000	40,000
Property, plant and equipment	273,000	74,000	11,000
30,000 shares in Sule Ltd	35,000		
4,000 shares in Oye Ltd	7,000		
Current assets	21,000	36,000	29,000
	236,000	110,000	40,000

Income statement of the year ended 31 December 2013

	Olu Plc.	**Sule Ltd**	**Oye Ltd**
	₦	₦	₦
Turnover	200,000	156,000	84,000
Operating profit, after charging	26,000	30,000	20,000
Directors' emoluments	9,000	2,000	3,000
Depreciation	2,000	11,000	1,200
Auditor's remuneration	1,000	1,500	500
Dividends from Sule Ltd	6,000		

Dividends from Oye Ltd	4,000		
	36,000	30,000	20,000
Company tax	9,000	11,000	7,000
	27,000	19,000	13,000
Dividend paid	-	8,000	6,000
Proposed dividend	10,000	-	4,000
	17,000	11,000	3,000
Bal b/ f from previous years	20,000	16,000	10,000
	37,000	**27,000**	**13,000**

You are given the following additional information:

1. Olu Plc purchased its investments two year ago when the relevant balances on the revenue reserve were Sule Ltd ₦12,000 and Oye Ltd ₦8,000.
2. The companies do not trade with one another.
3. None of the directors of Olu Plc is the director of Sule Ltd or Oye ltd

7.0 Reference/Further Reading

IAS 28: Adebayo, P.A.(2011). Financial Accounting and Reporting Standards for Students and Professionals, Abuja: Rainbow Graphic Printers and Publishers

Bello, S. O. & Barnabas, S. A. (2017).Advanced Financial Accounting, Bida, 9ICE LINK Production

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UNIT SIX: VERTICAL GROUP STRUCTURE
CONTENTS

1.0 Introduction
2.0 Objectives

3.1 Main Content
 3.1 Multiple Subsidiaries
 3.2 Vertical Structure
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1.0 Introduction

A vertical group arises where a subsidiary of the parent entity holds shares in a further entity such that control is achieved. The parent entity therefore controls both the subsidiary entity and, in turn, its subsidiary (often referred to as a sub-subsidiary entity).

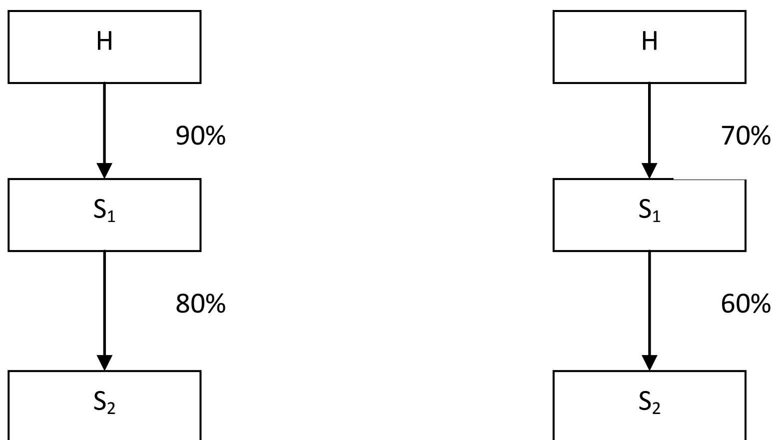
2.0 Objectives

- Define Vertical Group.
- Explain the principles for determining effective interest.
- Prepare a consolidated financial statement of financial sub-subsidiary.

- **Main Content**

3.1 Effective Interest

Situation 1: **Situation 2:**



In situation 1, H has an effective interest of only 72% (90% × 80%) in S_2. Nevertheless, S_2 is a sub-subsidiary of H because H has a controlling interest in S_1 and S_1 has a controlling interest in S_2. As H has an effective interest in S_2 of 72%, it follows that the non-controlling interest in S_2 is 28%. This can be analysed as follows:

	%
Owned by outside shareholders in T	20

Owned by outside shareholders in H [(100% – 90%) × 80%]	8
Effective NCI in S_2	28

In situation 2, H has an **effective interest** of just 42% (70% × 60%) in S_2. Nevertheless, S_2 is a sub-subsidiary of H because H has a controlling interest in S_1 and S_1 has a controlling interest in S_2. As H has an effective interest in S_2 of 42%, it follows that the non-controlling interest in S_2 is 58%. This can be analysed as follows:

	%
Owned by outside shareholders in T	40
Owned by outside shareholders in H [(100% – 70%) × 60%]	18
Effective NCI in S_2	58

3.2 Group reserve

Only the group or effective percentage of each of the reserves of the sub-subsidiary are included within group reserves. Often the only reserve will be retained earnings, but there could be others, such as revaluation reserve.

Date of acquisition

The date of acquisition of each subsidiary is the date on which H gains control. If S_1 already held S_2 when H acquired S_1, treat S_1 and S_2 as being acquired on the same day.

Consider the following situations to determine when the sub-subsidiary company, S_2, becomes a member of the H group:

(a) H acquired control of S_1 on 1 January 2004; S_1 subsequently acquired control of another entity, S_2, on 1 July 2006.

In this situation, S_2 does not come under the control of H until S_1 acquire shares in S_2– i.e. on 1 July 2006.

(b) H acquired control of S_1 on 1 July 2006; S_1 had already acquired control of another entity, S_2, on 1 January 2004.

Similarly, H cannot gain control of S_2 until S_1 acquires shares in S_2 on 1 July 2006

Illustration 1

Full goodwill method

The draft statements of financial position of D, C and J, as at 31 December 2012, are as follows:

	D	C	J		D	C	J
Sundry assets	280	180	130	Equity capital	200	100	50
				Retained earnings	100	60	30
Shares in subsidiary	120	80		Liabilities	100	100	50
	400	260	130		400	260	130

You ascertain the following:

(a) D acquired 75,000 ₦1 shares in C on 1 January 2012 when the retained earnings of C amounted to ₦40,000. At that date, the fair value attributable to the non-controlling interest in C was valued at ₦38,000.

(b) C acquired 40,000 ₦1 shares in J on 30 June 2012 when the retained earnings of J amounted to ₦25,000; they had been ₦20,000 on the date of D's acquisition of C. At that date, the fair value of the non-controlling interest in J (both direct and indirect), based on effective shareholdings, was valued at ₦31,000.

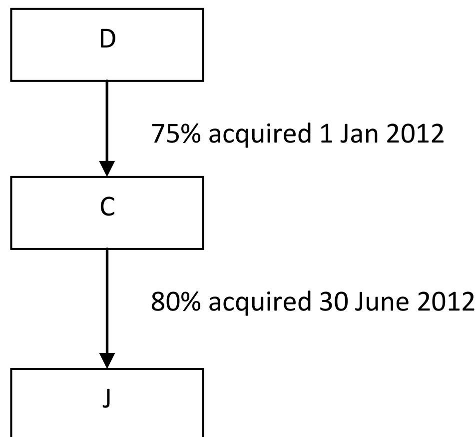
(c) Goodwill has suffered no impairment.

Required:

Produce the consolidated statement of financial position of the D group at 31 December 2012. It is group policy to use the full goodwill method.

Solution:

W1 Group structure



	C	J	
Group interest	75%	60%	(75% × 80%)
NCI	25%	40%	(25% × 80% + 20%)
	100%	100%	

W2 Net assets of subsidiaries at acquisition date

	C At acq'n ₦	J At acq'n ₦
Equity capital	100,000	50,000
Reserves	40,000	25,000
	140,000	75,000

W3 Goodwill

- A separate calculation is required to determine goodwill for each subsidiary.
- For the sub-subsidiary, goodwill is calculated from the perspective of the ultimate parent entity (D) rather than the immediate parent (C). Therefore, the effective cost of J is only D's share of the amount that C paid for J, i.e. ₦80,000× 75% = ₦60,000.

	C	**J**
	₦000	**₦000**

Cost of investment	120	60
Fair value of NCI	38	31
	158	91
Fair value of net assets (W2)	(140)	(75)
	18	16

W4 Group retained earnings

	D	C	J
	₦000	**₦000**	**₦000**
Per question	100	60	30
Less: Pre-acq. retained earnings		(40)	(25)
		20	5
Share of C (75% × 20)	15		
Share of J (60% × 5)	3		
	118		

Note that again, only the group or effective interest of 60% is taken of the post-acquisition retained earnings of J.

W5 Non-controlling interest

	C	J
	₦000	**₦000**
NCI FV at acquisition	38	31
NCI share of post-acq. retained earnings (25% × 20,000 (W4)) / (40% × 5,000 (W4))	5	2
Less: NCI share of cost of investment in J (25% × 80,000)	(20)	-
	23	33

Consolidated statement of financial position as at 31 December 2012

	₦000
Goodwill (18,000 + 16,000)	34
Sundry assets (280,000 + 180,000 + 130,000)	590
Total assets	624
Equity and liabilities	
Equity capital	200
Retained earnings (W4)	118
	318
Non-controlling interest (W5)	56
Total equity	374
Liabilities (100,000 + 100,000 + 50,000)	250
Total equity and liabilities	624

illustration 2

Illustration 2 – Proportion of net assets method

The draft statements of financial position of D, C and J, as at 31 December 2012, are as follows:

	D	C	J		D	C	J
Sundry assets	180	80	80	Equity capital	200	100	50
Shares in subsidiary	120	80		Retained earnings	100	60	30
	300	160	80		300	160	80

You ascertain the following:

(a) C acquired 40,000 ₦1 shares in J on 1 January 2012 when the retained earnings of J amounted to $25,000.

(b) D acquired 75,000 ₦1 shares in C on 30 June 2012 when the retained earnings of C amounted to ₦40,000 and those of J amounted to ₦30,000.

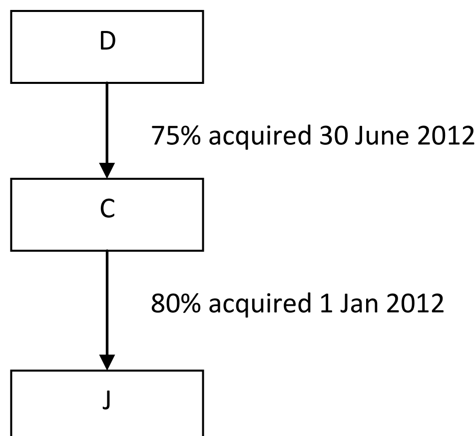
It is group policy to value the non-controlling interest using the proportion of net assets method.

Required:

Produce the consolidated statement of financial position of the D group at 31 December 2012. It is group policy to use the full goodwill method.

Solution:

W1 Group structure



	C	J	
Group interest	75%	60%	(75% × 80%)
NCI	25%	40%	(25% × 80%)
	100%	100%	

W2 Net assets of subsidiaries at acquisition date

	C	**J**

	At acq'n	At acq'n
	₦	₦
Equity capital	100,000	50,000
Reserves	40,000	30,000
	140,000	80,000

W3 Goodwill

	C	J
	₦000	**₦000**
Cost of investment (75% × 80,000)	120	60
Fair value of NCI		
(25% × 140,000 (W2)) / (40% × 80,000 (W2))	35	32
	155	92
Fair value of net assets (W2)	(140)	(80)
Goodwill	15	12

W4 Group retained earnings

	D	C	J
	₦000	**₦000**	**₦000**
Per question	100	60	30
Less: Pre-acq. retained earnings		(40)	(30)
		20	0
Share of C (75% × 20)	15		
Share of J (60% × 0)	0		
	115		

W5 Non-controlling interest

	C	J
	₦000	**₦000**
NCI FV at acquisition (25% × 140,000) / (40% × 80,000)	35	32
Share of post-acq. retained earnings (25% × 20,000) / [40% × (80,000 – 80,000)]	5	0
Less: NCI share of cost of investment in J (25% × 80,000)	(20)	-
	20	32

Consolidated statement of financial position as at 31 December 2012

	₦000
Goodwill (15,000 + 12,000) (W3)	27
Sundry assets (180,000 + 80,000 + 80,000)	340
Total assets	367
Equity and liabilities	

Equity capital	200
Retained earnings (W4)	115
	315
Non-controlling interest (W5)	52
Total equity	367

4.0 CONCLUSION

The principle for consolidation of multiple subsidiary and vertical group is same for consolidated that were discussed in previous units.

5.0 SUMMARY

This unit explained the procedures involved in the consolidation multiple subsidiaries and sub-subsidiaries. It demonstrates how to arrive at effective control for sub subsidiaries.

6.0 Tutor-Marked Assignment

On 1 May 2009, David Limited acquired investments as follows:

80% equity interest in Daniel Limited at a cost of ₦40.8 million

50% of Daniel Limited 8% Loan Notes at par

On 1 May 2009, Daniel Limited acquired 60% equity shares in Rosemary Limited at a cost of ₦60million

The following information was also provided:

i. Equity & liabilities

	David Ltd.	Daniel Ltd.	Rosemary Ltd.
	₦'000	₦'000	₦'000
Equity share at ₦1 each	30,000	9,000	12,000
Retained Earnings	111,000	24,000	60,000
8% loan notes	12,000	6,000	-

ii. Daniel Limited Land had a fair value of ₦1.2 million in excess of its carrying value. Its plant had a fair value of ₦4.8 million in excess of its carrying value at the date of acquisition. The pre-acquisition profit amounted to ₦21 million.

Required:

(a) Discuss how the investment purchased by David Ltd. on 1 May 2009 will be treated in its Consolidated Financial Statement.

(b) Calculate the net Goodwill that should be recognised in the Group's Balance Sheet, assuming that Goodwill is impaired by ₦1.2 million.

7.0 References/Further Reading

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MODULE TWO

Unit 1: Ratio and Interpretation of Account
Unit 2: Business Combination (Mergers, Acquisition and Takeover)
Unit 3: Internal Reconstruction and Reorganization
Unit 4: Account for Banks
Unit 5: Account for Insurances Companies
Unit 6: Bankruptcy and Insolvency
Unit 7: Valuation of business and shares
Unit 8: Accounting for Foreign Branches

UNIT ONE: RATIO ANALYSIS AND INTERPRETATION OF STATEMENTS

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
  3.1 Tools for interpretation of Financial Analysis
  3.2 Ratios analyses
  3.3 Factors to consider when carrying out firm comparison
  3.4 Intra- Firm Comparison
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  3.6 Limitations of Ratio Analysis

4.0 Conclusion
5.0 Summary
6.0 Tutor-Marked Assignment
7.0 References/Further Readings

1.0 INTRODUCTION

Interpretation and financial analysis includes analysis of the profitability of a company, the risk of the company, and the sources and uses of funds for the company. Profitability analysis is the evaluation of a company's return on investment. It focuses on a company's sources and levels of profits, and involves identifying and measuring the impact of various drivers of profitability. Profitability analysis includes evaluation of two sources of profitability: margins and turnover. Risk analysis is the evaluation of a company's riskiness and its ability to meet its commitments. Risk analysis involves assessing the solvency and liquidity of a company along with its earnings variability. An analysis of sources and uses of funds is the evaluation of how a company is obtaining and deploying funds. This analysis provides insights into a company's future financing implications.

2.0 OBJECTIVES

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

- Compute and interpret ratios;
- Discuss the implication of ratios
- Carry out intra-firm and inter-firm analysis

3.0 MAIN CONTENT

3.1 Financial analysis tools

Financial analysis tools include the following:

a. Comparative financial statements
   i. Year-to-year change analysis
   ii. Index-number trend analysis
b. Common-size financial statements
c. Ratio analysis
d. Cash flow analysis

Comparative analysis

Comparative analysis focuses on exceptions and variations and helps the analyst to formulate judgments about data that may be interpreted in various ways. In short, the usefulness of comparative analysis is the

notion that a number is more meaningfully interpreted when it is evaluated relatively to a comparable quantity.

Comparison can be made against (1) past experience, (2) external data—industry or economy-wide, or (3) accepted guidelines such as standards, budgets, or forecasts.

A comparison, to be meaningful and fair, must be made between data, which are prepared on a similar basis. If data are not directly comparable, the analyst should make appropriate adjustments before undertaking any comparative analysis. One also must remember that the past is not always an unqualified guide to the future.

Past trend often is a good predictor of the future *if* all relevant variables remain constant or nearly constant. In practice, however, this is seldom the case. Consequently, the analyst should use the results of trend analysis and adjust them in the light of other available information, including the expected state of the economy and industry. Trend analysis will, in most cases, reveal the direction of change in operating performance along with the velocity and the magnitude of change.

Indicators complement one another. Indeed, one indicator in the absence of the other is of limited value. To illustrate, an increase to ₦ 4,000 of receivables from base year receivables of ₦ 100 indicates a 3,900 % [(₦ 4,000-₦100)/₦ 100] increase. However, the huge percent change in this case is misleading, given the relatively small base year amount. This simple case demonstrates that both indicators need to be considered simultaneously. That is, reference to the absolute dollar amounts must be made to retain the proper perspective when a significant change in percent is revealed.

Several answers are possible. Since division by zero is not mathematically defined, it is impossible to get changes in percent when there is no figure for the base year. Also, if there is a negative figure in the base year and a positive figure in another year, or vice versa, a mere mathematical computation of percent change is nonsensical.

Index-number trend analysis
In index-number trend analysis, all figures are expressed with reference to a base year figure. Since the base year serves as the frame of reference, it is desirable to choose a year that is "typical" for the business. If the earliest year in the series analysed is not typical, then a subsequent (more typical) year should be chosen as the base year.

By utilising index numbers, the analyst can measure change over time. Such analysis enables the analyst to assess management's policies and, when examined in the light of the economic and industry environment of the periods covered, the ability of the company to effectively confront challenges and opportunities. Moreover, trend analysis of index-numbers enables the analyst to uncover important relations among various components of financial statements. This helps in the evaluation of the relative change in these components. For example, changes in sales and accounts receivable are logically correlated and can be expected to display a natural relation when examining trends.

Common-size financial statements
Common-size financial statements enable comparisons of changes in the elements that make up financial statements. The figures in each line item of financial statements are divided by a reasonable aggregate total and then expressed in percentage. The total of these elements will add to 100%. For example, the balance sheet items are usually expressed as a percentage of total assets and the income statement items are usually expressed as a percentage of total revenues. This makes it easier for the analyst to identify internal structural changes in companies that are reflected in financial statements.

The analysis of common-size financial statements focuses on major aspects of the internal structure of company operations such as:

- Capital structure and sources of financing
- Distribution of assets or make up of investing activities
- Composition of important segments of financial position such as current assets
- Relative magnitude of various expenses in relation to sale

Moreover, useful information can be obtained by a comparison of common-size statements of a company across years. The advantage of this temporal analysis is even more evident in comparisons between two companies of different sizes. Since analyses can be made on a uniform basis, this tool greatly facilitates such comparisons.

3.2 Ratio analysis

A ratio expresses a mathematical relation between two quantities or variables. To be meaningful (useful in analysis), a ratio of financial numbers must capture an important economic relation. Certain items in financial statements have no logical relation to each other and therefore, would not be amenable to ratio analysis.

Also, some type of benchmark or norm must exist for interpretation of the ratio. One can draw minimal inference from being told that the return on assets for a certain firm is .02. However, if the analyst is told that the company's return on assets is .02 and the industry average is .08, the ratio becomes more useful for interpretation purposes.

Since not all relations have meaning and not all ratios are useful for all analytical purposes, the analyst must be careful in selecting ratios that are useful for the particular task at hand. Unfortunately, ratios are too often misunderstood and their significance overrated. Ratios can provide an analyst with clues and symptoms of underlying conditions. Ratios also can highlight areas that require further investigation and inquiry. Still, ratios, like all other analysis tools, cannot predict the future. Moreover, the usefulness of insights obtained from ratios depends on their skillful interpretation by the analyst.

3.2.1 Profitability Ratios

Profitability ratios allow a more specific analysis of profit margin, e.g. expressing individual expenses as a proportion of sales or cost of sales. These ratios will identify any irregularities or changes in specific expenses from year to year.
Profitability may be expressed in relation to capital employed (profit as a percentage of assets used to earn that it) or in relation to sales (gross or net profit as a percentage of sales).
Common profitability ratios are:

Ratio	**Calculation**	**Discussion**
Gross Margin	(Sales – COGS) / Sales	This captures the relationship between sales and manufacturing (or merchandising) costs. (Also, called the gross profit margin.)
Return on Sales	Net Income / Sales	Measures the relationship of the bottom line to sales and thus captures sales to total costs of sales. (Also called the net profit margin).
Return on Assets	Net Income / Average Total Assets	Measures the firm's efficiency in using assets to generate earnings. Alternatively stated, it captures earnings to all providers of capital
Pretax Return on Assets	Earnings Before Interest & Taxes / Average Total Assets	Measures earnings from operations on a pretax and pre-interest expense basis.
Return on Total Equity	Net Income / Average Total Stockholders' Equity	Measures earnings to owners as measured by net assets.
Dividend Payout	Common Dividends / Net Income	Measures the percent of earnings paid out to common stockholders.
Asset turnover	Sales/Capital Employed	This ratio is express in times; a low rate shows that the company is not generating sufficient volume of business for the size of the assets invested

Illustration 1

The figures below relate to Omonso Ltd

Extract of Income statement for the year ended 31 December 2015

Gross profit 3,985,000
Net Profit 1,275,000
Turnover 13,715,000

Extract of assets and liabilities as at 31 December 2015

Shareholders' Fund 6,675,000
Total Assets 10,000,000

Required: Using the above figures, calculate each the following ratios

i) Net profit on Total Assets

ii) Gross Profit to sale

iii) Suggested Solution

i) Net profit on Total Assets = ₦ 1,275,000/10,000,000 X 100 =12.8%

ii) Gross Profit to sale = ₦ 3,985,000/13,715,000 X 100 =29.1%

iii) Net Profit to Sales = ₦ 1,275,000/13,715,000 X 100 =9.3%

3.2.2 Liquidity Ratios

Common liquidity ratios are:

Ratio	Calculation	Discussion
Current	Current Assets / Current Liabilities	Standard ratio to evaluate working capital.
Quick (Acid Test)	(Cash + Marketable Securities + Net Receivables) / Current Liabilities	This ratio eliminates inventory and other current assets from the denominator, focusing on “near cash” and receivables.
Cash	(Cash + Marketable Securities) / Current Liabilities	Only cash and cash equivalents considered for payment of current liabilities.
Operating Cash Flow	Cash Flows from Operations / Current Liabilities	Evaluates cash-related performance (as measured from the Statement of Cash Flows) relative to current liabilities.

When interpreting liquidity ratios, you should bear the following points in mind.

1. Companies and trades vary in their working capital requirements. A retail company does not have to invest capital in stocks and debtors, in the way that a manufacturing company probably does.
2. The current ratio might be anything from about 1.4:1 up to may be 3:1, depending on the trade. The liquid ratio is, however, expected to have a value not less than 1:1, otherwise the company could have difficulty in meeting its debts as they fall due.
3. An unnecessarily high ratio may indicate that the company is not using its resources efficiently or the company has built up its current assets at the balance sheet date for a major project, or seasonal sales, which is to begin shortly afterwards.
4. Many blue chip companies rely on bank overdraft as a permanent source of finance, although often times stated as part of their current liabilities. This may well give rise to very low current and liquid ratios, although no liquidity problem as such exists.

Illustration 2

You are evaluating the performance of Donald Corporation. From the Statement of Financial Position you find the follow balances: Cash and marketable securities = ₦400,000, Accounts receivable = ₦1,200,000, Inventory = ₦2,100,000, Accr wages and taxes = ₦500,000, Accounts payable = ₦800,000, and Notes payable = ₦600,000.

Required:

- Calculate Donald Corporation Current ratio, Quick ratio, and Cash ratio.

Current ratio = $\frac{₦400,000 + ₦1,200,000 + ₦2,100,000}{₦500,000 + ₦800,000 + ₦600,000}$ = 1.9474:1

Quick ratio (acid-test ratio) = $\frac{₦400,000 + ₦1,200,000 + ₦2,100,000 - N2,100,000}{₦500,000 + ₦800,000 + ₦600,000}$ = 0.84211:1

Cash ratio = $\frac{₦400,000}{₦500,000 + ₦800,000 + ₦600,000}$ = 0.21053:1

3.2.3 Management Efficiency/Assets Utilisation/Activity Ratios

These ratios measure the skills with which management looks after the assets, under its control, especially inventory, receivable, and the use of cash to pay its creditors the following ratios are relevant and frequently expressed in terms of days.

Common activity ratios are:

Ratio	Ratio	Discussion
Inventory Turnover	COGS / Average Inventory Sales/Inventory, COGS/Closing Inventory	Measures inventory management. Inventory should be turned over rapidly, rather than accumulating in warehouses.
Receivables Turnover	Sales / Average Accounts Receivables	Measures the effectiveness of credit policies and needed level of receivables investment for sales. (Also called the collection period).
Payables Turnover	Sales / Average Accounts Payables	Payables represent a financing source for operations.
Working Capital Turnover	Sales / Average Working Capital	Measures how much working (operating) capital is needed for sales.
Fixed Asset Turnover	Sales / Average Fixed Assets	Measures the efficiency of net fixed asset (property, plant & equipment after accumulated depreciation) investments.
Total Asset Turnover	Sales / Average Total Assets	Represents the overall (comprehensive) efficiency of assets to sales.

Illustration 3

Pepper Ltd. reported sales for 2015 of ₦23 million. Pepper listed ₦ 5.6 million of inventory on its Statement of Financial position. Calculate, using a 365 day year, how many days did inventory stay on the premises? How many times per year did inventory turnover?

Days' sales in inventory = $\frac{₦5.6m.+ 365}{₦23m}$ = 88.8696 days

Inventory turnover ratio = $\frac{₦23m}{₦5.6m}$ = 4.1071 days

Illustration 4

Edmond Ltd. ended the year 2015 with an average collection period of 32 days. The firm's credit sales for 2015 were ₦33 million. What is the year-end 2015 balance in accounts receivable for Edmond?

SOLUTION:

Let Account receivable be represented by A,

Average collection period (ACP) = $\frac{\text{ACCOUNT RECEIVABLE X 365}}{\textit{Credit Sales}}$

Average collection period (ACP) = 32 days

Credit sales =₦33 million

Account receivable (i.e. A) = ?

Substituting the figures in to the above formula, then we will have:

$32 = \frac{A \times 365}{₦33,000,000}$

Cross Multiply:

32 X ₦33,000,000 = 365A

₦1,056,000,000 = 365A

Divide both side by 365:

$\frac{₦1,056,000,000}{365} = \frac{365A}{365}$

₦2,893,151 = A

Therefore, Account Receivable for 2015 is ₦2,893,151

3.2.4 Investment/ Market ratios

Investment ratios such as earnings per share (EPS), price/earnings ratio (PE ratio), dividend cover and dividend yield.

Summary of Market Ratios are:

Book Value Per Share	Total Stockholders' Equity / Number of Shares Outstanding	Equity or net assets, as measured on the balance sheet
Earnings- based Growth Models	P = kE / (r-g), where E=earnings, k=dividend payout rate, r=discount rate, & g=earnings growth rate	Valuation models that discount earnings and dividends by a discount rate adjusted for future earnings growth
Market-to-book	(Stock Price x Number of Shares Outstanding) / Total Stockholders' Equity	Measure of accounting-based equity
Price Earnings Ratio (PE)	Stock Price / EPS	Measure of market premium paid for earnings and future expectations
Price Earnings Growth Ratio (PEG)	PE / Earnings Growth Rate	PE compared to earnings growth rates, a measure of PE "reasonableness"
Sales-to-market Value	Sales / (Stock Price x Number of Shares Outstanding)	A sales activity ratio based on market price
Dividend Yield	Dividends Per Share / Stock Price	Direct cash return on stock investment

Illustration 5

You are considering an investment in Bed& Breakfast Ltd. During the last year the firm's income statement listed addition to retained earnings = ₦ 4.8 million and common stock dividends = ₦2.2 million. The year-end Statement of Financial Position shows common stockholders' equity = ₦35 million with 10 million shares of common stock outstanding. The common stock's market price per share = ₦9.00. What is Bed & Breakfast's earnings per share and PE ratio.

Earnings per share = $\frac{₦4.8m + ₦2.2m}{₦10m}$ = ₦0.70

Price-earnings (PE) ratio $\frac{₦9.00}{₦0.70}$ = 12.86 times

3.2.5 Gearing/leverage ratios are:

Gearing is the term used to describe the extent to which a company's total capital is provided by fixed interest securities, such as debentures.

Summary of Gearing Ratios are:

Ratio	Calculation	Discussion
Debt to Equity	Total Liabilities / Total Stockholders' Equity	Direct comparison of debt to equity stakeholders and the most common measure of capital structure.
Debt Ratio	Total Liabilities / Total Assets	A broader definition, stating debt as a percent of assets.
Interest Coverage (Times Interest Earned)	(Net Income + Interest Expense + Tax Expense) / Interest Expense	This is a direct measure of the firm's ability to meet interest payments, indicating the protection provided from current operations.
Long-term Debt to Equity	Long-term Liabilities / Total Stockholders' Equity	A long-term perspective of debt and equity positions of stakeholders
Debt to Market Equity	Total Liabilities at Book Value / Total Equity at Market Value	Market valuation may represent a better measure of equity than book value. Most firms have a market premium relative to book value.

Illustration 6

You are considering a stock investment in one of two firms (Lots of Debt, Inc. and Lots of Equity, Inc.), both of which operate in the same industry. Lots of Debt, Inc. finances its ₦25 million in assets with ₦24 million in debt and ₦1 million in equity. Lots of Equity, Inc. finances its $25 million in assets with ₦1 million in debt and ₦24 million in equity. Calculate the debt ratio, equity multiplier, and debt-to-equity ratio for the two firms.

	Lots of Debt	Lots of Equity
Debt ratio	$= \frac{₦24m}{₦25m} = 96.00\%$	$\frac{₦1m}{₦25m} = 4.00\%$
Equity multiplier ratio	$= \frac{₦25m}{₦1m} = 25$ times	$\frac{₦25m}{₦24m} = 1.042$ times
Debt-to-equity ratio	$= \frac{₦24m}{₦1m} = 24$ times	$\frac{₦1m}{₦24m} = .042$ times

3.3 Factors to consider when carrying out firm comparison

External factors

There are a number of external factors that need to be understood. These include:

- Ratios need to be interpreted bearing in mind the political context within which a business has been operating as, for example, when governments adopt protectionist measures that can impact on a company's sales.

- Ratios need to be interpreted bearing in mind the economic context within which a business has been operating by considering any changes that have occurred in the accounting period that could impact on assets or transactions of an entity.

Internal factors
There are internal factors to consider:

- Ratios need to be interpreted in conjunction with reading the narrative and notes in the annual reports.

- Whether confident that the financial statements give a true and fair view: Have liabilities been omitted, e.g. use of off balance sheet finance, is there risk of fraudulent misrepresentation? Is there risk of window dressing?

- Ratios might be distorted because they are based on period-end figures:

- Factors that could invalidate inter-company comparisons, such as:

- Use of different measurement bases with non-current assets reported at historical cost or revaluation and revaluations carried out at different dates;

- Use of different commercial practices, e.g. factoring trade receivables so that cash is increased

- Applying different accounting policies: e.g. adopting different depreciation methods such as straight-line and reducing balance.

- Having different definitions for ratios, e.g.: the numerator for ROCE could be operating profit, profit before interest and tax, profit before interest, profit after tax, etc.; the denominator for ROCE could be total assets, total assets less intangibles, net assets, average total assets, etc.;

- The use of norms can be misleading, e.g.: a current ratio of 2:1 might be totally inappropriate for some company

3.4 Intra- Firm Comparison
It is normal practice for the financial director to make a comparison with the previous year's ratios to identify, investigate significant changes and make a report to the board. In approaching this there could be some preconceived ideas as to the reason based on local knowledge of the company. For students and those taking examinations, the task may be to consider what questions to ask in the absence of this local company knowledge. For example, consider the scenario where the inventory turnover rate has increased significantly. This should give rise to questions such as:

- Has the sales increased significantly? If so, is this from a one-off contract or is it likely to be a permanent increase? If a permanent increase, is there any risk of overtrading where there is insufficient capital to maintain inventory at a level which does not affect liquidity or a risk of stock-outs?

- Has the inventory level fallen? If so, is this because there is a restriction of credit and if so, why has that occurred? Have there been significant write-downs? If due to obsolescence, what is the possible effect on the reported inventory? Is the company experiencing liquidity problems and reducing inventory levels? Has there been a change in staff resulting in improved inventory control?

3.5 Inter-firm comparisons and industry averages)

Financial ratios provide management with the means to question any significant changes arising during the financial year. They are also a convenient way of assessing the current financial health and performance of a company relative to similar companies in the same industrial sector. This enables a company to be judged directly against its competitors, rather than merely against its own previous performance. Provided that each company uses exactly the same bases in calculating ratios, inter-firm comparisons provide an objective means of evaluation. Every company is subject to identical economic and market conditions in the given review period, allowing a much truer comparison than a single company's fluctuating results over several years. Inter-firm comparisons are ideal for identifying the strengths and weaknesses of a company relative to its immediate competitors and the industrial sector. These comparisons can be analysed by both internal users (management can take the necessary actions to maintain strengths and rectify weaknesses) and external users (lenders, creditors, investors, etc.). There are numerous sources of inter-firm information, but the organisations providing it can be divided into those which gather their data from external published accounts and those which collect the data directly from the surveyed companies on a strictly confidential basis.

Illustration 7

Nonat Co is a manufacturer of domestic appliances. Its chairman is pleased with the results for the year ended 31 December 2015 as they show a continuing improvement over recent past performance. However, the finance director says that a better assessment of the company's performance would be made by a comparison to other companies in the same sector. The finance director has obtained some ratios for Nonat Co.'s business sector, based on a year end of 31 December 2015, which are:

Return on capital employed (ROCE)	18·5%
Net asset (total assets less current liabilities) turnover	1·8 times
Gross profit margin	21%
Operating profit margin	10·3%
Current ratio	1·6:1
Gearing (debt/equity)	36%

The summarised financial statements of Nonat Co are:

Statement of profit or loss for the year ended 31 December 2015

	₦'000
Revenue	62,500
Cost of sales	(51,800)
Gross profit	10,700
Operating costs	(5,800)
Finance costs	(1,800)
Profit before tax	3,100
Income tax expense	(1,000)
Profit for the year	2,100

Statement of financial position as at 31 December 2015

	₦'000	₦'000
Assets		
Non-current assets		
Property		8,100
Owned plant		12,600

Leased plant		12,200
		32,900
Current assets		16,400
Total assets		49,300
Equity and liabilities		
Equity		
Equity shares of ₦1 each		9,000
Property revaluation surplus		4,000
Retained earnings		10,600
		23,600
Non-current liabilities		
10% loan notes	10,000	
Finance lease obligations	6,400	16,400
Current liabilities		
Finance lease obligations	2,100	
Other current liabilities	7,200	9,300
Total equity and liabilities		49,300

Required:

(a) Prepare for Nonat Co the equivalent ratios to those of its sector.

Note: The finance lease obligations should be treated as debt in the ROCE and gearing calculations.

(b) Analyse the financial performance and position of Nonat Co for the year to 31 December 2015 in comparison to the sector averages.

Suggested Solution

(a) Equivalent ratios for Nonat Co

		Nonat Co	Sector Average
Return on capital employed	((3,100 + 1,800)/(23,600 + 16,400 + 2,100) x 100)	11·6%	18·5%
Net asset turnover	(62,500/40,000)	1·6 times	1·8 times
Gross profit margin	(10,700/62,500 x 100)	17·1%	21%
Operating profit margin	(4,900/62,500 x 100)	7·8%	10·3%
Current ratio	(16,400:9,300)	1·8:1	1·6:1
Gearing (debt/equity)	((16,400 + 2,100)/23,600)	78%	36%

Analysis of comparative financial performance and position

Financial performance

As measured by the return on capital employed (ROCE), Nonat Co.'s overall profitability does not compare well with its competitors, underperforming the sector average profitability by over 37% ((18·5% –

11·6%)18·5%). The component parts of overall profitability are asset turnover and profit margins and, on both of these, Nonat Co considerably underperforms the sector average. The underperformance is worse for profit margins than for asset utilisation and indeed it is the gross margin which is the main cause of the unfavourable comparison. This may be due to a deliberate policy of under-pricing competitors (to increase sales) or it may be due to inefficient manufacturing. Nonat Co.'s control of operating expenses, as shown by the difference between gross and operating profit margins, is relatively good (at 9·3% of revenue compared to 10·7% for the sector) which confirms that it is gross profit margin which is the problem area, assuming there are no differences in cost classification.

Nonat Co., is generating approximately 11% ((1·8 – 1·6)/1·8) less revenue from its assets compared to the sector average which (as already noted) is also contributing to overall lower profitability (ROCE). Apart from the obvious implication that NonatCo. may be a less efficient manufacturer, there could also be a number of other reasons for the lower asset utilisation. Nonat Co. has revalued its property, whereas it is not known if its competitors have (without the revaluation Nonat Co.'s ROCE would be 12·9% ignoring additional depreciation). Some of Nonat Co.'s plant may have been recently acquired and therefore may not be up to full production capacity, meaning the current year's revenue does not contain sales for a full year in respect of production from this plant. The leasing of plant is usually more expensive than outright purchase (although the finance costs would not affect ROCE). Of course other competitors may also experience some of these issues, the effects of which would be included in the sector average figures.

Financial position

The current ratio shows that the liquidity of Nonat Co. is within expected norms and compares well with its competitors. There may be an argument to exclude the current finance lease liability from the current ratio which would then put it at 2·3:1 (16,400:7,200) which is perhaps a little higher than expected norms (usually an upper limit of 2). Nonat Co.'s gearing is quite high at more than double that of its competitors. This obviously increases finance costs and with an interest cover of only 2·7 times (4,900/1,800), any downturn in profit may place Nonat Co. in a difficult position. That said, a finance cost of 10% on the loan notes (plus the finance costs of the lease obligations) is a lower percentage than the ROCE so shareholders are getting a (slight) benefit from the debt, but this is at considerable risk.

It is tempting to say that if Nonat Co. had not leased some of its plant, its gearing would be more in line with the sector average, but this begs the question of how else would it have financed the plant. Issuing a further loan note would leave Nonat Co. in a similar debt position as now; only a cash injection from a new share issue would reduce the gearing. Another possibility is that NonatCo. could structure its plant leases such that they qualified as operating rather than finance leases. Indeed, it may be that Nonat Co. already has some operating leased plant, but this cannot be determined from the information provided.

Conclusion

Nonat Co. is considerably underperforming its sector averages and the finance director is correct to say that a comparison with its competitors is a better indication of Nonat Co.'s current performance than looking at the past trend of its own performance, subject to the definitions and accounting policies used by other companies in the sector.

The analysis indicates Nonat Co. may need to look at its pricing policy or manufacturing efficiency and also needs to investigate a strategy of reducing its gearing.

4.0 CONCLUSION

We could calculate hundreds of ratios from a set of financial statements; the expertise lies in knowing which ratios provide relevant information. For example, an investor would be interested in the availability of profits to pay dividends, whereas a credit controller of a supplier would be more interested in a customer's ability to pay and would be concentrating on the liquidity ratios. The relative usefulness of each

ratio depends on what aspects of a company's business affairs are being investigated.

5.0 SUMMARY

- Ratios are one means of analysing financial statements.
- Ratios can be grouped into categories such as Profitability, Liquidity (short term financial stability), Efficiency, Gearing (Long term financial stability) hand Investor ratios.
- Different users of financial statements are interested in different ratios.
- Horizontal of intra-company analysis involves comparing the current year with the previous year(s) and noting any significant changes.
- Intercompany analysis involves comparing an entity's performance with another entity of comparable standard
- Ratios are only as good as the underlying information and this must therefore be considered as to its reliability and the degree to which it may have been manipulated.

6.0 TUTOR-MARKED ASSIGNMENT

Progress Ltd. sells jewelry through stores in retail shopping centers throughout Ghana. In the last three years, it has experienced declining turnover and profitability and Management is wondering if this is related to the industry as a whole. It has engaged a consultant who produced average ratios of many businesses. Below are the ratios that have been provided by the consultant for the jewelry business sector based on year end of 31st December 2012.

Return on Capital employed	16.8%
Net assets to Turnover	1.4 times
Gross profit margin	35%
Operating profit margin	12%
Current ratio	1.25:1
Average Inventory turnover rate	3 times
Trade payables payment period	64 days
Debt to equity	38%

The Financial Statements of Progress Ltd. For the year ended 31st December 2012 are:

INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2012

	₦ 000	₦ 000
Revenue		168,000
Opening inventory	24,900	
Purchases	131,700	
	156,600	
Closing inventory	30,600	126,000
Gross profit		42,000
Operating costs		(29,400)
Finance costs		(2,400)
Profit before tax		10,200
Income tax		3,000
Profit for the year		7,200

Statement of Financial Position as at 31 December 2012

	₦		₦
Non-current assets:			
Property and shop fittings			76,800
Deferred development expenditure			15,000
			91,800
Current assets:			
Inventories	30,600		
Bank	3,000		33,600
			125,400
Equity and liabilities:			
Sated Capital			45,000
Capital surplus (Revaluations Surplus)			9,000
Income surplus			25,800
			79,800
Non-current liabilities :			
20% Loan notes			24,000
Current liabilities:			
Trade payables		16,200	
Current tax payable		5,400	21,600
Equity & liabilities			125,400

(i) Stated Capital is made up of 45,000 Ordinary Shares of no par value issued at a consideration of GH¢1000 per share.

(ii) The deferred development expenditure is in respect of an investment in a process to manufacture artificial precious gem for future sale by Progress Ltd in the retail jewelry market.

Required:

(a) Prepare for Progress Ltd. equivalent ratios that have been provided by the consultant.

(b) Assess the financial and operating performance of Progress Ltd. using the consultant's ratios as benchmarks.

8.0 Further Reading

Aborede, R (2006) *A Practical Approach to Advanced Financial Accounting,* 2 Ed, EL-TODA Ventures Ltd, Lagos, Nigeria.

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UNIT TWO: BUSINESS COMBINATION (MERGERS, ACQUISITION AND TAKEOVER)

CONTENTS

1.0 Introduction

2.0 Objectives

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3.2 Reasons/benefits of business combination include

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5.0 Summary

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1.0 INTRODUCTION

The term "business combination" is used to describe an arrangement where two or more businesses owned and operated as separate entities come together to become a single entity under the same ownership. Theimplication of this is that the separate businesses will discontinue their ownership and come under a single ownership.Business combination can take many forms:

(a) Amalgamation
(b) Merger
(c) Absorption
(d) Acquisition
(e) Takeover
(f) Reconstruction

2.0 Objectives

- Understand meaning of Amalgamation, Absorption and External Reconstruction.
- Understand the reasons for business combination.
- Understand the accounting treatment of business combination
- Understand the distinction between Amalgamation, Absorption and External Reconstruction.
- Understand forms of Amalgamation

3.0 Main Content

3.1 Forms of business combination

Amalgamation

Amalgamation signifies the transfer of all or some part of assets and liabilities of one or more than one existing company or two or more companies to a new company. It is the blending of two or more existing companies into one undertaking; the shareholder of each blending companies becoming substantially the shareholders of the company which will carry on blended undertaking. There may be amalgamation by

transfer of one or more undertaking to a new company or transfer of one or more undertaking to an existing company.

Merger

A merger refers to a combination of two or more companies, usually of not greatly disparate size, into one company. A merger involves the mutual decision of two companies to combine and become one entity; it can be seen as a decision made by two 'equals'. It refers to a situation when two or more existing firms combine together and form a new entity. It is a marriage between two companies of roughly same size. It is thus a combination of two or more companies in which one company survives on its own name and the other ceases to exist as legal entity.

Absorption

The process in which one company acquires the business of another company is known as Absorption. In this process, a smaller existing company is overpowered by an existing larger company. No new company is established in absorption. There are two companies involved in this process, i.e. the company who takes over the business of the other company is known as Absorbing Company, and the company whose business is taken over is known as Absorbed Company

Acquisition

Acquisition refers to the acquiring of ownership right in the property and asset without any combination of companies. Thus in acquisition two or more companies may remain independent, separate legal entity, but there may be change in control of companies. Acquisition results when one company purchase the controlling interest in the share capital of another existing company.

Takeover

There is no tangible difference between an acquisition and a takeover; both words can be used interchangeably - the only difference is that each word carries a slightly different connotation. Typically, takeover is used to reference a hostile takeover where the company being acquired is resisting. In contrast, acquisition is frequently used to describe more friendly acquisitions

External Reconstruction

The term 'External Reconstruction' means the winding up of an existing company and registering itself into a new one after a rearrangement of its financial position. Thus, there are two aspects of 'External Reconstruction', one, winding up of an existing company and the other, rearrangement of the company's financial position. Such arrangement shall be approved by its shareholders and creditors and shall be sanctioned by the court. The accounting treatment is similar to that of absorption.

3.2 Reasons/benefits of business combination include:

(a) The desire to gain larger share of the market.
(b) The desire to attain synergy.
(c) The desire to establish a solid capital base.
(d) To provide efficient customer service.
(e) To acquire a base adequately for raw material sourcing in the case of a manufacturing firm.
(f) To be able to challenge a major competition.
(g) In order to meet legal and statutory requirement.

When businesses amalgamate, two major accounting problems arise, viz:

(i) Those concerned with closing the books of the discontinuing businesses which are being wound up;

3.3 Closing the Books of the Discontinuing Companies

To close the books of the discontinuing companies, the following ledger accounts are necessary;

(a) Realization account.

(b) New company account.

(c) Sundry members account.

(d) Each liability account, for example creditors, liquidation expenses payable/creditors for dissolution expenses, loan or debenture account.

(e) Bank account.

(f) Components of purchase consideration, for example ordinary shares issued, preference shares issued, debenture stock issued and cash paid.

Realisation Account

This is the account in which the profit or loss on the dissolution of a company is determined. It is usually prepared in a columnar form. The number of columns will depend on the number of companies amalgamating.

New Company Account

This is the account where the purchase consideration and related transactions are treated. The purchase consideration, when agreed, is debited to this account (remember that the credit entry goes to realisation account) while transactions relating to the purchase consideration are credited to the account when settlement of the agreed purchase consideration is made. The account can therefore be regarded as a "self-balancing" account.

Purchase Consideration

This is the aggregate amount, which the new company is to pay the owners (that is the stakeholders) of the discontinuing business and creditors. The components of the purchase consideration in amalgamation of companies may comprise of some or all of the following:

(i) Ordinary shares issued by the new company.

(ii) Preference shares issued by the new company.

(iii) Debenture stock issued by the new company.

(iv) Cash given by the new company.

(v) Liabilities of the old companies taken over by the new company.

Where liabilities are taken over, they form part of the purchase consideration. Such liabilities are debited to the liabilities account and credited to the new company's account.Components of the purchase consideration account

On settlement of the purchase consideration as agreed, the account of each of the components of the purchase consideration is debited while the new company's account is credited.

On distribution to the owners of discontinuing businesses, the sundry members account is debited and the account of each of the components of the purchase consideration is credited.

3.4 Accounting Entries for Closing Discontinuing Businesses

The accounting entries necessary to close the book of discontinuing businesses being liquidated are summarized below.

S/No.	Events	Account to be Debited	Account to be Credited
1.	Book value of the asset taken over by the company at the date of cessation.	Realisation Account	Individual Asset Account
2.	Liabilities taken over by the new company at the date of cessation, (if part of purchase consideration).	Individual Liability Account	New Company Account
3.	Agreed purchase consideration (Includingliabilities taken over).	New Company's Account	Realisation Account
4.	Realisation expenses payable/creditors for realisation expenses.	Realisation Account	Realisation expenses payable account/ creditors account for realisation expenses.
5.	Portion of the realisation expenses paid by the existing company being discontinued.	Liquidation expenses	Bank Account
6.	Portion of the realisation expenses to be paid by the new company.	Included in the purchase consideration recorded in (3) above. OR New Company's Account	Realisation Account
7.	Discount received from creditors.	Creditors account	Realisation Account
8.	Profit on realisation (this is to be derived)	Realisation account	Sundry shareholders and debenture holders account
9.	Loss on realisation (this is to be derived)	Sundry shareholders and debenture holders account	Realisation Account
10.	Transfer of balances on share capital, reserves and debentures Accounts.	Share capital reserves and debentures account.	Sundry shareholders and debenture holders account
11.	Settlement of the agreed purchase consideration by the new company.	Bank and/or shares and/or debentures in new company account.	New Company's Account
12.	Settlement of liabilities not taken over by the new company.	Creditors account	Bank account
13.	Distribution of balances.	Sundry shareholders and debenture holders account	Bank and/or shares and/ or debentures in the New company account.
14.	Arrears of preference dividend includedin the balance sheet as liability.	Preference dividends in arrears.	Sundry members Preference Shares account
15.	Cumulative preference dividend in arrears but not included in the balance sheet and not to be forfeited.	Retained profit or any other revenue reserve account.	Sundry members preference account.
16.	Arrears of debenture interest	Retained profit or any	Debenture Stock Account

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	(if any).	other revenue account.	
17.	Ordinary share dividend included in the balance sheet.	Proposed dividend account	Sundry members shares account.

3.6 Accounting Entries in the Books of the New Company

The accounting entries in the books of the new company can be divided into two:

(a) The amalgamation journal

(b) The statement of financial Position after amalgamation.

Amalgamation Journal

This is a composite journal which is prepared to reflect the assets and liabilities taken over as well as goodwill or capital reserve on amalgamation.

On the debit side of the journal are all tangible assets taken over at revaluation value or taken over value. However, if the takeover values are not given, it is assumed that the assets are taken over at book values. The takeover value will only be used when such assets are not revalued. If revalued, the revaluation value will be used instead of the takeover value.

On the credit side of the journal are all the components of purchase consideration (including liabilities taken over) as contained on the credit side of the new company account in the books of the discontinuing businesses.

The difference between the debit side and the credit side of the journal, represents goodwill or capital reserve. If the balancing figure on the journal is an asset (i.e. debit balance) it is referred to as goodwill. If it is a claim over the assets (i.e. credit balance) it is referred to as capital reserve.

Illustration 1

Luck & Co. has been making losses over the last few years. Its statement of financial position at 31 December, 2013 showed the following:

Luck & Co. Statement of financial position as at 31 December, 2013

	₦	₦
Non-current assets:		
Property, plant and equipment		80,000
Current assets:		
Inventory	20,000	
Receivables	40,000	60,000
		140,000
Equity and Liabilities:		
Ordinary capital		100,000
Retained earnings		(140,000)
Secured loan stock		100,000
Payables		80,000
		140,000

On liquidation, the assets would realise the following:

	₦	₦
Property, plant and equipment		30,000
Inventory		12,000

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Receivables		36,000
		78,000

If the company continues to trade for the next four years, profit after charging ₦20,000 per annum as depreciation on the property, plant and equipment would be as follows:

	₦
2014	4,000
2015	20,000
2016	26,000
2017	28,000
	78,000

Assume that there would be no surplus cash to settle the payables and loan- stock holders until after four years when inventory and receivables could be realised at their book values.

Required:

(a) advise the management of Luck and Co on the options available to them and

(b) redraft the statement of financial position of Luck and Co after the exercise.

Solution

(a) Options available to the management of Luck & Co:

Option 1

If liquidation takes place now, the amount that will be available to the loan stock holders is ₦78,000, leaving them with a deficiency of ₦22,000. In this case, there would be nothing for the creditors and shareholders.

Option 2

If trading continues for the next four years and the estimated results are achieved, the available cash would be as follows:

	₦
Profit	78,000
Depreciation	80,000
Inventory	20,000
Receivables	40,000
	218,000

With this option, loan stockholders and creditors would be paid in full ₦100,000 and ₦80,000 respectively, leaving ₦38,000 available for the shareholders.

However, the loan stockholders probably have the right to appoint a receiver and would insist on some compensation for not enforcing their right.

In addition, the creditors might also expect compensation for having to wait for four years before receiving payment.

Option 3

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The loan stockholders and creditors may be persuaded to waive the amounts owed to them in exchange for ordinary shares to enable them have full participation in the future profit of the company. Terms of such an exchange might be as follows:

(i) 75,000 units of ₦1 ordinary shares to the loan stockholders (3 of ₦1 ordinary shares for every ₦4 of loan stock)
(ii) 40,000 units of ₦1 ordinary shares to the creditors (1 of ₦1 ordinary shares for every ₦2 due)
(iii) 25,000 units of ₦1 ordinary shareholders (1 of ₦1 ordinary shares for every 4 of the existing ₦1 ordinary share.

(b) **LUCK & CO**

Redrafted Statement of Financial position after the exercise.

	₦
Assets:	
Property, Plant and Equipment	80,000
Inventory	20,000
Receivables	40,000
	140,000
Equity	140,000

4.0 Conclusion

Amalgamation and Absorption signify the merging of two of more companies either for eliminating competition among them or for growing in size to reap the economics of large-scale production or for controlling the market.

5.0 Summary

Business combination describe an arrangement where two or more businesses owned and operated as separate entities come together to become a single entity under the same ownership.
Amalgamation, merger, absorption, acquisition, takeover and reconstruction are different forms of business takeover.

6.0 Tutor-Marked Assessment

Small Company Limited and Big Company Limited have decided to combine their business operations to become Large Company Limited.
The balances in the terminal balance sheets of the combining businesses are as follows:

	Small Co. Ltd.	Big Co. Ltd.
	₦'m	₦'m
Fixed Assets	27.50	35.00
Goodwill	10.00	3.00
Other Assets	2.50	21.00
	40.00	59.00

Large Company Limited is to take over all the assets of the combining businesses

by the issuance of its shares on the basis of 3 new shares of ₦1.00 each for existing ₦2.50 worth of Net Tangible Assets in each of the combining companies.

- How many shares are due to the shareholders of Small Company Limited?
- What is the total number of shares issued by Large Company Limited?
- What is the value of purchased goodwill from the transaction?

7.0 References/Further Readings

Jennings A. R. (1993) *Financial Accounting*, DP Publication, London

Lewis L. &Pendrill S. (1981) *Advanced Financial Accounting,* Pitman, London

Wood F. & Sangster A. (1998) *Business Accounting 1,*8th ed. United Kingdom, Financial Times Professional Ltd

UNIT THREE: INTERNAL RECONSTRUCTION AND REORGANIZATION

CONTENTS

1.0 Introduction
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3.0 main Content
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3.2 Situations which call for internal reconstruction of a company
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1.0 INTRODUCTION

The ideal goal that every company strives to achieve is a balanced capital structure. A balanced capital structure is one in which the long- term funds (share capital plus long term liabilities) adequately cover investment in long term assets and leave a surplus which substantially covers current assets. A balanced capital structure also implies that the gearing ratio should be optimal. When a company is faced by problems arising from imbalance in capital structure, it may have to carry out a capital reconstruction to redress the problem. Capital reconstruction refers to the re-organization of capital and/or re-arrangement of the rights of shareholders as between themselves in order to revive an ailing company or transfer its operation to another company. Indicators of imbalance capital structure include overcapitalisation, overtrading, unhealthy working capital ratio, excessive amount of reserve and capital not represented by available assets. Reconstruction can take any of the three forms:

- Through alteration of capital
- Through reduction of capital
- Through scheme of external reconstruction (discussed under business combinations)

2.0 Objectives

3.0 **Main Content**

3.1 Meaning of Reconstruction and Reorganization

Internal reconstruction means a recourse undertaken to make necessary changes in the capital structure of a company without liquidating the existing company. In internal reconstruction neither the existing company is liquidated, nor is a new company incorporated. It is a scheme in which efforts are made to bail out the company from losses and put it in profitable position. They are the company's shareholders, debenture holders, creditors etc. Under internal reconstruction, the accumulated trading losses and fictitious assets are written off against the sacrifice made by these interest holders in the form of reduction of paid up value of their interest.

3.2: Situations which call for internal reconstruction of a company

The following situations are generally responsible for the internal reconstruction of a company:

(i)When the capital structure of a company is complex and it is required to make it simple.
(ii) When there are huge accumulated losses and it is required to write off these losses to depict a better position of the company.
(iii) When a part of the capital is not represented by available tangible assets.
(iv) When change is required in the face value of shares of the company so that they can become attractive for future investors.
Internal reconstruction of a company can be carried out in the following different ways. These are as under:
(A) Alteration of Share Capital; and
(B) Reduction in Share Capital
A capital reduction is a scheme approved by the court in which the nominal or par value of a company's paid up share capital is reduced.

3.3 Rule for Capital Reduction

The general rule, going by section 105 of CAMA, 1990, is that a company is not permitted to reduce its share capital.

a. A company, however, may reduce its issued share capital on fulfillment of the following conditions;

I. It must be authorised by its articles;
II. It must be by a special resolution passed at a general meeting;
III. The resolution must specify the amount of reduction; and
IV. The capital reduction must be approved by the court.

The purpose of requiring court's approval is to ensure the protection of creditors whose interest may be jeopardised should the company embark on the capital reduction scheme. They are, therefore, entitled to object to the scheme. Specifically, Section 107(4) requires the company to apply to the court for an order confirming the reduction, after passing a special resolution, while section 107(2) provides that every creditor of the company who is entitled to any debt or claim admissible in proof against the company shall be entitled to object to the scheme if;

(a) The proposed reduction of share capital involves a diminution of liability in respect of unpaid share capital; and
(b) It involves the payment to a shareholder of any paid up share capital or any other form of reduction.

Section 107(4) empowers the court to settle the list of creditors entitled to object to the scheme.

All these provisions are to ensure that the creditors are protected and do not suffer any loss as a result of the capital reduction scheme unless they allow it by refusing to come forward and object when their interest is not protected.

Capital reduction should not be construed to be the same as Capital Reconstruction. The latter is wider and embraces the former. A company in severe financial difficulties which needs to reach a compromise with its creditors may embark on capital reconstruction. Whereas, in capital reduction scheme, only the existing shareholders (ordinary and preference) are involved, in capital reconstruction external creditors are involved.

3.4 Steps in capital Reconstruction

Step 1. Total Amount Loss Ascertained:

At first, total amount of loss which is to be written-off should be ascertained. This includes debit balance of Profit and Loss Account, all fictitious assets, like Goodwill, Preliminary Expenses, Discount on issue of shares and Debentures etc., any fall in the value of assets, any increase in liability or arrears of cumulative preference dividend etc. In short, only net assets are left.

Step 2. Writing-off the Loss so Ascertained:
After ascertaining the total loss, it becomes necessary to reduce the capitals contributed by the various parties, viz: equity shareholders, preference shareholders, unsecured creditors and creditors having a floating charge. The above persons suffer the loss. Practically, equity shareholders are to suffer the maximum amount of loss. They also agree to bear the loss to the maximum amount since they know very well that, in reality, their capital does not exist at all. As a result, if the company goes into liquidation they will get nothing. Therefore, for a better prospect, to get something in the form of dividend and bonus shares in future they agree to share such losses. But if the amount of loss is such that it is not covered by the equity capital alone, in that case, preference shareholders are asked to suffer such loss. The loss may also be borne by the unsecured creditors and creditors having a floating charge. Under no circumstances preferential creditors or secured creditors (up to the extent of realisable value of assets pledged) are asked to make any sacrifice.

Step 3. Compensation to be made by the Various Parties:
Distribution of loss among the various parties depends on the circumstances. If the loss is to be borne by the equity shareholders alone understanding that the loss will ultimately by compensated by future earnings, question of compensation does not arise. But if preference shareholders are asked to make any sacrifice (i.e., if they are to share the amount of loss) they must be compensated by increasing their rate of dividend in such a way that their total earning must not be affected by the reduction of the capital. The same can be done by a company only when the trend of profit is not fluctuating. Of course, there is another alternative which can be followed for this purpose. That is, a part of preference share capital may be converted into equity share capital which gives them an opportunity of exercising voting rights together with the higher rate of dividend in this converted part in order to compensate their losses.

If debenture-holders or creditors are asked to make any sacrifice they should also be compensated in the same manner. They should be paid in cash for the balance or they should be given some sort of security for the rest. Debenture-holders may be given a high rate of interest.

Arrear preference dividends are generally cancelled since it may create some difficulties if paid in cash. In that case deposit certificates may be issued as against compensation made to the preference shareholders. This is preferable since (a) it will not affect the voting power, and (b) the certificates can be redeemed when the opportunity will arise.

Step 4. Arrangements for Working Capital:
Scheme of capital reduction will be successful only when there will be proper provision for working capital.

The following methods may be advocated for the purpose:
(i) to issue some shares;
(ii) to request debenture-holders to extend their loans;
(iii) to reduce the share capital to partly paid amount so that the rest of the call (money) may be made when needed; and
(iv) to invite any fresh loan (short-term).

Illustration 1
The following is the abridged Statement of Financial Position of Hind Ltd. as at 31.12.2014:

Liabilities	**₦**	**Asset**	**₦**
Paid-up Capital		**Goodwill at Cost**	30,000
10,000, 6% Cumulative Pref. Shares of ₦10 each	100,000	Net Tangibles Assets	152,000
15,000 Equity Shares of ₦10 each	150,000	P&L Account	68,000
	250,000		250,000

The Preference share dividend is in arrear for three years. The net tangible assets are estimated to be worth ₦136,000 on the expectation that the annual profits will be ₦20,000. Draft a scheme of reconstruction to be submitted to the Directors mentioning the important matters which would require consideration and state the effect of such proposal on the two classes of shareholders. Redraft the Balance Sheet.

Solution:

(a) Estimated total loss which is to be written-off may be computed as:

	₦
Goodwill	30,000
Profit & Loss Account	68,000
Net Tangible Assets (maybe reduced by	22,000
Loss to be written-off	**120,000**

The company has been running at a loss and as such, has shown an accumulated loss of ₦68,000 in the asset side of the Statement of Financial Position and at the same time the Goodwill Account which has shown in the asset side has no value at all. A deduction of ₦22,000 is made by way of depreciation against net tangible assets on the assumption that the same was overvalued, and, hence, net tangible assets are shown at their real values.

(b) Since preference shareholders have priority as to the return of capital they are not made to suffer any loss. As a result, the entire amount of loss is to be borne by the equity shareholders. Of course, preference shareholders may be asked to waive their arrear of dividend amounting to ₦18, 000.
(₦100,000 x 6/100 x 3) which is a loss on the part of them. But in view of the sacrifices made by them for arrear dividend, rate of their dividend may be increased at 8% instead of 6% by way of compensation.

(c) From the above, it is quite clear that equity shareholders may be asked to suffer a loss of ₦120,000 i.e. each share will be valued at ₦2 each, or, will be reduced by ₦8 each.
(d) Value of each equity share of ₦10 each may be reduced to a share of ₦4 each, ₦2 called-up. Therefore, this will help the company to make a further call of ₦2 per share resulting in a cash inflow of ₦30,000 (15,000 x ₦2) and the same may be used by way of working capital. At the same time, it will help to write-off the loss.

(e) Expected future income on the basis of the above proposals:

	₦
Profit (after tax, may be assumed)	*20,000*
Less: Transfer to Reserve @ 25%	*(5,000)*
	15,000
Less: Preference Dividend @ 8%	*(8,000)*
Profit available for equity shareholders	*7,000*

Rate of Dividend ₦ $\frac{7,000}{30,000}$ *x 100=23.33%*

If the above scheme is accepted, it will not only yield a return of 23.33% which is highly satisfactory but also the transfer which will be made out of profit to reserve fund @ 25% is very much desirable on the part of the company.

The Statement of Financial Position under the circumstances will be:

Liabilities	₦	Assets	₦
10,000, 6% Cum.Pref. Shares of ₦10 each, fully paid	100,000	Net Tangibles Assets	130,000
15,000 Equity Shares of ₦4 each fully paid	60,000	Bank	30,000
	160,000		160,000

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Illustration 2

Rich and Poor Construction Company Plc is in financial difficulty. The following is the Trial Balance of the company as at 30 June, 2015.

	DR	CR
Land	580,000	
Building (Net)	136,230	
Ordinary shares of 1 each		500,000
5% cum-preference shares at 1 each		350,000
8% Debenture (2020)		400,000
Equipment (Net)	53770	
Goodwill	200,000	
Investment in shares (quoted)	135,000	
Inventory and work in progress	501,235	
Debtors	253,460	
Profit/Loss Account	199,105	
Interest payable on debenture		64,000
Trade creditors		481,235
Loan from Directors		80,000
Bank draft		183,565
	2,058,800	2,058,800

Authorized capital is 1,000,000 ordinary shares of 1.00 each and 500,000 5% cumulative preference shares of 1.00 each.

During the meeting of the shareholders and directors it was decided to carry out a scheme of internal reconstruction.

The following scheme was agreed:

(a) Each ordinary share is to be reduced to a share of 25k.

(b) The existing 5% cumulative preference shares are to be exchanged for new issue of 175,000 8% cum preference shares of 1.00 each and 700,000 ordinary shares of 25k each.

(c) Ordinary shareholders accepted a reduction in the nominal value of the shares of 1.00 for 25k, with subscription to a new issue on the basis of 1 to 1 at a price of 30k per share.

(d) 30,000 of Directors loan is to be cancelled. The balance is to be settled by issue of 50,000 ordinary shares of 25k each.

(e) Goodwill and loss in the profit and loss account are to be written off.

(f) Investments in shares are to be sold at market price of 300,000.

(g) Bank overdraft to be repaid, 100,000 is to be paid to trade creditors and the balance payable by installment.

20% of debtors are to be written off.

(h) Assets are revalued as follows:

Land	1,450,000
Building	400,000
Equipment	50,000
Inventory and Work-in-Progress	250,000

s

Required:
Show the necessary journal entries to effect the reconstruction scheme.

	Debit	Credit
Director's Loan Capital reconstruction Ord. Shares (50,000 @ 25k each Share premium Write-off and issue of shares to settle Director's Loan	80,000	 30,000 12,500 37,500
Capital Construction Goodwill P&L Account Goodwill and Loss written off	399,105	 200,000 199,105
Bank Investment Capital reconstruction Sale of investment at market price	300,000	 135,000 165,000
Bank overdraft Trade Creditors Bank Payment of overdraft and part payment of creditors	183,565 100,000	 283,565
Capital reconstruction Debtors 20% written off debtor account	50,629	 50,629
Land Building Inventory and WIP Equipment Capital reconstruction Revaluation of asset	870,000 263,770	 251,235 3,770 878,765

4.0 Conclusion

A company in severe financial difficulties can carry out internal restructuring through share capital alteration or capital reduction.

5.0 Summary

The steps to be taking for capital reconstruction are:

- Total Amount Loss Ascertained:
- Writing-off the Loss so Ascertained:
- Compensation to be Made by the Various Parties:
- Arrangements for Working Capital:

6.0 Tutors Marked Assignment

What are the benefits of internal reorganisation

7.0 Reference/ Further reading

Fatimehin, A. E. (2004) "Introduction to Bankruptcy Executorship and Trusteeship" Fatimehin and Associates, Lagos

Federal Government of Nigeria (2004) Companies and Allied Matters Act CAP C20 LFR 2004

Igben, O.R. (2004). *Financial Accounting Made Simple. EL-TODA Ventures Limited*

UNIT FOUR: ACCOUNT FOR BANKS (WITH SPECIAL RELEVANT LEGISLATION)
CONTENT

1.0 Introduction
2.0 Objectives
3.0 Main Content
    3.1 law and regulations of Banks in Nigeria
    3.2 Specific Guidance
4.0 Conclusion
5.0 Summary
6.0 Tutor Marked Assignment
7.0 References/Further Reading

1.0 Introduction
Financial statements of banks are guided and regulated by legislation enacted and amended from time to time. These laws and regulation explain when and how financials of banks should be report and presented. Bank financial reports are regulated by standards issued by International accounting Standard board, with IFRS 10; financial instrument-disclosure occupying a prominent place.

2.0 Objectives
At the end of this unit, you should be able to:

- Identify the relevant laws that regulate banking operation in Nigeria.
- Identify some specific provisions relating to account of banks.
- Describe financial statement of bank

3.0 Main Content
3.1 law and regulations of Banks in Nigeria

The Laws regulating the establishment of banks in Nigeria include principally:
Companies and Allied Matters Act, Cap. C. 20 LFN 2004; Banks and Other Financial Institutions Act, Cap. B.3 LFN 2004; and Central Bank of Nigeria Cap C4 LFN 2004.

Companies and Allied Matters Act. (CAMA)
Banks operating in Nigeria are corporate bodies. They must firstly be incorporated as a company under the CAMA by complying with the requirements in respect of registration of such a company. See Sections 18, and 35 CAMA See also Section 2(1) BOFIA. Once a company is incorporated, it becomes a body corporate by the name contained in the memorandum of association to carry out business. See Sections 37 and 38 (1) CAMA.

Banks and other Financial Institutions Act. (BOFIA)

The BOFIA was enacted in 1991 along with a new CBN law to ensure close monitoring and complete control of the financial system in the country by the regulatory body. The BOFIA repealed the Banking Act 1969 and consequently also repealed the Banking Amendment Acts 1970, 1972, 1975 and 1976.

BOFIA regulates banking and other financial institutions by prohibiting the carrying on of such businesses in Nigeria without valid license owned by a company duly incorporated in Nigeria. In pursuance of prudence and accountability, BOFIA makes it mandatory for a bank not later than four (4) months after the end of its FY to:

(i) Publish in a daily Newspaper printed in and circulating in Nigeria and approved by the CBN (BOFIA Section 27

(ii) Disclose in detail in such publication penalties paid as a result of contravention of any policy guidelines which are in force during the FY in question and auditor's report shall reflect such contravention (BOFIA Section 27 (2)); and,

(iii) Any bank which fails to comply with any of the requirements of Section 27 is in respect of each failures guilty of an offence and liable on conviction to a fine of ₦100,000 (BOFIA Section 27(5).

Central Bank of Nigeria Act 1958.
The Central Bank of Nigeria was established as a body corporate under S.1. CBN Act. The Act provides for the powers of the Bank to print currency notes and coins and the monopoly of issuing them.The general operation powers of the CBN are contained elaborately under Section 26 while the activities it is prohibited from undertaking are stipulated under S. 28. The CBN is entrusted with certain services which it renders to the Federal. It is also mandated to act as banker to other banks in Nigeria and outside Nigeria, very importantly, it has power to make and alter rules and regulations for the good order and management of its activities.

Nigeria Deposit Insurance Corporation Act Cap N102 Laws of the Federation of Nigeria (NDIC Act)
The Act grant complementary oversight responsibilities to Nigeria Deposit Insurance Corporation (NDIC) NDIC effectively took off in 1989 and was set up to provide deposit insurance and related services for banks in order to promote confidence in the banking industry. The NDIC is empowered to examine the books and affairs of insured banks and other deposit taking financial institutions. Licensed banks are mandated to pay 15/16 of 1 per cent of their total deposit liabilities as insurance premium to the NDIC. A depositor's claim is limited to a maximum of ₦50, 000.00 in the event of a bank failure.

Bills of Exchange Act. (BEA)
This Act deals with cheques, which is a bill of exchange that is commonly used by commercial banks, ("whose business includes the acceptance of deposits withdrawable by cheques") S. 66 BOFIA. By virtue of Section 73 BEA " Acheque is a bill of exchange drawn on a banker payable on demand. Therefore, the provisions of the BEA apply to a cheque. There are specific provisions in respect of cheques under the BEA such as presentment of cheque for payment S. 74, crossed cheques. S. 78-84. In Addition, other provisions of the BEA in respect of bills of exchange generally apply to cheques, so banks are bound by them.

Other statutes regulate the activities and financial reporting of the Banking industry in Nigeria are:

- Nigeria inter-bank settlement system guideline (NIBSS)
- Nigeria Automated Clearing system guideline (NACS)
- Security and Exchange Commission Guidelines (SEC)
- Circular issued from time to time by the Ministry of Finance
- International Accounting standards issued by International accounting Standard Board

3.2 Specific Guidance
Minimum Capital
The President shall on the advice of the Central bank of Nigeria (CBN) determine, from time to time, the appropriate minimum paid up share capital of each category of banks subject to subsection (1) of this section. The minimum shareholders' fund of banking institutions shall in respect of:

(a) Universal banks be at ₦25 billion
(b) Bureau de change be at ₦500 million
(c) Micro finance banks be at ₦20 million
(d) Mortgage institutions be at ₦2 billion

Cash Reserves, Special Deposits and specified Liquid Assets

The BOFIA requires every bank to maintain with the CBN, cash reserves and special deposit and hold specified liquid assets or stabilization securities, as the case may be, as prescribed by the Central Bank by virtue of section 39 of central bank of Nigeria Act, 1991 (as amended) where both assets and liabilities are due.

For the purpose of this section, specified liquid assets are:

(a) Currency notes and coin which are legal tender in Nigeria;
(b) Balances at the bank;
(c) Net balances at any licensed bank and money at call in Nigeria;
(d) Treasury bills and treasury certificates issued by the Federal Government;
(e) Inland bills of exchange and promissory notes re-discountable at the Central Bank; and
(f) Negotiable Certificate of deposit approved by the Central Bank
(g) Such other negotiable instruments may from time to time be approved by the Central Bank.

Conditions for payment of dividends No bank shall pay dividend until:

(a) All its preliminary expenses, organisational expenses, share selling expenses, brokerage, losses incurred and other capitalised expenses not represented by tangible assets have been written-off;
(b) Adequate provision has been made for contingent losses on risk assets, liabilities, off balance sheet commitment; and
(c) It has complied with capital ratio requirement specified by section 13(1) of the Act.

Reserve for Small Scale Industries

CBN monetary and credit policies require each bank to set aside 10 percent of its profits for the financing and promotion of small scale industries in Nigeria.

Illustration 1

An extract from the books of EZINWA Commercial Bank Plc revealed the following as at 31 December.

	₦million
Issued Ordinary Share Capital	250,000
Statutory Reserves	189,000
Profit Before Taxation	102,000
Taxation	36,000
Profit After Taxation	66,000
Dividend paid	20,000

Calculate how much should be transferred to reserve in relation to small and medium enterprises equity investment scheme. Assuming the bank has only been in existence for five years.

SMIEIS Reserve 5% of PAT

$$5 \times \frac{66{,}000}{100} \text{ million}$$

$$= \text{₦}3{,}300\text{m}$$

Prudential guidelines

A credit facility is deemed to be performing if the payment of both principal and interest are up to date in accordance with the agreed repayment terms. The interest accrued on it should be recognised as income in the financial statement for performing loan made provision of 1%.

Prudential guidelines issued by the CBN required banks to classify non-performing loans and advances, and to provide for loan impairment as follows:

	Substandard credit facilities	Doubt credit facilities	Lost credit facilities
Remark	Facilities remain inactive for 90 days	Facilities inactive for 180-360 days	Facilities inactive for over 360 days
Interest income	Interest suspended	Interest suspended	Interest suspended
Principal amount	10% provision	50% provision	100% provision

Illustration 2

The following are extracted from the notes to the accounts of Moore Commercial Bank Plc

Loans and advances:	₦"million
Performing	400
Non-performing - Substandard	90
Doubtful	150
Lost	40

Calculate the amount of provision for bad debts.

Solution

Performing – ₦400 @ 1%	₦4m
Substandard ₦90m @ 10%	₦9m
Doubtful ₦150 @ 50%	₦75m
Lost ₦40m @ 100%	₦40m
	128m

PREPARATION OF PUBLISHED FINANCIAL STATEMENTS FOR BANK

Banks and other financial institutions are also required to comply with the accounting requirements of Banks and Other Financial Institutions Act, 1991 (as amended), in preparing their financial statements.

Disclosure requirements

In addition to the disclosure requirements of IAS No 1, Information to be disclosed in Financial Statements, Banks should also disclose the following:

(a) Accounting policies in respect of identification and provision for losses of non-performing loans, nature of off -Statement of financial position engagements, such as letters of credits, bonds, guarantees, indemnities, acceptances, and trade related contingencies such as documentary credits and methods used to recognise income thereon.

(b) Income statements, stating each principal revenue item:

- (i) interest income, split between bank and non-bank sources
- (ii) interest expenses, split between bank and non-bank sources.
- (iii) Credit related fee income and expenses.

A bank should not offset one item of revenue or expense by deducting it from another item of revenue or expense.

(c) Assets and liabilities in the Statement of financial positions to be grouped according to their nature and listed in the order of their liquidity and maturity. Assets should start with cash and short-term funds while liabilities with loan stock.

(d) A maturity profile of risk assets and deposit liabilities classified into the following

categories:

Under 1 month 1 - 3 months 3 - 6 months 6 - 12 months

Over 12 months

The above maturity profile should be based on the expected normal repayment periods of the assets and liabilities.

(e) The amount of provision for loan losses, segregated between principal and interest. Provision for losses of "off-Statement of financial position" engagements should be shown separately as component of other liabilities.

(f) An analysis of the movements in the various categories of loan loss provision should be disclosed.

(g) One item of asset or liability should not be offset by deducting another asset or liability unless a legal right of 'set-off' exists.

(h) An analysis of loans and advances between "performing" and "non-performing" loans.

(i) The nature and amount of contingencies and commitments arising from the "off Statement of financial position" engagements which the bank has undertaken and analysis between the different classes of contingencies. "Off Statement of financial position" engagements should not form part of Statement of financial position totals.

(j) The major items that make up its "other assets" and "other liabilities" in form of notes to the accounts.

FORMAT OF THE REVENUE ACOUNT

Consolidated Statement of Comprehensive Income as at the year ended

	Notes	**₦'000**	**₦'000**	**₦'000**		
Gross Earnings					xx	
Continuing operations						
Interest income	1		xx			
Interest expense	1		(xx)			
Net interest income					xx	
Fee and commission income	2		xx			
Fee and commission expense			(xx)			
Net fee and commission income					xx	
Net trading income	3		xx			
Other operating income	4		xx			
					xx	
Underwriting profit					xx	
Operating income						**xx**
Net impairment loss on financial assets 5					(xx)	
Impairment charge on goodwill					(xx)	
Net operating income after net impairment loss on financial assets					**xx**	
Personnel expenses	6				xx	
Operating lease expenses					xx	
Depreciation and amortisation				xx		
Other operating expenses	7				xx	
Total expenses					(xx)	
Share of profit/(loss) of equity accounted investee						xx
Profit before income tax						**xx**
Income tax expense	8					(xx)
Profit from continuing operations						**xx**
Discontinued operations						
Loss from discontinued operations (net of tax)					(xx)	
Profit for the year						**xx**

Other comprehensive income net of income tax:			
Foreign currency translation differences for foreign operations		xx	
Fair value (loss)/gain on available-for-sale investments recognised in equity		xx	
Fair value gains on property and equipment			xx
Other comprehensive (loss)/gain for the year, net of tax		xx	
Total comprehensive income for the year			**xx**
Profit attributable to:			
Owners of the Bank			xx
Non-controlling interest			xx
Profit for the year			**xx**
Total comprehensive income attributable to:			
Owners of the Bank			xx
Non-controlling interest			xx
Total comprehensive income for the year			**xx**
Earnings per share			
Basic earnings per share (kobo)	9	xx	
Earnings per share – continuing operations			
Basic earnings per share (kobo)	9	xx	

Consolidated Statement of Financial Position as at the year ended

Assets				
Cash and cash equivalents		10		xx
Non-pledged trading assets		11		xx
Pledged assets	12		xx	
Derivative financial instruments				xx
Loans and advances to banks	13		xx	
Loans and advances to customers				xx
Insurance receivables	14		xx	
Investments in equity accounted investee		15		xx
Investment in subsidiary		16		xx
Investment securities				xx
Trading properties		17		xx
Investment properties	18		xx	
Property and equipment		19		xx
Intangible assets				xx
Deferred tax assets				xx
Other assets		20		xx
Assets classified as held-for-sale				xx
Total assets				**xx**
Liabilities				
Deposits from banks		21		xx
Deposits from customers		22		xx
Derivative financial instruments				xx
Debt securities issued				xx
Retirement benefit obligations			xx	
Current tax liabilities				xx
Other liabilities	23		xx	
Claims payable			xx	

Liabilities on investment contracts				xx
Liabilities on insurance contracts		24		xx
Interest-bearing loans and borrowings	25		xx	
Deferred tax liabilities			xx	
Contingent settlement provisions				xx
Liabilities classified as held-for-sale				xx
Total liabilities			**xx**	
Equity				
Share capital and share premium		26		xx
Retained earnings				xx
Other components of equity				xx
Total equity attributable to owners of the Bank			**xx**	
Non-controlling interest				xx
Total equity				**xx**
Total liabilities and equity			**xx**	

Notes to the Account:

1. Net interest income

Interest income

- Cash and cash equivalents
- Loans and advances to banks and customers
- Investment securities

Interest expense

- Deposit from banks
- Deposit from customers
- Securities dealing
- Interest-bearing loans and borrowings
- Other borrowed funds
- Other interest expense

2. Fee and commission income

- Credit-related fees and commissions
- Commission on turnover and handling commission
- Other fees and commissions

Credit related fees and commissions relate to fees charged to corporate customers other than fees included in determining the effective interest rates relating to loans and advances carried at amortised cost.

3. Net trading income

- Fixed-income securities
- Foreign exchange
- Equity securities

Net trading income includes the gains and losses arising both on the purchase and sale of trading instruments and from changes in fair value.

4. Other operating income

- Dividends on available-for-sale equity securities
- Gain on bargain purchase
- Gain on disposal of property and equipment

- Profit on sale of trading properties
- Profit on sale of subsidiary
- Rental income
- Gain on disposal of equity investment
- Bad debt recovered
- Other income

5. Net impairment loss on financial assets

- Additional/(reversal) of collective impairment charges on loans and advances to banks
- Additional/(reversal) of collective impairment charges on loans and advances to customers
- Write back of specific impairment charges on loans and advances to customers
- Additional specific impairment charges on loans and advances to banks
- Additional specific impairment charges on loans and advances to customers
- Additional/(reversal) of impairment charge on available-for-sale
- Additional/(reversals) impairment allowance on other assets
- Reversal of impairment allowance on investment property
- Diminution of investment in subsidiaries
- Impairment charge on insurance receivables

6. Personnel expenses

- Wages and salaries
- Increase in liability for defined benefit plans
- Contributions to defined contribution plans
- Termination benefits
- Other staff costs
- Increase/(decrease) in liability for share appreciation rights

(a) Amount represents the net loss incurred by the Bank on the winding down of the Staff Investment Trust Scheme (SIT) during the year.
(b) Staff and executive directors' costs:
Employee costs, including those of executive directors, during the year amounted to:

- Wages and salaries
- Pension costs
- Other retirement benefit cost

7. Other operating expenses

- Other premises and equipment costs
- Professional fees
- Insurance
- Business travel expenses
- AMCON surcharge This represents the Bank's contribution to AMCON's sinking fund for the period ended
- Loss of control of subsidiaries
- Loss on disposal of investments
- Deposit insurance premium
- Auditor's remuneration
- General administrative expenses

8. Income tax expense recognised in the profit or loss

Current tax expense:

- Corporate Income Tax
- Education Tax

- Prior year's under-provision
- Deferred tax expense: (Origination)/reversal of temporary differences

9. Basic earnings per share

Basic earnings per share and diluted earnings shares are calculated by dividing the net profit attributable to equity, holders of the Bank by the weighted average number of ordinary shares in issue during the year, excluding the average number of ordinary shares purchased by the Bank and held as treasury shares.

10. Cash and cash equivalents

- Cash on hand and balances with banks
- Unrestricted balances with central banks
- Money market placements and other cash equivalents

(i) Included in cash and cash equivalents is an amount of NX (is Nx for prior year) representing unclaimed dividend held in the account of the Registrar with the Bank. The corresponding liability is included in other liabilities.
(ii) Included in cash in hand balances with other banks is an amount of NX (is Nx for prior year) representing the Naira value of foreign currencies held on behalf of customers to cover letter of credit transactions. The corresponding liability is included in other liabilities.

11. Non-pledged trading assets

- Government bonds
- Treasury bills
- Equities

12. Pledged assets

Financial assets that may be re-pledged or resold by counterparties:

- Treasury bills
- Government bonds

13. Loans and advances to customers

- Loans to individuals
- Loans to corporate entities and other organisations

14. Insurance receivables

- Due from agents, brokers and reinsurers
- Allowance for doubtful receivables

15. Investments in equity accounted investee

Balance, beginning of year	xx
Acquired through business combination	xx
Reversal of share of impairment	(xx)
Exchange difference	xx
Disposal during the period	(xx)
Balance end of period/year	**xx**

16. Investment securities

- Available-for-sale investment securities
- Government bonds
- Treasury bills

- Eurobonds
- Underwriting commitment
- Equity securities with readily determinable fair values
- Unquoted equity securities at cost
- Others
- Specific impairment for underwriting commitment
- Specific allowance for impairment on unquoted equity securities

Held-to-maturity investment securities

- Treasury bills
- Government bonds
- AMCON bonds (see note below)
- Corporate bonds
- Eurobonds
- Local contractors bonds
- Other bonds
- Investment securities

AMCON consideration bonds represent consideration bonds issued by the Asset Management Corporation of Nigeria (AMCON) and fully guaranteed by the Federal Government of Nigeria. The consideration bonds were issued in exchange for non-performing loans and the issued shares in Intercontinental Bank, as part of the acquisition by Access Bank. Based on the terms of the transactions, AMCON reserves the right to review the valuation of the sale.

17. Trading properties

This represents the cost of real estate properties held by the Bank's subsidiaries which are designated for resale to customers.

18. Investment properties

These investment properties must be valued by reputable estate surveyors and valuers using the comparative method of valuation to arrive at the open market value.

Balance, beginning of year		xx
Acquired through business combination		xx
Additions during the year		xx
Asset classified as held-for-sale	xx	
Loss of control	(xx)	
Transfer from property and equipment	xx	
Disposals during the year		(xx)
Allowances for impairment		(xx)
Balance end of year		**xx**

19. Property plant and equipment

Cost		
Balance at 1 January		xx
Acquisitions		xx
Disposals		(xx)
Reversals		xx
Write-off		(xx)
Transfers to assets held-for-sale		(xx)
Transfer (to)/from other assets	xx	
Translation difference	xx	
Balance at 31 December		**xx**

20. Other assets

Restricted deposits with central banks (see note below) xx
Accounts receivable xx
Cash collateral receivable on letters of credit transactions xx
Prepayments xx
Subscription for investment xx
Allowance for impairment on other assets xx

This balance is made up of Central Bank of Nigeria's cash reserve requirement and statutory deposits required by the National Insurance Commission (NAICOM). Restricted deposits with central banks are not available for use in the Bank's day-to-day operations.

21. Deposits from banks

- Money market deposits
- Other deposits from banks

22. Deposits from customers

- Term deposits
- Demand deposits
- Saving deposits

23. Other liabilities

- Cash-settled share-based payment liability
- Creditors and accruals
- Certified cheques
- Deferred income
- Customers' deposit for foreign trade (see note below)
- Collections
- Unclaimed dividend
- Other current liabilities

This represents the Naira value of foreign currencies held on behalf of customers in various foreign accounts to cover letters of credit transactions. The corresponding balance is included in cash and balances with banks.

24. Liabilities on insurance contracts

- Life assurance contracts
- Non-life insurance contracts

25. Interest-bearing loans and borrowings

- European Investment Bank
- African Development Bank
- Nigeria Export Import Bank
- Central Bank of Nigeria under the Commercial Agriculture Credit Scheme
- Bank of Industry-Intervention Fund for SMEs
- Bank of Industry-Power & Airline Intervention Fund (see note (d))
- Other loans and borrowings

26. Capital and reserves

a) Equity capital

(a) Authorised:
Ordinary shares:
Preference shares:

(b) Issued and fully paid-up:

Illustration

The following is the trial balances of Olowo bank Plc. for the year to 31st December 2014

	₦'m	₦'m
Share capital of N1.00 each		1,500
Statutory Reserve		1,380
General Reserve		1,410
Deposit: Fixed		8,460
: Demand		5,800
: Savings		6,050
Taxation		750
Money at call and short notice from other banks		3,820
Bills payable		2,400
Profit and loss account		730
Creditors		45
Unclaimed dividends		82
Income Interests on loans		8,820
Commissions, charges and fees		4,135
Foreign exchange transactions		585
Lease income		410
Others		238
Provision for bad and doubtful accts		598
Contingent liabilities and other obligations on behalf of customers and customers liabilities there of	6,750	6,750
Loan and advances	23,000	
Interests paid to other banks	250	
On deposits by customers	530	
Rent	410	
Sundry expenses	180	
Money on call short notice	3,800	
Equipment on leases	2,500	
Salaries	38	
Investments	3,500	
Freeholds property	4,600	
Motor vehicles	700	
Furniture and fittings	850	
Cash in hand and with other banks	5,300	
Bills discounted-Treasury	800	
-Others	755	…………
	53,963	**53,963**

Additional Information

1.The analysis by performance of the loans and advance is as shown below:

	₦'m	
Performing accounts	1,200	1%
Substandard accounts	2,750	10%
Doubtful accounts	18,120	50%
Lost accounts	930	100%

2.A general provision of ₦8 million is to be made on all other risk assets.

3. Taxation is at the rate of 35%

4. Provide for the following:

Proposed dividend at 10k per share

Statutory reserve in accordance with section 16 of BOFID

Bonus issue reserve of ₦500m

5. Provide for depreciation as follows:

Equipment on lease	10%
Freehold property	10%
Motor vehicle	20%
Furniture and fittings	10%

Required: Prepare the Income Statement for the year ended 31 December 2014 and a Statement of Financial position as at that date; show all workings:

Solution: **OLOWO BANK Plc**

Income Statement for the year ended 31st December 2014

	Notes	₦'000	₦'m
Gross income	1		14,188
Interest paid	2		780
Net income			13,408
Overhead	3		628
Depreciation	4		935
Provision for bad and doubtful accounts	5		9,687
Profit for the year			2,158
Taxation			755
Profit from continuing operations			**1,403**

OLOWO BANK PLC Statement of financial position as at 31st December 2014

	Notes	N'm	N'm
Assets			
Cash and short term funds			5,300
Money call and short notice			3,800
Loans and advances	6		12,715
Investments			3,500
Bills discounted	7		1,555
Equipment on lease	8		2,250
Fixed assets	9		5,465
Total assets			34,585
Deposits liabilities	10		24,130
Others Liabilities	11		4,182
Total Liabilities			28,312
Equity and reserves			
Share capital			1,500
Reserves	12		4,773
Total Liabilities and equity			34,585
Contingent liabilities obligation & customers liability thereof			6,750

Workings

1. Gross Income	**₦'m**
Interest on loans and advance	8,820
Commissions, charge fees etc	4,135
Foreign exchange income	585
Lease income	410
Others	238
	14,188

2. Interest paid	**₦'m**
To banks	250
To customers	530
	780

3. Overhead	**₦'m**
Rent	410
Sundry Expenses	180
Salaries	38
	628

4. Depreciation	**₦'m**
Equipment on lease: 10% of N500m	250
Freehold property: 10% of N4,600m	460
Motor vehicle: 20% of N700m	140
Furniture and fittings: 10% of N850m	85
	935

5a. Provisions	**Principal**	**Provision**
	₦'m	**₦'m**
Performing account (1%)	1,200	12
Substandard account (10%)	2,750	275
Doubtful accounts (50%)	18,120	9,060
Lost account (100%)	930	930
		10,277
Less provision brought forward		(598)
Other risk assets		8
		9,687

5b. Movement in provision for bad and doubtful account	**₦'m**
Balance brought forward	598
Profit and loss account	9,687
Balance carried forward	10,285

6. Loans and advances	**₦'m**
Balance brought forward	23,000
Provision for bad and doubtful acct	(10,285)
Balance carried forward 10,277+8	12,715

7. Bills discounted	**₦'m**

s

Treasury	800
Others	755
	1,555

8. Equipment on lease	**₦'m**
Cost	2,500
Less Depreciation (10%)	250
Net Book Value	2,250

9. Fixed Assets		**₦'m**
Cost – Freehold property		4,600
- Motor Vehicles		700
- Furniture and Fittings		850
		6,150
Less Depreciation (w4)	935	
Excluding depreciation on equipment on lease	250	
		685
		5,465

10. Deposit:	**₦'m**
Fixed	8,460
Demand	5,800
Savings	6,050
Money at call and short notice from other banks	3,820
	24,130

11. Other Liabilities	**₦'m**
Taxation brought forward	750
Taxation for the year	755
Dividends for the year	150
Unclaimed dividends b / fwd	82
Bills payable	2,445
	4,182

12. Reserves

	Statutory reserve	Profit or loss	General reserve	Bonus issue	Total
Balance b/f	1,380	730	1,410		3,520
For the year	421	332		500	1,253
Balance c/f	**1,801**	**1,062**	**1,410**	**500**	**4,773**

4.0 CONCLUSION

The conduct or operation of banking in Nigeria is regulated by BOFIA and CBN Act. These laws provide operational standard to be conformed to by banks. They also provide the legal basis for their activities. Consequently, every bank is mandated to operate within the ambit of the laws.

5.0 SUMMARY

The Banks and other Financial Institutions Act regulates the activities of all banks apart from the Central of Nigeria. The BOFIA regulates banking business and management of banks while the CBN Act

establishes the CBN as the apex regulator of the banking sub-sector with functions and powers under the Act. The Bills of Exchange Act deals with the negotiable instruments, which are used by banks in the conduct of their business, especially cheques.

6.0 TUTOR MARKED ASSIGNMENT

What is the relevance of Bills of Exchange Act to the conduct of banking business in Nigeria?

1.0 REFERENCES/FURTHER READINGS

Adebayo, P.A. (2011). Financial Accounting and Reporting Standards for Students and Professionals, Abuja: Rainbow Graphic Printers and Publishers

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Bills of Exchange Act, Cap. B8, LFN 2004.

Federal Government of Nigeria (1992)Banks and Other Financial Institution Act

Federal Government of Nigeria (1959)Central bank of Nigeria Act

UNIT FIVE: ACCOUNTING FOR INSURANCE BUSINESS (WITH SPECIAL RELEVANT LEGISLATION)

CONTENT

1.0 Introduction
2.0 Objectives
3.1 Main Content
- 3.1 Regulation in insurance Industry
- 3.2 Insurance Act of 2003
- 3.3 Accounting Standard in Insurance Industry
- 3.4 Basis of Accounting

4.0 Conclusion
5.0 Summary
6.0 Tutor Marked Assignment
7.0 References/Further Reading

1.0 INTRODUCTION

Insurance is a species of business that specifically deals with risk management. It is concerned with appraising and controlling risk. It is an intricate legal, economic and social device for the handling of risks to life and property. An insurance company differs in nature, from other business concerns, it involves the payment of periodic sums known as premiums to the insurer and by the exchange agree to cover risks that may occur in the future.

Section 102 of the insurance Act, 2003 described insurance as a transaction in which the insurer (the insurance company) for a certain consideration (premium) promises to reimburse (indemnify) the insured or render services in the case of certain accidental losses suffered during the subsistence of the agreement.

Insurance business is classified into:
(a) General Insurance Business: This is also referred to as non-life business. It indemnifies the policy holder against losses, which may result from occurrence of events within specified periods covered by the contracts.

(b) Life Assurance Business: These companies sell life insurance, annuities and pensions products.The benefits due to the policy holder, become payable on the attainment of a stipulated age, at death or on the occurrence of a specified event. It is a long-term insurance business.

(C) Re-Insurance: The term re-insurance is used to designate insurance that is purchased by an insurance company (insurer) from another insurance company (re-insurer) as a means of risk management to transfer risk from the insurer to the re-insurer. The re-insurer and the insurer enter into a reinsurance agreement which stipulates the conditions upon which the reinsurer would pay the insurer’s losses. A reinsurance premium is paid by the insurer to the reinsurer.

2.0 OBJECTIVES

After studying this unit, you should be able to:
1. Discuss the regulatory environment of insurance business
2. Discuss the accounting standards in insurance industry
3. Identify the classes of insurance business.

4. Discuss the accounting policies peculiar to insurance companies.
5. Note the format of published financial statements of insurance companies.

3.0 MAIN CONTENT

3.1 Regulation in Insurance Industry

Insurance activity in Nigeria is regulated by two Acts and supervised by the National Insurance Commission. The Insurance Act, No. 1 of 2003 governs the licensing and the operation of insurers, reinsurers, intermediaries, and other providers of related services. The National Insurance Commission Decree, No. 1 of 1997 established the National Insurance Commission (NAICOM) as the supervisory institution with the power of inspection, remedial and enforcement actions, and composition of fines. NAICOM is funded by industry levy and government grants, 50 percent of which is for operational purposes, 30 percent for upgrading industry capacity and 20 percent for industry development and compensation. Insurers must be established as limited liability companies under the Companies and Allied Matters Act, 1990 with the exception of the National Insurance Corporation of Nigeria (NICON) and Nigeria Reinsurance Corporation.

The Governing Board of NAICOM comprises 11 individuals representing public interest and relevant public and professional entities. Functions of NAICOM include licensing; approval of premium rates, commission rates and policy terms and conditions; and protect policyholders and beneficiaries to insurance contracts.

3.2 INSURANCE ACT, 2003

Relevant sections of the statute are summarized below:

Minimum paid up capital (section 9(1))

The Act mandates every insurance business in Nigeria to maintain specified minimum paid up capital which has been reviewed by NAICOM as follows:

(a) Non-life companies ₦3 billion (US$19.14 million).
(b) Life companies: ₦2 billion (US$12.76 million).
(c) Composite companies: ₦5 billion (US$31.9 million).
(d) Reinsurance companies: ₦10 billion (US$63.8 million).
(e) Brokers are not required to have a minimum capital.

Statutory books and record (Section 17 and 18)

Section 17(1), requires an insurer to keep and maintain at its principal office, the following records:

(a) The Memorandum and Articles of Association or other evidence of the Constitution of the insurer;
(b) A record containing the names and addresses of the owners of the insurance business, whether known as, or called shareholders or otherwise.
(c) The minutes of any meeting of the owners and of the policy making executives (whether known as or called the Board of directors);
(d) A register of all policies, in which shall be entered, in respect of every policy issued, the names and addresses of the policy-holders, the date when policy was effected and a record on any transfer, assignment or any transfer, assignment or nomination of which the insurer has notice.
(e) A registrar of claims, in which shall be entered, every claim made together with the date of claim, the names and addresses of the claimant and the date on which the claim was settled, or in

the case of claim which is repudiated, the grounds for the rejection or in the case of litigation, the particulars of the litigants and the court in this matter.

(f) A register of investments, showing those which are attributable to the insurance funds and those which are not, and also any alteration in their values, from time to time.
(g) A register of its assets.
(h) A register of re-insurance ceded, showing separately those ceded in Nigeria and those ceded outside Nigeria.
(i) A cash book.
(j) A current account book.
(k) A register of open policies, in respect of marine insurance transactions, and management report by external auditors.

Section 17(2), requires a life insurance business, to maintain and keep the following additional records:

(a) A register of assured, under group policies;
(b) A register of loans on policies;
(c) A register of cash surrendered values; and (d)A registrar of lapsed and expired policies.

Section 18(1), mandates a re-insurance business, to keep and maintain at its principal office, the following records:

(a) The Memorandum and Articles of Association or other evidence of the Constitution of the reinsurer;
(b) Records containing the names and addresses of the owners of the reinsurer (whether known as or called shareholders or otherwise);
(c) Minutes of any meeting of the owners and of the policy making executives (whether known as the board of directors or otherwise);
(d) A register of all treaties, in which shall be entered, in respect of every treaty issued, the name of the cedent, and the date when the date when the treaty was effected;
(e) A register of all claims, in which shall be entered, every claim made together with the date the claim is settled;
(f) A register of events, showing those which are attributable to the insurance funds and those which are not and also any alteration in value from time to time;
(g) A register of assets;
(h) A register of business or retrocession, showing separately those ceded within ant outside Nigeria;
(i) A register of new and existing clients;
(j) A cash book; and
(k) Domestic or management report prepared by the external auditors.

A life reinsurance business, shall keep the following additional records:

(a) A register of assured, under group policies;
(b) A register of cancelled, leased and expired policies, and
(c) A register of claims, showing the names of the cedent and when the claim is settled.

Separation of Accounts and Insurance Funds (Section 19)

Section 19(1), requires every insurer, who carries on the two classes of insurance business, to enter all receipts of each of those classes of insurance business, in a separate and discount account. Separate insurance funds are also required for each class of insurance business and, in the case of life insurance business, there should be:

(a) The individual life insurance business fund;

(b) The group life insurance business and pension fund; and (c) Health insurance business.

Section 19(2), contains the following additional requirements:

(a) In the case of life insurance business, the life business funds, shall be a sum not less than the mathematical reserve; and
(b) In the case of general insurance business, the insurer is required to maintain provisions for unexpired risk and provisions for outstanding claims, including in the case of the latter, provisions estimated to provide for the expenses of adjustment or settlement of suck claims.

The insurance fund of each particular class, shall:
(a) Be absolutely the security of the policy holders of that class, as though it belongs to an insurer carrying on other business than insurance business of that class;
(b) Not be liable for any contract of the insurer for which it would not have been liable, had the business of the insurer been only that of particular insurance class; and
(c) Not be applied directly or indirectly, for a purpose other than those of the class of business, to which the fund is applicable.

Technical reserves (Sections 20 – 23)
Section 20(1), requires an insurer, in respect of its general business, to establish and maintain the following provisions applicable in respect of each class of insurance business:

(a) Provisions for unexpired risks which shall be calculated on a time appointment basis of the risks accepted in the year.
(b) Provisions for outstanding claims which shall be credited with an amount equal to the total estimated amount of all outstanding claims with a further amount representing 10 percent of the estimated figure for outstanding claims in respect of claims incurred but not reported at the end of the year under review and

Under section 21
(a) An insurer shall establish and maintain contingency reserves to cover fluctuations in securities and variations in statistical estimates.
(b) The contingency reserves shall be credited with an amount not less than 3 percent of the total premium or 20 percent of the net profit (whichever is greater) and the amount shall accumulate until it reaches the amount of the minimum paid up capital or 50 percent of the net premium (whichever is greater).

Section 22(1), requires an insurer maintain the following reserves in respect of its life insurance business.

(a) A general reserve fund which shall be credited with an amount equal to the net liabilities on policies in force at the time of the actuarial valuation and an additional 25 percent of net premium for every year between valuation date; and
(b) A contingency reserve fund which shall be credited with an amount equal to 1 percent of the gross premium or 10 percent of the profits (whichever is greater) and accumulated until it reaches the amount of the minimum paid up capital.

A reinsurer shall establish a general reserve fund which shall be credited with an amount:
(a) Not less than 50 percent of the reinsurer's gross profit for the year, where the fund is less than the authorized capital of the insurer; and
(b) Not less 25 percent of the reinsurer's gross profit for the year, where the fund is equal to or exceeds the authorized capital of the reinsurer.

Margin of safety (Section 24(1))
The Act further requires an insurer to maintain at all times, in respect of its general business, a margin of solvency, being the excess of the value of its admissible assets in Nigeria over its liabilities in Nigeria, consisting of:

(a) Provision for unexpired risks;
(b) Provisions for outstanding claims;
(c) Provision for claims incurred but not yet reported; and (d)Funds to meet other liabilities.

The margin of solvency shall not be less than 15 percent of the gross premium income less reinsurance premium paid up capital, whichever is greater.

The Act defines "admissible assets" as those designated as admissible assets, consisting of the following:
(a) Cash and bank balances;
(b) Quoted investment at market value;
(c) Unquoted stock at cost;
(d) Land and buildings;
(e) Furniture and fittings;
(f) Office equipment;
(g) Motor vehicles;
(h) Prepared expenses made to members of staff;
(i) Amount due from retrocession; (j)Staff loans and advances; and (k)Claims receivable.

Assets and investments (Section 25)
An insurer, shall at all times, in respect of the insurance transacted by it in Nigeria, invest and hold in Nigeria assets equivalent to not less than the amount of policy holder's funds in such insurance business, as shown in the balance sheet and the revenue account of the insurer.

Subject to the provisions of this Section, the policy holders' funds shall not be invested in property and securities except;

(a) Shares of limited liability companies;
(b) Shares in other securities of a cooperative society registered under a law of relating to cooperative societies;
(c) Loans to building societies approved by the Commission;
(d) Loans on real property, machinery and plant in Nigeria;
(e) Loans on life policies within their surrender values;
(f) Cash deposit in bills of exchange accepted by license bank; and (g)Such investments as may be prescribed by the Commission.

No insurer, shall:
(a) In respect of its general insurance business, invest more than 25 percent of its assets in real property; or
(b) In respect of its life insurance business, invest more than 35 percent of its assets as defined in subjection (1), in real property.

3.3 Accounting standard in Insurance Industry
IFRS 4 Insurance contracts
The objective of IFRS 4 is to specify the financial reporting for insurance contracts, by any insurer that issues such contracts, until the IAS Board completes the second phase of its project on insurance contracts.

In particular, IFRS 4 requires:

(i) certain improvements to accounting, by insurers, for insurance contracts.

(ii) disclosure that identifies (and explains) the amounts in an insurer's financial statements, arising from insurance contracts, and helps users understand the amount, timing and uncertainty of cash flows from insurance contracts

(iii) the income statement of the company, fund or other undertaking that issues the contract.

Currently applicable IFRS does not yet contain comprehensive accounting treatment of transactions that are specific to insurance contracts. As a result, insurance groups generally tend to apply the provisions as set out under GAAP for insurance contracts, modified as appropriate to comply with the IFRS framework and applicable standards.

(iv) SAS No 16; Nigeria GAAP, establishes financial accounting and reporting standards for the financial statements of non-life and life assurance undertakings.

3.4 Basis of Accounting

There are several bases of accounting for insurance transactions. However, three bases commonly adopted are as follows:

Annual Accounting: This is used where it is possible to determine the underwriting result of an insurance business written in an accounting period at the end of that period. The underwriting results that are disclosed in the financial statements, under this basis, usually include the result of the current accounting period and adjustments, if any, made to estimates used in determining results of the previous accounting period.

(b) Deferred Annual: This is adopted where it is not possible to determine the underwriting result of an insurance business until the following accounting period.

(c) Fund Accounting: This is adopted where it takes a long time to determine the underwriting result with a reasonable degree of certainty. Under this basis, a fund is created for each underwriting year. Premiums or business written during the year and the related claims or expenses are posted to the fund. The fund for each underwriting year will remain open until there is enough information to determine the underwriting results. No profit is recognised for 'open years' but provision is usually made for any anticipated losses.

Final Accounts

1. The Revenue Accounts

	Fire accident	Other accident	Motor	Marine aviation	Total
1. Premium receives	x	x	x	x	xx
2. Re-insure premium	x	x	x	x	xx
Gross Premium	x	x	x	x	xx
3. Less commission paid	x	x	x	x	xx
4. Net premium	x	x	x	x	xx
5. Commission received	x	x	x	x	xx
6. Total income	x	x	x	x	xx
Less	x	x	x	x	xx
7. Reinsurance	x	x	x	x	xx
8. Increase (decrease) in provision for unexpired risk	x	x	x	x	xx
9. Net income	x	x	x	x	xx
10. Expenses	x	x	x	x	xx
11. Insurance claims	x	x	x	x	xx
12. Re-insurance claims	x	x	x	x	xx

13. Increase (decreases) in provision for outstanding claims	x	x	x	x	xx
14. Surrenders	-	-	-	x	x
15. Re-insurance recoveries	(x)	(x)	(x)	(x)	(xx)
16. Underwriting expenses	x	x	x	x	xx
Total expenses	x	x	x	x	xx
17. Transferred to P&L	x	x	x	-	xx
18. Transferred to life fund	-	-	-	-	xx

2. Statement of Profit or Loss and Other Comprehensive Income

The net important financial statement of an insurer is the profit or loss account. The terms found on the face of a usually Statement of Profit or Loss and Other Comprehensive Income are listed and discussed below.

STATEMENT OF COMPREHENSIVE INCOME

For the year ended 31 December 20xx	Note		N'000	
Gross premium written			**xx**	
Gross premium revenue				xx
Premium ceded to 'retrocessionaires'				(xx)
Net premium revenue			**xx**	
Insurance benefits				
Insurance claims and loss adjustment expenses		xx		
Insurance claims and loss adjustment expenses				
Recoverable from 'retrocessionaires'		(xx)		
Net insurance benefits and claims			**xx**	
Underwriting expenses		xx		
Insurance benefits and underwriting expenses			**xx**	
Underwriting profit				**xx**
Net Investment/Interest income				xx
Net fair value gains on assets at fair value through profit or loss			xx	
Other operating income				xx
Depreciation and amortisation			(xx)	
Finance cost				(xx)
Administration expenses				(xx)
Impairment of financial assets			(xx)	
Impairment provision on trade & Reinsurance Receivables				(xx)
Profit before taxation			**xx**	
Income tax expense				(xx)
Profit for the year				**xx**
Attributable to:				
Shareholders				xx
Non-Controlling Interest				xx
Total				**xx**
Other comprehensive income, net of tax:				
Net gains on available-for-sale financial assets				
Net unrealised gains/(losses) arising during the year			xx	
Other comprehensive income for the year, net of tax			xx	
Total Comprehensive Income for the year			**xx**	

Attributable to:

Shareholders			xx
Non-Controlling Interest			xx
Total			**xx**
Basic Earnings per share(kobo)		**xx**	
Diluted Earnings per share(kobo)			**xx**

3. Statement of Financial Position

Assets		N'000
Cash and cash equivalents		xx
Financial assets		
–Financial asset designated as fair value		xx
–Loans and other receivables		xx
–Available-for-sale investments	xx	
–Held to maturity investments	xx	
Reinsurance receivables		xx
Retrocession assets		xx
Deferred acquisition costs		xx
Other assets		xx
Investment properties		xx
Intangible assets		xx
Property, plant and equipment	xx	
Statutory deposits		xx
Total assets		**xx**
Liabilities and equity		
Liabilities		
Insurance contract liabilities		xx
Reinsurance Receivable	xx	
Other liabilities/payables		xx
Investment contract liabilities		xx
Retirement benefit obligations	xx	
Current income tax		xx
Deferred taxation		xx
Total liabilities	**xx**	
Equity		
Share capital		xx
Share premium	xx	
Revaluation reserves		xx
Contingency reserve		xx
Retained earnings		xx
Available-for-sale reserve		xx
Total equity to shareholders of Group	xx	
Non-controlling interest	xx	
Total equity and liabilities		**xx**

Illustration 1

The figures set out below are extracted from the books of the Life assurance society Ltd and related to the 12 months ended 31 December 2013.

Share capital: Authorized and issued:	₦
200,000 Ordinary share of N4 each	800,000
200,000 10% preference share of N1 each	200,000
Premiums	680,000
Mortgages on property	1,200,000
Amount of life assurance fund	4,319,000
Claims	436,000
Loans on policies with surrender values	207,000
Amount due from re-insurance	70,000
Commissions	20,700
Outstanding premiums	80,800
Premium paid in advance	350
Management expenses	391,000
Surplus on sale of investment	25,000
Investments	4,025,750
Interest, dividends and Rents	280,000
Taxation	105,000
Cash	120,000

The securities have been valued at cost. You are required to prepare the draft trial balance, the revenue account and the Statement of Financial Position for the company as at 31December 2013.

SOLUTION 1

LIFE ASSURANCE SOCIETY LTD

Draft Trial balance as at 31 December 2013.

Share capital:	**DR**	**CR**
Ordinary share		800,000
Preference share		200,000

Mortgages on property	120,000	
Premiums		680,000
Amount of life assurance fund		4,319,000
Claims	436,000	
Loans	207,000	
Amount due from re-insurance	70,000	
Commission	20,700	
Outstanding premium	80,800	
Premium paid in advance		350
Management expenses	39,100	
Taxation	105,000	
Surplus on sale of investments		25,000
Interest, dividend and Rent		280,000
Investments	4,025,750	
Cash	120,000	…………
	6,304,350	6,304,350

Revenue Account for the year ended 31 December 2013

		₦
Premiums		680,000
Interest, dividend & Rent		280,000
Surplus on sale of investments		25,000
		985,000
Claims	436,000	
Commission	20,700	
Mgt expenses	39,100	495,800
		489,200
Taxation		105,000

	384,200
Add fund b/f	4,319,000
Insurance fund c/f	4,703,200

LIFE ASSURANCE SOCIETY LTD

Statement of Financial Position as at 31 December 2013.

	₦	
Share capital: authorized & issued:		
200000 ordinary share of N4 each		800,000
200000 10% pref. Share of N1 each		200,000
Life assurance fund		4,703,200
		5,703,200
Current Liabilities:		
Premium paid in advance		350
Total equity and Liabilities		**5,703,550**
Assets		
Cash		120,000
Amount due from re-insurance		70,000
Outstanding premium		80,800
Mortgage on property		1,200,000
Loan on policies		207,000
Investments		4,025,750
Total assets	**5,703,550**	

4.0 CONCLUSION

The conduct or operation of insurance business in Nigeria is regulated by insurance act 2003. The Act provide operational standard to be conformed to, by insurance companies.

5.0 SUMMARY

Insurance activity in Nigeria is regulated byInsurance Act, No. 1 of 2003 and Insurance Commission Decree; No. 1 of 1997 .The Insurance Act, No. 1 of 2003 governs the licensing and the operation of insurers, reinsurers, intermediaries, and other providers of related services. The National Insurance Commission

Decree, No. 1 of 1997 established the National Insurance Commission (NAICOM) as the supervisory institution with the power of inspection, remedial and enforcement actions, and composition of fines.

6.0 TUTOR MARKED ASSIGNMENT

Discuss the different method of accounting for insurance business.

7.0 REFERENCES/FURTHER READINGS

Adebayo, P.A.(2011). Financial Accounting and Reporting Standards for Students and Professionals, Abuja: Rainbow Graphic Printers and Publishers

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UNIT SIX: INSOLVENCY AND BANKRUPTCY

CONTENT

1.0 Introduction
2.0 Objectives
3.0 Main Content
3.1 Definition of Bankruptcy
3.2 Conditions for filling Bankruptcy Petition against a Debtor
3.3 Objectives of Bankruptcy Law
3.4 Legal Disabilities of a Bankrupt
3.5 Duties of trustees under bankruptcy which could be carried out with the permission of the Committee of Inspection
3.6 What constitute an Act of Bankruptcy
3.7 First Meeting of the creditors
3.8 Adjudication Order
3.9 Meaning of Insolvency
3.10 Statement of Affairs
4.0 Conclusion
5.0 Summary
6.0 Tutor-marked Assignment
7.0 References / Further Reading

1.0 INTRODUCTION

Bankruptcy is a legal status of a person or other entity that cannot repay the debts it owes to creditors. Bankruptcy in Nigeria is governed by the Bankruptcy Act of 1979, now the Bankruptcy Act 1990. The provision of the Act is only applicable to sole proprietors i.e. individuals and partnership firms. The law of bankruptcy does not apply to corporate bodies registered pursuant to the provisions of CAMA 1990.

2.0 Objectives

At the end of this study session, you should be able to:

- Identify the objectives of bankruptcy laws
- Explain the conditions under which petition can be filed against a debtor
- Ascertain when can a debtor be said to have committed an act of bankruptcy
- Identify the differences between the statement of affairs under bankruptcy and the statement of financial position of an entity.
- Identify the order in which liabilities of a bankrupt debtor would be settled
- Ascertain liabilities that should be given preferential treatment under bankruptcy.
- Prepare deficiency account

3.0 MAIN CONTENT

3.1 Definition of Bankruptcy:

A bankruptcy proceeding is a proceeding by which the state takes possession of the property of a debtor by an officer appointed for that purpose and such property is realized and the proceeds distributed, subject to certain priorities ratably amongst persons to whom the debtor owes money or has incurred pecuniary liabilities.

3.2 The conditions for filing bankruptcy petition against a debtor.

i. The amount of the debt must not be less than, N2,000.00

ii. The amount must be a liquidated sum i.e. certain in money.

Iii The debtor must be a Nigerian resident or must have resided in Nigeria with the last twelve months before the bankruptcy proceedings.

iv. The debtor must be doing business in Nigeria or must have carried on business in Nigeria within the last twelve months before the bankruptcy proceedings.

v. The debtor must be a partner of a Nigerian partnership or must have being a partner within the last twelve months before the bankruptcy proceedings.

vi. The debtor must have committed an act of bankruptcy.

vii The petition must be filed within three months after the commitment of an act of bankruptcy.

3.3 Objectives of Bankruptcy Laws:

i Fair treatment of all creditors

ii. Equitable distribution of the proceeds of the properties of the debtor amongst the creditors who have proof.

iii. A means of investigating the causes of the failure of the bankrupt debtor.

iv. To relief the bankrupt debtor of the burden of indebtedness.

v. Protect the creditors and the general public from reckless and fraudulent business practitioners.

vi. A means of peaceful resolution between the creditors and the bankrupt debtor.

3.4 Legal disabilities of a bankrupt

(i) He cannot vote or be voted for;

(ii) He cannot be appointed as a trustee;

(iii) He cannot join in the formation of a company or a partnership;

(iv) He cannot act as a director of a registered company or take part in the management of such a company; and

(v) He cannot be a Chairman or a member of any government parastatal.

(vi) He must bear the title “bankrupt” whenever his name is mentioned

3.5 Duties of trustees

The trustee may, with the permission of the committee of inspection, do all or any of the following:

(i) Carry on the business of the bankrupt so far as may be necessary for the beneficial winding up of the business;

(ii) Bring, institute or defend any action or other legal proceedings relating to the property of the bankrupt;

(iii) Employ a legal practitioner or other agent to take any proceedings or do any business, which may be sanctioned by the Committee of Inspection.

(iv) Accept as consideration for the sale of any property of the bankrupt, a sum of money payable at a future time, subject to such stipulations as to security and otherwise as the committee of inspection may deemed fit;

(v) Mortgage or pledge any part of the property of the bankrupt for the purpose of raising money for the payment of his debt,

(vi) Refer any dispute to arbitration, or compromise any debts, claims and liabilities, whether present or Future, certain or contingent, liquidated or unliquidated, subsisting or supposed to subsist between the bankrupt, and any other person who may have incurred any liabilities to the bankrupt.

(vii) Make such compromise or other arrangement as may be thought expedient with creditors or persons claiming to be creditors in respect of any debts provable under the bankruptcy.

(viii) Make such compromise or other arrangement as may be thought expedient with respect to any claim arising out of or incidental to the property of the bankrupt, made or capable of jerry made on the trustee on any person or by the trustee on any person.

(ix) Divide in its existing form amongst the creditors, according to its estimated value, any property, which from its peculiar nature or other special circumstances cannot be readily or advantageously sold.

(x) Appoint the bankrupt himself to superintend the management of the property or to carry on the trade of the bankrupt for the benefit of the creditors., and

(xi) Make such allowance from time to time, as he may think just to the bankrupt out of his property for the support of the bankrupt and his family, or in consideration of his services if he is engaged in winding up of his estate.

3.6 What constitute an Act of Bankruptcy?

Where a creditor has obtained a final judgment against a debtor upon which a Notice of Bankruptcy is served on the debtor and the debtor fails to pay the judgment debt or sum ordered to be paid in accordance with the terms of the judgment, or fails to satisfy the court of having a counterclaim equal to or exceed the amount of debt, within 14 days of the Notice of bankruptcy, the debtor would be said to have committed an Act of Bankruptcy.

Where execution has been levied against a debtor, under a court order and the debtor's properties have been seized and sold or held by the court bailiff for *21 days.* Where a debtor files an application in a law court declaiming his inability to pay his debt, he would be said to have committed an Act of Bankruptcy.

A receiving order will be issued by the court with which an official receiver will be appointed who takes over the properties of the debtor on behalf of the creditors.

3.7 First Meeting of the creditors:

i. To be convened and presided over by the official receiver.

ii. They may resolve to:
- a scheme of arrangement or
- arrangement of composition

For the resolution to be effective;
- The majority of the creditor must agree
- The amount owed to the majority must not be less than two third (2/3) of the total outstanding debts.

What is the significance of the first meeting of the creditors?

- It is a meeting called and presided over by the official receiver where the debtor under bankruptcy is given the opportunity of making propositions to the creditors for their consideration. The creditors, through a resolution can agree to a scheme of arrangement, where the debtor proposes to pay the outstanding debt at an appointed date after which his properties will be reassigned to him. The creditors, alternatively, can agree to a composition in which the debtor proposes paying certain proportion of the debt in full settlement of the total amount due.

3.8 Adjudication order

An adjudication order, it is an order issued by the court in which a debtor is pronounced and declared bankrupt.

A debtor will be adjudged bankrupt under the following circumstances;

i. Where the creditors cannot meet

ii. Where no resolution is passed
iii. Where the debtors runs away
iv. Failure, to submit Statement of Affairs within the stipulated time.

Order of Settlement:

a) Secured creditors
b) Priority costs and charges:
- Costs of securing the properties
- Realization expenses
- Remuneration of the official receiver
- Petitioner's legal fees

c) Priority Debts:

i. Preferential creditors
ii. Unsecured creditors
iii. Deferred creditors
   - Spouse
   - Partners in partnership
   - Loan under a profit / loss sharing arrangement.

Preferential creditors:

i. Amount owed to the state, not later than twelve months before the commencement of the bankruptcy proceedings.

ii. Salaries owed to employees within the last four months to the bankruptcy proceedings ***subject to a maximum amount of N300 per employees.***

3.9 Meaning of Insolvency

Insolvency is the state of being unable to pay the money owed, by a person or company, on time; those in a state of insolvency are said to be *insolvent*. There are two forms: cash-flow insolvency and balance-sheet insolvency.

Cash-flow insolvency

This is when a person or company has enough assets to pay what is owed, but does not have the appropriate form of payment. For example, a person may own a large house and a valuable car, but not have enough liquid assets to pay a debt when it falls due. Cash-flow insolvency can usually be resolved by negotiation. For example, the bill collector may wait until the car is sold and the debtor agrees to pay a penalty.

Balance-sheet insolvency

This is when a person or company does not have enough assets to pay all of their debts. The person or company might enter bankruptcy, but not necessarily. Once a loss is accepted by all parties, negotiation is often able to resolve the situation without bankruptcy.

A company that is balance-sheet insolvent may still have enough cash to pay its next bill on time. However, most laws will not let the company pay that bill unless it will directly help all their creditors. For example, an insolvent farmer may be allowed to hire people to help harvest the crop, because *not* harvesting and selling the crop would be worse for his creditors.

3.10 Statement of Affairs

This is the statement of assets and liabilities of the debtor under bankruptcy. It is expected to be prepared and submitted to the official receiver within 14 days after the issuance of the receiving order by the court.

Major differences between a statement of affairs under bankruptcy and a statement of financial position of a going concern include the following:

i.) a statement of affairs include the private assets and liabilities of the owner of the business
ii.) a statement of affairs is prepared for and on behalf of the creditors while statement of financial position is prepared on behalf of the business
iii.) assets are arranged in order of liquidity in the statement of affairs
iv.) assets are stated at their net realizable value in the statement of affairs but at cost or net book value in the statement of financial position.

Illustration 1

On 1 January 2000, Yakowa commenced business with ₦672,000. For years 2007 to 2011, profits were ₦80,000, ₦64,000, ₦36,000, ₦28,000 and ₦8,000 respectively. His average annual drawing was ₦44,000.

A receiving order was made against him on 31 December 2011, when his position was as follows:

	₦„000
Unsecured creditors	400
Mortgage Freehold Factory	80
Trade payables (partly secured)	240
(Security: Life Policy estimated at ₦80,000)	
Amount payable in respect of salaries and wages (preferential)	9.6
Bills receivable, discounted and expected to rank	64
Freehold factory (cost ₦800,000) Estimated to realise	400
Trade receivables: Good	120
Doubtful (Estimated to realise₦12,000)	40
Bad	100
Furniture & Fittings (Estimated to realise₦7,000)	16
Plant and Machinery (Estimated to realise₦40,000)	160
Trade inventories (Estimated to realise₦111,000)	160
Cash -in- hand	1.6

Required:
Prepare a Statement of Affairs and Deficiency Account in statutory form.

Solution

YAKOWA

Statement of Affairs as at 31 December 2011

Gross Amount	Amount Expected to rank				Amount expected to realize
₦'000	₦'000	₦'000	₦'000		₦'000
400	Unsecured	-	400	Debtors:	
	Trade Payables			- Good	120
	Fully secured			- Doubtful	12
	Trade Payables			- Bad	-
80	Mortgage	80		- Inventories	111

	Less: Freehold			- Cash	1.6
	Factory (400)			Plant & Mach	40
	Surplus (320)			Furniture & Fittings	7
	Partly Secured				291.6
240	Trade Payables	240		Add: Surplus	320
	Less: Life Policy	(80)		Less: Pref.	611.6
	Expected to Rank		160	Creditors	9.6
64	Bills Receivable		64		602.0
	Preferential			Deficiency	22.0
96	Trade Payables	9.6			
			624.0		624.0

Deficiency Account

	₦'000		₦'000
Capital	672	Drawing (44 x 5)	220
Profits	216	Loss on freehold fact	400
Life policy	80	Bills receivable	64
Balance as per		Loss on P & M	120
Statement of Affairs	22	Bad Debts – Loss in debtors	100
		(40,000 – 12,000)	28
		Loss on furn. & fittings	9
		Loss on inventories	49
	990		990

4.0 Conclusion

Bankruptcy laws relates to sole proprietorship and partnership. It is an arrangement where the court, through the state, takes over the properties of a debtor, who has become incapable of paying his debt, disposes of such properties and uses the proceeds to settle the creditors, in order of certain priorities. Unlike liquidation laws, the liabilities of a debtor, under bankruptcy, extend beyond the business to cover his private properties, excluding his beddings, tools and properties held on trust.

5.0 Summary

In this course of analysis in this last study unit, we have discussed bankruptcy, and in the process, we have espoused on: Meaning of Bankruptcy; Financial Distress and Bankruptcy; Financial Distress; Insolvency; Bankruptcy; Factors That Can Lead to Bankruptcy in Banking Industry; Bankruptcy and Debt Restructuring; Bankrupt Proceeding to Recover Debts; and Proceeding in Individual Bankruptcy to Recover Debts.

6.0 TUTOR-MARKED ASSIGNEMENT

1. Bankruptcy law is NOT meant to ridicule the bankrupt. In the light of this statement, state TWO purposes of bankruptcy law.

2. An undercharged bankrupt may suffer from some legal disabilities. State THREE of them.

3. State any FOUR duties of trustees under bankruptcy which could be carried out with the permission of the Committee of Inspection.

7.0 References / Further Reading

Fatimehin, A. E. (2004) “Introduction to Bankruptcy Executorship and Trusteeship” Fatimehin and Associates, Lagos

Wood F. Sangster A. (1998) *Business Accounting 1,*8th ed. United Kingdom, Financial Times Professional Ltd

UNIT Seven: VALUATION OF BUSINESS AND SHARES

CONTENT

1.0 Introduction
2.0 Objectives
3.0 Main Content
  3.1Definition and reasons for valuation
  3.2 Concept of value
  3.3 Factors to be consider in selecting valuation approach
  3.5 Valuation Approaches
4.0 Conclusion
5.0 Summary
6.0 Tutor Marked Assignment
7.0 References/Further Reading

1.0 INTRODUCTION

There is no one way to establish what a business is worth. That is because business value means different things to different people. A business owner may believe that the business connection to the community it serves is worth a lot. In addition, economic conditions affect what people believe a business is worth. For instance, when jobs are scarce, more business buyers enter the market and increased competition results in higher business selling prices.

Business valuation is a complicated issue because there are many acceptable valuation methods. Rather than using a "one-size-fits-all" valuation approach, buyers and sellers need to decide which method is right for their business based on industry, size and the circumstances of the sale.

2.0 Objectives

After studying this unit, the student should be familiar with:

- Common reasons for valuing business/ Shares
- Various concepts of value
- Factors to be consider in selecting valuation approach
- How to value business and shares using various approaches

3.0 MAIN CONTENT

3.1 Definition and reasons for valuation

Simply put, business valuation is a process and a set of procedures used to determine what a business is worth. While this sounds easy enough, getting your business valuation done right takes preparation and thought.

The following are most common reasons for valuing business/ Shares

- To establish a price for a new share issue
- Valuing a business can also help motivate staff
- Employee share option scheme
- On the death of a shareholder
- Regular valuations provide measurement criteria for management in order to help them evaluate how the business is performing
- On events in respect of trusts which give rise to a tax charge
- For capital gains tax purposes
- When certain transactions in companies take place, for example, purchase of own shares by the company.
- Under provisions in a company's Articles of Association
- Under shareholders' or other agreements
- In disputes between shareholders
- For financial settlements in divorce
- In insolvency and/or bankruptcy matters.

3.2 Concepts of Value

There are various concepts of value, depending on what value is being discussed.

Book Value

The book value of an asset is the value of an asset as stated in the books of account. It is the cost less depreciation to date. The book value of the firm is the aggregate book value of all the company s assets less the total book value of its liabilities.

Market Value

The market value of an asset is just the price at which the asset will be bought and sold in the open market. The market value of a security is the market price of the security.

Intrinsic (true) value

The intrinsic value of a security is what the value should he if appropriately valued based on the company s fundamentals, that is, - its turnover, earnings, assets, future prospects, management and so on.

Going-concern value

This value is based on the assumption that the firm will continue to operate into an indefinite future period and generate positive future cash flows for its investors.

Break-up (Gone Concern)

This is the value of the firm where the assets (class of assets; are individually sold at their realisable values. This often happens when the firm is being liquidated and assets have to be realised in order to pay off the liabilities of the firm and distribute the balance (if any) to the owners.

Fair Value

Under IFRS, fair value is "the price that would be received for an asset or paid to transfer a liability in a current transaction between marketplace participants in the reference market for asset or liability." Under US GAAP, fair value is defined as "the price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Replacement cost

A replacement cost is the cost to replace an asset of a company at the same or equal value

3.3 Factors to be consider in selecting valuation approach

Depends on the:

1. Nature of operations
2. Life cycle stage.

- Earliest stage: Asset-based approach because the going-concern premise of value and/or the expected future cash flows may be uncertain or difficult to predict.
- Development stage: Income/free cash flow method if the company is growing rapidly.
- Mature stage: Market approach.

3. The circumstances of a business (**Going Concern or Breakup value)**

   In **Going Concern Value,** the utility of the assets is to be considered for the purpose of arriving at the value of the assets, but, in **Breakup value**, the realizable value of the assets is to be taken.

4. Valuation perspective
5. The reason for the valuation.

3.4 Valuation Approaches

The principal valuations approaches discuss in this study are: (a) Asset based approach, and (b) Income approach. Each of these principal valuation approaches includes different detailed methods of application.

3.4.1 Asset approach

The asset approach views the business as a set of assets and liabilities that are used as building blocks to construct the picture of business value.An asset-based valuation is a straightforward method in which the value of the business is determined by the total value of the company's tangible and intangible assets. The challenge with this method is that asset-based valuations can over-simplify the process and neglect the value of the company's earnings potential. That is why asset-based valuation is a common method for the sale of defunct businesses and liquidations, but not as common for thriving companies.

The difficulty in an asset valuation method is establishing the asset values to use. The figure attached to an individual asset may vary considerably depending on whether it is valued on a going concern or a break-up basis.

(a) Historic basis – unlikely to give a realistic value as it is dependent upon the business's depreciation and amortization policy.

(b) Replacement basis – if the assets are to be used on an on-going basis.

(c) Realisable basis – if the assets are to be sold, or the business as a whole broken up. This won't be relevant if a minority shareholder is selling his stake, as the assets will continue in the business's use

How it works

- Add up the value of all the assets such as cash, stock, plant and equipment and receivables
- Add up liabilities, such as any bank debts and payments due
- Subtract the liabilities from the assets to get the net assets value

Limitations

- Does not take into account the ability of those assets to generate wealth in the future
- Does not take into account goodwill
- For these reasons, assets valuation may understate the true value of the business

What about goodwill?

- Goodwill is the difference between the true value of a business and the value of its net assets.
- It can be crucial to the value of the retail and service based businesses.
- For example, if you value a hair salon, where service, location and reputation are important, the value of any goodwill will have to added to the net assets to get a valuation.
- Goodwill may or may not be transferred if you buy a business, since it can come from physical features like location, or from personal factors, like the owner's reputation or relationships with customers or suppliers.
- If a business is underperforming and has no goodwill, then using net asset valuation could be an accurate way to value it.

Illustration 1

Osezele wants to buy a dry cleaning business. Here is an extract from the statement of financial position.

	₦	₦
Current assets		
Cash	180,000	
Debtors	570,000	
Stock	210,000 960,000	
Non-current assets		
Plant and equipment	320,000	
Accumulated depreciation	(30,000)	
Building	1,750,0002,040,000	
Total assets		3,000,000
Current Liabilities		
Creditors	60,000	
Provision for Taxes	180,000240,000	
Non-current liabilities		
Loan	290,000	
Mortgage	1,470,0001,760,000	
Total liabilities		2,000,000

The business has ₦3,000,000 of assets and N2,000,000 liabilities
The net assets value is ₦1,000,000

3.4.2 Income approach

The income approach relies upon the economic principle of expectation: the value of business is based on the expected economic benefit and level of risk associated with the investment. Income based valuation methods determine fair market value by dividing the benefit stream generated by the subject or Target

Company multiplied by a discount or capitalization rate. The discount or capitalization rate converts the stream of benefits into present value.

There are several different income methods, including capitalization of earnings or cash flows, discounted future cash flows ("DCF"), and the excess earnings method (which is a hybrid of asset and income approaches).

Although there are many ways to implement the income approach, all methods under the income approach are effectively based on discounting future amounts of cash flow to present value.

Under the DCF method the forecasted cash flow is discounted back to the valuation date, resulting in a present value of the asset. A discount rate or capitalization rate is used to determine the present value of the expected returns of a business. The discount rate and capitalization rate are closely related to each other, but distinguishable. Discount rate is used when there are multiple streams of income and capitalization is used when there is a single stream of income.

The key steps in the DCF method are:

(a) choose the most appropriate type of cash flow for the nature of the subject asset and the assignment (ie, gross or net, pre-tax or post-tax, total cash flows or cash flows to equity, real or nominal, etc),

(b) Determine the most appropriate explicit period, if any, over which the cash flow will be forecast,

(c) Prepare cash flow forecasts for that period,

(d) Determine whether a terminal value is appropriate for the subject asset at the end of the explicit forecast period and then determine the appropriate terminal value for the natureof the asset,
(e) Determine the appropriate discount rate, and apply the discount rate to the forecasted future cash flow, including the terminal value, if any.

Discount Rate

The rate at which the forecast cash flow is discounted should reflect not only the time value of money, but also the risks associated with the future operations of the asset or business.While there are many methods for developing or determining the reasonableness of a discount rate, they commonly consider a risk-free rate plus some form of risk premium. Non-exhaustive lists of common methods include:

(a) capital asset pricing model (CAPM),

(b) weighted average cost of capital (WACC), (c) internal rate of return (IRR),

(d) weighted average return on assets (WARA), and

(e) build-up method (generally used only in the absence of market inputs).

3.4.3 Dividend Discount Model (DDM)

In the dividend discount model (DDM), dividends are the relevant cash flows. The rationale behind the DDM is that the cash flows are the cash flows equity investors will receive in the future. Note, however, that some firms do not pay dividends and other firms reinvest a substantial portion of earnings back in the firm. The argument for using the DDM is that sooner or later, all firms will pay dividends and reinvestment in the firm will increase future dividends.

The DDM is a basic tool in valuing common stock. The DDM is based on the idea that the value of an investment is the present value of future cash flows, where here the future cash flows are the dividends.

$$V_0 = \frac{D_t}{(1+r)^t} + \frac{D_n}{(1+r)^n} \sum_{t=1}^{n}.$$

The formula says that the value of common stock at time zero (V_0) is equal to the discounted stream of future dividends (D_t) plus the expected price (P) of the stock when sold at time period n. The discount rate is the required return on common equity (r). The formula assumes the stock will be held for n periods.

When to Use DDMs

DDMs are most appropriate when:

1. The firm has a history of dividend payments. This provides an analyst with a history from which to extrapolate future dividends. Otherwise, it is difficult to forecast when a non-dividend-paying firm will start paying dividends and how much they will eventually be.
2. The firm's dividends have a consistent relationship with the firm's earnings. Dividends should be related to firm earnings if they are to be a good indicator of future firm and shareholder wealth.
3. The valuation perspective is that of a non-controlling shareholder. If the perspective is that of a controlling shareholder where firm cash flows can be controlled, a free cash flow model would be more appropriate.
4. DDMs are usually most applicable to mature, profitable firms with a history of stable dividend payments.

Illustration 2

	0	1	2	3
D		**N1.00**	**N1.05**	**N1.10**
P				**N20.00**

In this example, we assume that the investor will sell the stock in three years for N20. The dividend stream for the first three years is shown on the slide.

$$V_o = \frac{N1.00}{1.10} + \frac{N1.05}{1.10^2} + \frac{N21.10}{1.10^3}$$

V_o **= N17.63**

s

We discount the future cash flows at a required return on equity of 10 (percent).
The total future value in Year 3 is N21.10 (the dividend in Year 3 is N1.10 and the stock price is N20).
In practice, analysts will often forecast dividends for the next 3–10 years. The length of the projected period will often depend on the perceived predictability (referred to as the visibility) of the firm's earnings.
The stock price in the last year (here the third year) is referred to as the terminal share price.

Gordon Growth Model

$$V_0 = \frac{D0(1+g)}{r-g} = \frac{D1}{r-g}$$

To get an infinite stream of dividends to converge to a finite stock value at Time 0, we must assume that the required return on common equity is greater than the growth rate in dividends. To arrive at a simple stock valuation formula, we must also assume that the growth rate in dividends is constant. The resulting formula is the Gordon growth model.

The Gordon growth model formula says that the value of common stock at Time 0 (V_0) is equal to the dividend next period (D_1) divided by the required return on common equity (r) minus the constant growth rate for dividends (g).

Notice that the dividend next period (D_1) is equal to the current dividend (D_0) times (1 + Constant growth rate in dividends).
The formula assumes the following:

1) that $r > g$ and
2) that$g$ is constant.

Illustration 3

The current dividend of Datacorp.is N2.50, the growth rate is 5% and the cost of capital is 10%.
a. What should the price of this stock be using a constant DDM model?
Value = N2.50(1.05)/(.1-.05) = N52.50.

Illustration 4

Keffi Plc dividend next year is expected to be N5 with a growth rate of 3% and a cost of capital of 9%.
What should the current price of the stock be using a constant DDM model?
Value = N5/(.09-.03) = N83.33

Illustration 5

Keffi Plc dividend next year is expected to be N5 with a growth rate of 3% and a cost of capital of 9%.

a. What should the current price of the stock be using a constant DDM model?

Value = N5/(.09-.03) = N83.33

b. What would the price of the stock be 5 years from now?

To find the price 5 years from now, we need to find the dividend in the 6th year. Thus, $D_6 = D_1(1 + g)^5$. Note if given D_0, $D_6 = D_0(1 + g)^6$. $D_6 = 5(1.03)^5$ = N5.796, so value = N5.796/(.09-.03) = N96.61.

Value preferred stock

Preferred stock usually pays a fixed dividend that does not grow. In this case, we can use the Gordon growth model to value it, but with a growth rate equal to zero. Because the growth rate is zero (the dividend is constant), we divide by only the required return. For this reason, the required return is often referred to as the capitalization rate (i.e., it capitalizes the dividend).

The strengths of the Gordon growth model are the following:

- It is simple to understand and applicable to stable, mature firms that have constant growth in dividends.
- It can be used to value an entire stock market using the data for the entire stock market.
- *g*, the growth rate in dividends, can be estimated using *g* = nominal GDP (gross domestic product) growth, which is the sum of real GDP growth and long-term inflation.
- The Gordon growth model can be applied to firms that both pay dividends and repurchase stock if an analyst forecasts per share dividends that reflect the number of shares that will be repurchased over time. Note, however, that firms do not commit to repurchase policies the way they do dividend policies; forecasting repurchases is thus difficult.

The limitations of the Gordon growth model are the following:

- The model cannot be reliably applied to firms without a dividend history because forecasting future dividends becomes more difficult. Dividends should also have a consistent relationship with the firm's earnings.
- The model assumes that the dividend growth rate is constant, so it cannot be applied to firms with several different future growth rates in dividends. Recall also that the model assumes that the required return on equity (*r*) is greater than the dividend growth rate.
- The estimated stock value is very sensitive to the *r* – *g* denominator. If the denominator changes by just 1%, for example, estimated valuations will change by a large monetary value. For this reason, an analyst should perform sensitivity analysis, where the stock is valued under different required returns and growth rates.
- Many, perhaps most, firms have nonconstant growth in future dividends, so the Gordon growth model cannot be directly applied. For these firms, we will need to use multistage models, which are discussed in the slides to follow.

3.4.4 Free cash flow (FCF)

Free cash flow is the cash flow left over after the firm fulfills certain obligations. When defined as free cash flow to the firm (FCFF), it refers to the cash flow from operations minus that needed to purchase assets needed to sustain the firm's productive capacity.

The FCF measure gives investors an idea of a company's ability to pay down debt, increase savings and increase shareholder value, and FCF is used for valuation purposes.

Free cash flow to the firm is the cash available to all investors, both equity and debt holders.

Firm Value= $\frac{FCFF_t}{(1+WAC}$ $\sum_{1}^{\infty}$

Firm Value $\sum_{t=1}^{\infty}$ $)^t$

Single-Stage Free Cash Flow Models

Firm Value = $\frac{FCFF1}{WACC-g}$

Equity Value = Firm Value – Debt Value

Equity Value $\frac{FCFF1}{r-g}$

Free cash flow models are most appropriate when

1. The firm does not have a history of dividend payments so DDMs are difficult to use.
2. The firm does pay dividends, but they are a small part of the firm's earnings. In this case, free cash flow may be better for valuation.
3. The firm has positive free cash flow. If a firm has negative cash flows for the foreseeable future because of, for example, large capital expenditures, it can be difficult to forecast when cash flows will become positive.
4. The firm's free cash flow has a consistent relationship with the firm's earnings so that they are a good indicator of future firm and shareholder wealth.
5. The perspective is that of a controlling shareholder because a controlling shareholder can control all the firm's cash flows (not just the dividends).

Calculation of Cash Flow from Cash Flow from Operations (CFO) and Net Income

Calculation of FCFF using CFO.

Because FCFF is the cash flow allocated to all investors including debt holders, the interest expense which is cash available to debt holders must be added back. The amount of interest expense that is available is the after-tax portion, which is shown as the interest expense multiplied by 1-tax rate [Int x (1-tax rate)]. .

This makes the calculation of FCFF using CFO equal to:

FCFF = CFO + [Int x (1-tax rate)] – FCInv

Where:
CFO = Cash Flow from Operations
Int = Interest Expense
FCInv = Fixed Capital Investment (total capital expenditures)

This formula is different for firm's that follow IFRS. Firm's that follow IFRS would not add back interest since it is recorded as part of financing activities. However, since IFRS allows dividends paid to be part of CFO, the dividends paid would have to be added back.

Calculation OF FCCF using Net Income

The calculation using Net Income is similar to the one using CFO except that it includes the items that differentiate Net Income from CFO. To arrive at the right FCFF, working capital investments must be subtracted and non-cash charges must be added back to produce the following formula:

FCFF = NI + NCC + [Int x (1-tax rate)] – FCInv – WCInv

Where:
NI = Net Income
NCC = Non-cash Charges (depreciation and amortization)
Int = Interest Expense
FCInv = Fixed Capital Investment (total capital expenditures)
WCInv = Working Capital Investments

Calculation OF FCCF using EBIT and EBITDA

FCFF = EBIT (1 Tax rate) + Dep – FCInv – WCInv

FCFF = EBITDA (1 Tax rate) + Dep – (Tax rate) FCInv – WCInv

Illustration 6

EBITDA	N1,000
Depreciation expense	$400
Interest expense	$150
Tax rate	30%
Purchases of fixed assets	$500
Change in working capital	$50
Net borrowing	$80
Common dividends	$200

NI = (EBITDA – Dep – Int) (1-Tax rate)
NI = ($1000-S400-$150) (1-0.30) = $315

FCFF = NI+NCC +Int (1-Tax rate) – FCInv-WCInv
FCFF= $315+$400+$150 (1-0.30)-$500-$50=$270

EBIT=EBITDA – Dep = $1000 - $600
FCFF = EBIT (1 Tax rate) + Dep – FCInv – WCInv
FCFF = $600 (1-0.30) +$400 – $500-$50=$270
FCFF = NI+NCC +Int (1-Tax rate) – FCInv-WCInv
FCFF= $1000 (1-0.30)+$400(0.30)_500-$50=$270
CFO = NI + Dep – Wcinv
CFO = $315 + 400 - $50 = $665
FCFF = CFO + Int (1-Tax rate) – FC Inv
FCFF = $ 665 + $ 150 (1-0.30) -$500 = $270

Illustration 7

Ekpoma Corporation is expected to have EBIT of N2.3M this year. Ekpoma Corporation is in the 30% tax bracket, will report N175,000 in depreciation, will make N175,000 in capital expenditures, and have no change in net working capital this year. After the coming year, cash flows are expected to grow at 7% per year. The appropriate market capitalization rate for unleveraged cash flow is 13% per year. What is Ekpoma's corporation FCFF?
Solution

FCFF = EBIT(1 − T) + depreciation − capital expenditures − increase in NWC or 2,300,000(.7) + 175,000 − 175,000 − 0 = 1,610,000/(.13 − .07)

3.4.5 Residual income (RI)

Residual income is the income left over after the firm has satisfied its investors' required return. The investors' required return is their opportunity cost for allocating capital to the firm. In the residual income model, the value of equity is the book value of common stock plus the present value of future residual income. RI is sometimes called; economic profit, abnormal earnings, or economic value added (EVA).

The appeal of residual income models stemmed from a shortcoming of traditional accounting models which ignore a charge for the cost of equity capital.In the traditional income statement, net income accounts for the cost of debt capital (in the interest expense) but does not account for the cost of equity capital. Residual income accounts for the cost of both debt and equity capital.
The equity charge is also known as

1. the cost of equity capital, and
2. the required return on equity.

Note that a firm could have positive net income but negative residual income.

Illustration 8

The following is extracted from the income statement and balance sheet of a firm for 2011. (Amounts in N thousands)

Operating income (after tax)		17,507
Net financial expenses	3,060	
Comprehensive income	14,447	

The firm paid out all income in dividends at the end of the year and there were no share issues during 2011. The book value of common equity at the end of 2001 was N100,600. The cost of equity capital is 11%.

(a) Calculate residual income for 2011.

(b) The residual income for 2012 and all subsequent years is expected to be the same as in 2011. Calculate the value of the equity at the end of 2011.

Solution

First calculate the book value at the beginning of 2011, then calculate residual earnings earned in 2011 on this book value. Residual earnings equals comprehensive income minus a charge against the book value at 11%.

Book Value (2010) *= Book Value (2011) – Earnings (11) + Dividends (11)*
= 100,600 – 14,447 + 14,447
= 100,600

Residual Earnings (2011) = 14,447 – (0.11 x 100,600)

= 3,381

Calculate the value of the equity using the residual earnings model.

Value = Book Value + Present Value of RE

As residual income is expected to be a perpetuity,

$$Value = 100{,}600 + \frac{3{,}381}{0.11}$$

= 131,336

Residual income models are most appropriate when

1. The firm does not have a history of substantial dividend payments so DDMs are difficult to use.
2. The firm has negative free cash flow, which makes the application of free cash flow models difficult.
3. The firm has accounting disclosures of high quality. This allows an analyst to rely on the reported earnings and book value needed to calculate firm value with a residual income model.

Illustration 9

A firm announces that it will invest N150 million in an asset that is expected to generate a 15% rate of return on its beginning-of-period book value for the next five years. The required return for this type of project is 12%; the firm depreciates the cost of assets straight-line over the life of the investment.

What is the value added to the firm from this investment?

Solution

First calculate the book value of the asset at the beginning of each year. This is the original cost of the asset less accumulated depreciation to that year. Then calculate earnings as a 15% return on book value.
Proceed to apply the residual earnings model to value the project.

Year	0	1	2	3	4	5
Depreciation		**30**	**30**	**30**	**30**	**30**
Book value	**150**	**120**	**90**	**60**	**30**	**0**
Earnings (15%)		**22.5**	**18**	**13.5**	**9**	**4.5**
RE (.12)		**4.5**	**3.6**	**2.7**	**1.8**	**0.9**
PV of RE (1.12^t)		**4.02**	**2.87**	**1.92**	**1.14**	**.51**
Total PV of RE	10.47					
Value of Project	160.47					

The investment added N10.47 million over the cost.

3.4.6 Price Earnings (P/E) ratio method

The P/E ratio is a valuation ratio of a company's current share price compared to its per-share earnings. It is the most common measure of how expensive a stock is. It is also known as the "price multiple" or "earnings multiple". It is calculated as:

P/E = Market price per share / Earnings per share (EPS)

This is a common method of valuing a controlling interest in a company, where the owner can decide on dividend and retentions policy. The P/E ratio relates earning per share to a share's value.

This can then be used to value shares in unquoted companies as:

Market value (or market capitalization) of company = total earnings x P/E ratio

Value per share = EPS x P/E ratio

In general, a high P/E suggests that investors are expecting higher earnings growth in the future compared to companies with a lower P/E. However, the P/E ratio doesn't tell us the whole story by itself. It's usually more useful to compare the P/E ratios of one company to other companies in the same industry, to the market in general or against the company's own historical P/E. It's not useful to use the P/E ratio to compare a technology company (typically higher P/E) to a utility company (typically lower P/E) as each industry has much different growth prospects.

When a stock's P/E ratio is high, it is often considered pricey or overvalued while stocks with low P/Es are typically considered a good value.

Problems with using P/E ratio Problems with using P/E ratio

(a) A single year's P/E ratio may not be a good basis, if earnings are volatile, or the quoted company's share price is at an abnormal level, due for example to the expectation of a takeover bid.

(b) Finding a quoted company with a similar range of activities may be difficult. Quoted companies are often diversified.

(c) If a P/E ratio trend is used, then historical data will be being used to value how the unquoted company will do in the future.

(d) The quoted company may have a different capital structure to the unquoted company.

(e) It is subjective in that there is no proven method for converting the PE ratio of a listed company to one applicable to the entity being valued.

(f) The method focuses only on one aspect of the company and that is earnings. It ignores the asset values and ability of the company to generate cash flows, among other things.

Illustration 10

For example, if a company is currently trading at N43 a share and earnings over the last 12 months were N1.95 per share. What is the P/E ratio?

Solution

The P/E ratio for the stock would be 22.05 (N43/N1.95). This number basically shows how much investors are willing to pay per naira of earnings. If a company were currently trading at a multiple (P/E) of 22, the interpretation is that an investor is willing to pay N22 for N1 of current earnings.

4.0 CONCLUSION

In this unit, we discussed different types of value and various reasons while valuation is carried out. We also looked at some common approaches to valuation; asset base approaches, Income approach, dividend approach, free cash flow approach etc. Business valuation is a complicated issue because there are many acceptable valuation methods. Rather than using a "one-size-fits-all" valuation approach, buyers and sellers need to decide which method is right for their business based on industry, size and the circumstances of the sale.

5.0 SUMMARY

There are various concepts of value, depending on what value is being discussed. The asset approach views the business as a set of assets and liabilities that are used as building blocks to construct the picture of business value. Income based valuation methods determine fair market value by dividing the benefit stream generated by the subject or Target Company multiplied by a discount or capitalization rate.

6.0 Tutors Mark Assessment

1.Ubiaja Corporation is expected have EBIT of N6.2M this year. Ubiaja Corporation is in the 40% tax bracket, will report N1.2M in depreciation, will make N1.4M in capital expenditures, and have a N160,000 increase in net working capital this year. What is Ubiaja's FCFF?

2.The directors of Omonso plc, a large conglomerate, are considering the acquisition of the entire share capital of Ojiso, which manufactures a range of engineering machinery. Neither company has any long-term debt capital. The directors of Omonso believe that if Ojiso is taken over, the business risk of Omonso will not be affected.

The accounting reference date of Ojiso is 31 July. Its balance sheet as on 31 July 2004 is expected to be as follows.

	N	N
Non-current assets (net of depreciation)		651,600
Current assets		
Inventory	515,900	
Receivables	745,000	
Bank balances	158,100	1,419,000
		2,070,600
Capital and reserves		
Issued ordinary shares of N1 each		50,000
Distributable reserves		404,100
		454,100
Current liabilities		
Payables	753,600	
Bank overdraft	862,900	1,616,500
		2,070,600

Ojiso's summarized financial record for the five years to 31 July 2004 is as follows.

Year ended 31 July	2000	2001	2002	2003	2004 (estimated)
	N	N	N	N	N
Profit before non-recurring items	30,400	69,000	49,400	48,200	53,200
Non-recurring items	2,900	(2,200)	(6,100)	(9,800)	(1,000)
Profit after non-recurring items	33,300	66,800	43,300	38,400	52,200
Less dividends	20,500	22,600	25,000	25,000	25,000
Added to reserves	12,800	44,200	18,300	13,400	27,200

The following additional information is available.

1. There have been no changes in the issued share capital of Ojiso during the past five years.
2. The estimated values of Ojiso's non-current assets and inventory and work in progress as on 31 July 2004 are as follows.

	Replacement cost	Realisable value
	N	N
Non-current assets	725,000	450,000
Inventory	550,000	570,000

3. It is expected that 2% of Ojiso's receivables at 31 July 2004 will be uncollectible.
4. The cost of capital of OmonsoCarment plc is 9%. The directors of Ojiso estimate that the shareholders of Ojiso require a minimum return of 12% per annum from their investment in the company.

5. The current P/E ratio of Omonso is 12. Quoted companies with business activities and profitability similar to those of Ojiso have P/E ratios of approximately 10, although these companies tend to be much larger than Ojiso.

Required:

(a) Estimate the value of the total equity of Ojiso as on 31 July 2004 using each of the following bases:
   (i) Book value;
   (ii) Replacement cost of the assets;
   (iii) Realisable value of the assets;
   (iv) The dividend valuation model;
   (v) The P/E ratio model.
   (b) Explain the role and limitations of each of the above five valuation bases in the process by which a price might be agreed for the purchase by Omonso of the total equity capital of Ojiso.

7.0 References/Further Reading

James C. Van Horne John M. Wachowicz, Jr. (2009) Fundamentals of Financial Management 13th Edition Pearson Education Limited

UNIT EIGHT: ACCOUNTING FOR FOREIGN BRANCHES

CONTENT

8.0 Introduction
9.0 Objectives
10.0 Main Content
3.1 Rules for Conversion
3.2 Differences in Exchange
11.0 Conclusion
12.0 Summary
13.0 Tutor Marked Assignment
14.0 References/Further Reading

1.0 Introduction

Foreign branches are branches situated outside the country where the head office of the firm/business organization is located. They usually maintain a complete set of book under the double entry principles. Before a trial balance of the foreign branch is incorporated in the head office books, it has to be converted into the home currency.

Accounting for foreign branches is covered under International Accounting Standards (IAS) 21. (The Effects of Changes in Foreign Exchange Rates)

2.0 Objectives

After studying this unit, the student should be familiar with :

- Rules for translation of trial balance of foreign branch
- How to convert trial balance in foreign currency to functional currency of head office
- How to prepare final account incorporating foreign branch

3.1 Rules for conversion.

	Nature of Account	**Exchange Rate Applicable**
1	Non- Current Assets	Rates ruling at the time they were acquired
2	Non- Current Liabilities	Rates ruling as at the date of the trial balance

3	Current Assets and Liabilities	Rates ruling as at the date of the trial balance
4	Goods received/return to Head Office	At the rates ruling on the date of dispatch or the date of receipt
5	Nominal accounts (Except dep. And closing inventory)	Average rate ruling during the accounting period
6	Depreciation of Fixed Assets	Rate of conversion applicable in case of the particular assets concerned
7	Opening and closing inventory	Rates ruling on the opening and closing dates respectively
8	Balance in HO account	Value at which the branch account appears in H.O. books on the date
9	Remittances sent by the branch	At the actual rates at which remittances were made.

3.2 Differences in Exchange

As a result of conversion of branch trial balance in home currency, a difference in the trial balance will often arise. If a loss (Dr.), it should be debited to profit and loss account. If a profit (Cr.) the prudent course is to credit it to exchange reserve account so as to provide for future losses on exchange.

Illustration1

Obeto ltd (a Nigerian company) has a branch at Washington. Its Trial Balance as at 30th September, 2003 is as follows:

Particulars	***Dr. Us $***	***Cr. Us $***
Plant & Machinery	1,200,000	---
Furniture & Fixtures	8,000	---
Stock on Oct.1st, 2002	56,000	---
Purchases	2,400,000	---
Sales	---	4,160,000
Goods from Nigerian Co. (H.O)	80,000	---
Wages	2,000	---
Carriage inward	1,000	---
Salaries	6,000	---
Rent, rates and taxes	2,000	---
Insurance	1,000	---
Trade Expenses	1,000	---
Head Office A/c	---	1,140,000
Trade Debtors	24,000	---

Trade Creditors	---	17,000
Cash at Bank	5,000	---
Cash in Hand	1,000	---
	5,470,000	***5,470,000***

The following further information is given:

a. Wages outstanding $ 1,000
b. Depreciate Plant & Machinery and Furniture & Fixtures @ 10 Per cent p.a.
c. The H.O. sent goods to Branch for ₦ 39,400,000
d. The H.O. shows an amount of ₦ 43,000,000 due from Branch
e. Stock on 30th September, 2003-$ 52,000
f. There were no in transit items either at the start or at the end of the year.

Exchange rates:

a. On 1st September 2001 when the fixed assets were purchased, the rate of exchange was ₦38 to one $.
b. On 1st October, 2002 the rate was ₦39 to one $.
c. On 30th September, 2003 the rate was ₦41 to one $.
d. Average rate during the year was ₦40 to one $.

You are asked to prepare **(a)** Trial Balance incorporating adjustments given above, converting dollars into naira, **(b)** Trading and P & L A/c for the year ended 30.9.2003 and Balance sheet as on that date.

Solution

	Incorporated TB	
	Dr	**Cr**
	N	**N**
Cost		
Plant and Machinery	4,560,000	-
Furniture and Fittings	304,000	-
Accumulated Depreciation:	-	-
Plant and Machinery	-	456,000
Furniture and Fittings	-	30,400
Stock on Oct 1, 2002	2,184,000	-
Purchases	9,600,000	-
Sales	-	16,640,000
Goods from indian Co. (HO)	3,940,000	-
Wages	80,000	-
Carriage inward	40,000	-
Salaries	280,000	-
Rent, rates and taxes	80,000	-
Insurance	40,000	-
Trade Expenses	40,000	-
Head Office A/c	-	4,300,000
Trade Debtors	984,000	-

Trade Creditors	-	738,000
Cash at Bank	205,000	-
Cash in Hand	41,000	-
Depreciation:	-	-
Plant and Machinery	456,000	-
Furniture and Fittings	30,400	-
Closing stock		
Exchange Loss		**700,000**
Profit		
Total	22,864,400	22,864,400

Obeto ltd		
Profit or Loss Account		
for the year ended September 30, 2003		
Sales		16,640,000
Opening Stock	2,184,000	
Add : Purchases	9,600,000	
Goods sent from HO	3,940,000	
Carriage Inward	40,000	
Cost of goods available for sale	15,764,000	
Less Closing Stock	2,132,000	
Cost of goods sold		13,632,000
Gross Profit		3,008,000
Administrative Expenses		
Salaries	280,000	
Wages	80,000	
Rent, rates and taxes	80,000	
Insurance	40,000	
Trade Expenses	40,000	
Exchange Loss	- 700,000	

Depreciation	486,400	
Total Expenses		306,400
Net Profit		2,701,600

Obeto ltd		
Balance Sheet		
As at September 30, 2003		
Fixed Asset		4,377,600
Current Asset		
Stock	2,132,000	
Trade Debtors	984,000	
Cash at Bank	205,000	
Cash in Hand	41,000	
	3,362,000	
Curent Liability		
Trade Creditors	738,000	2,624,000
Net Current Asset		
Asset Employed		7,001,600
		-
		-
Finance By		
Net Profit		2,701,600
Head Office Account		4,300,000
		7,001,600

4.0 Conclusion

A Foreign branch usually maintains a complete set of books under double entry principles. So, the accounting principles of a Foreign Branch will be the same as those applying to an Inland Branch. Before a Trial Balance of the Foreign Branch is incorporated in the head office books, it has to be converted into home currency.

5.0 Summary

Foreign branches are branches situated outside the country where the head office of the firm/business organization is located. Various rules exist for conversion of branch trial balance to the home currency. Conversion of branch trial balance will often result to exchange loss or gain which is either debited to profit and loss account or credited to exchange reserve account.

6.0 Tutor Marked Assignment

London Branch of Akwanga Export House sent the following T.B. as on 31.12.2001.

Particulars	***Dr.***	***Cr.***
Fixed assets	17,500	
Loan (taken to purchase		
of fixed assets)		13,000
Depreciation	2,500	
Stock 1-1-2001	8,200	
Goods from H.O.	58,800	
Sales		1,05,200
Salaries & Wages	15,200	
Interest	2,880	
Cash & Bank	1,700	
Debtors	21,200	
H.O. Account		9,780

Fixed assets were purchased on 1-1-99 when 1 ₤ = 25.50, life was estimated to be 10 years. To finance the fixed asset a loan amounting to ₤.22,000 was taken @ 18% interest p.a. Annual loan installment of 3,000 and interest were payable in every December. Exchange Rates are as follows:

Average of 1999	₤ 1 = ₦ 25.70
On 31.12.1999	₤ 1 = ₦ 26.10
Average of 2000	₤ 1 = ₦ 26.20
On 31.12.2000	₤ 1 = ₦ 26.40
Average of 2001	₤ 1 = ₦ 36.50
On 31.12.2001	₤ 1 = ₦ 42.20

In the Head Office books London Branch A/c appeared as follows:

London Branch A/c

Particulars	***₤***	***₦***	***Particulars***	***₤***	***₦***
To Balance b/d	7,000	1,840,800	By Bank	56,020	20,440,730
To goods	58,800	21,460,200	By Balance	9,780	4,120,716
To P&L A/c	-	1,260,446			
Exchange gain	-				

Closing Stock: ₤ 2,400.

You are required to show Branch fixed assets A/c., Branch Loan A/c., Branch Trial balance in naira terms, Branch P & L A/c, Adjustment Entries to incorporate branch balances in the H.O. Books.

7.0 References/Further Reading

Frank wood, alansangster (2008) business accounting, volume 2, FT Press

Bello, S. O. & Barnabas, S. A. (2017).Advanced Financial Accounting, Bida, 9ICE LINK Production

MODULE THREE (Specialized transaction)

Unit 1: Joint Venture
Unit 2: Hire Purchase
Unit 3: Goods on Sale or Return
Unit 4: Royalty Account
Unit 5: Container
Unit 6: Consignment
Unit 7: Investment account
Unit 8: bill of exchange
Unit 9: Pension Fund

UNIT ONE: JOINT VENTURE

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
  3.1 Main Features of a Venture Defined
  3.2 IFRS 11: Joint Arrangements
  3.3 Main Features of a Joint Venture
  3.4 Accounting Entries Joint Venture account
4.0 Conclusion
5.0 Summary
6.0 Tutor-Marked Assessment
7.0 References/Further Reading

1.0 INTRODUCTION

For most large-scale project or program, a single business has not enough strength both in finance or technology to undertake it as a whole. However, it would be a strong point for them to undertake a particular part of the project. Under this circumstance, joint efforts with other business in necessary to undertake the project. The collaborative approach to the manufacture of an aircraft is a good example of this type of joint venture where the wings, body and engine are built by different companies. Each company bears its own costs and takes an agreed contractual share of the revenue from the sale of the aircraft.

A joint venture is simply a venture undertaken jointly by two or more persons with a view to making a profit. It differs from a partnership in that it is more temporary in nature and has more specific limited objective(s).

Joint Ventures can be found in almost every business sphere but they are often associated with one-off transaction, such as buying up the stocks of a bankrupt business or engaging in other short term operations. A party to a joint venture may be called a co-venture or simply a venture.

2.0 OBJECTIVES

At the end of this unit, you should be able to:
Define a joint venture business
Understand types of joint ventures
Prepare joint venture Accounts from Information provided.

3.0 Main Content

3.1 Main Features of a Joint Venture

- The ratio in which business profits (losses) are to be shared must be clearly stated and agreed by the venture. Where this has not been explicitly stated, profit is assumed to be shared to be shared equally.
- The scope of the venture and the respective responsibilities of each venturer must be agreed upon, e.g. one venturer does the buying and the other the selling; but often each venture makes a financial contribution.
- The parties may agree to pay a venture for services rendered e.g. handling or selling and such payment is deducted from revenue before the profit (or loss) of the venture is ascertained

3.2 IFRS 11: Joint Arrangements

Types of joint arrangement identified in IFRS 11

(i) Joint Operations

A Joint operation is a joint arrangement whereby the parties that have joint control of the arrangement have right to the assets and obligations for the liabilities relating to the arrangement. Those parties are called joint operators.

(ii) Joint venture

A Joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have right to the net asset of the arrangement. These parties are referred to as joint venturers.

Definition of Terms by IFRS 11

Joint arrangement:
An arrangement of which two or more parties have joint control.

Joint control
The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

Joint operation
A joint arrangement whereby the parties that have joint control of the arrangement have rights to

the assets, and obligations for the liabilities, relating to the arrangement.
joint operator
A party to a joint operation that has joint control of that joint operation.

Joint venture
A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

Joint venture
A party to a joint venture that has joint control of that joint venture.
Party to a joint arrangement
An entity that participates in a joint arrangement, regardless of whether that entity has joint control of the arrangement.

Separate vehicle
A separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality.

3.3 Main Features of a Joint Venture

(i) The ratio in which business profits (losses) are to be shared must be clearly stated and agreed by the venture. Where this has not been explicitly stated, profit is assumed to be shared to be shared equally.

(ii) The scope of the venture and the respective responsibilities of each venturer must be agreed upon, e.g. one venturer does the buying and the other the selling; but often each venture makes a financial contribution.

A joint operator shall recognise in relation to its interest in a joint operation:

(a) its assets, including its share of any assets held jointly;
(b) its liabilities, including its share of any liabilities incurred jointly;
(c) its revenue from the sale of its share of the output arising from the joint operation;
(d) its share of the revenue from the sale of the output by the joint operation; and
(e) its expenses, including its share of any expenses incurred jointly.

3.4 Accounting Entries for Joint Venture Accounts

(i) If cash is paid out: **DR** Joint Venture A/C
CR Cash A/C

(ii) If cash is received : (from sales or from co-venturer):
DR Cash

CR Joint Venture Account

(iii) Any charges agreed upon e.g. Sales Commission:
DR Joint Venture Account

CR Commissions Account in the books of the venture that is to receive the Commission

(iv) When it is time to ascertain profit (or loss), the Joint Venture Account of each party (venture) are combined together in a Memorandum Joint Venture Account. This account does not form part of double entry in the books of any venturer.

It is purely a memorandum of what has occurred and it is used to ascertain profit (or loss) of the venture.

(v) When profit (or loss) is found, each venture will:
DR Joint Venture Account with his share

CR Profit and Loss on Joint Venture Account with the same amount

(vi) In the event of a loss, each venture must:
DR Profit and Loss on Joint Venture Account with his share of the loss **CR** Joint Venture Account, with the same amount

Memorandum of Joint Venture Account
Where one party is paying out money and the other receiving money, some procedure must be devised to bring the accounting records together to ascertain whether the venture has made a profit or loss. This is done by means of a memorandum joint venture account that is opened by each party. This account contains all the operating entries in the joint venture account of all the parties on the same side as the original accounts; however, any capital entries should be excluded from this account. This account does not form part of the double entry system. Contra entries between the parties are excluded from it. The valance on the memorandum joint venture account is the profit or loss on the venture.

JOINT VENTURE A/C

	₦		₦
Purchases	xx	Sales	xx
Expenses	xx	Interest on drawing	xx
Interest on capital	xx	Share of loss	xx
Share of profit	xx	Remittance from other	xx
Remittance to others	xx		

Illustration 1

Ralie and Kadio entered into a joint venture to buy and sell second-hand cars. Profits and losses were to be shared: Ralie three-fifths, Kadio two-fifths. It was agreed that each party would record his own transactions only.

On 23 September 2008, Ralie purchased two cars for ₦322,000 and ₦420,000. He incurred expenditure of ₦98,000 on repairs and on 4 September 2008 sold one of the cars for ₦469,000. On 10 September 2008 the other car was sold for ₦525,000, paying the proceeds in each case into his own bank account.

On 14 September 2008, he purchased another car for ₦560,000 and sold it on 30 September 2008 for ₦546,000 the amount he paid over to Kadio who paid it into his bank account.

On 25 September 2008, Kadio purchased a car for N245,000 on which he incurred expenditure of ₦56,000 and which he sold on 10 October 2008 for ₦350,000; the amount he paid into his bank account. This car was returned by the purchaser on 20 October 2008 and Kadio paid him ₦322,000 for it. As this car was still unsold, on 30 November 2008, it was agreed that it should be taken over by Kadio at a valuation of ₦315,000.

Other expenditure was incurred by the parties as follows:

	Ralie	Kadio
	₦	₦
Insurance	17,500	3,500
Garage	14,000	7,000

On 30 November 2008, the sum required in full settlement as between Ralie and Kadio was paid by the party accountable.

You are required to prepare:

(a) The Joint Venture account as it would appear in the books of Kadio recording his transactions for the joint venture.

(b) The memorandum account for the joint venture showing the net profit

RALIE AND KADIO

(a) In the books of Kadio

JOINT VENTURE WITH RALIE

	₦		₦
Purchases (cash)	245,000	Sales	350,000
Expenses (cash)	56,000	Car taken over by Kadio	315,000
Sales return (cash)	322,000	Cash	546,000
Insurance	3,500		
Garage	7,000		
Share of profit	56,000		
Cash	521,500		
	1,211,000		1,211,000
	======		======

(b) <u>MEMORANDUM JOINT VENTURE ACCOUNT</u>

	₦		₦
Ralie:		Ralie:	
Purchases	1,302,000	Sales	1,540,000
Repairs	98,000		
Kadio:			
Insurance	17,500	Sales	350,000
Garage	14,000	Car taken over	315,000
Kadio:			
Purchases	245,000		

Sales return	322,000		
Expenses	56,000		
Insurance	3,500		
Garage	7,000		
Share of profit:			
Ralie 3/5 ₦84,000			
Kadio 2/5 ₦56,000	140,000		
	2,205,000		2,205,000
	======		======

4.0 CONCLUSION

A joint venture is simply a venture undertaken jointly by two or more persons with a view to making a profit. It differs from a partnership in that it is more temporary in nature and has more specific limited objective(s).

5.0 Summary

Joint Ventures can be found in almost any sphere of business activity. The parties to the venture are called co-ventures or simply ventures. Sometimes a separate set of books is maintained for the venture.

In most cases, however, each venture records in his own ledger the transactions undertaken by him on behalf of the venture.

6.0 Tutor-Marked Assessment

Mohsin and Ali entered into a joint venture to buy and sell laptops. Profits and Losses were to be shared equally.

On 7th October, 2014 Mohsin purchased three laptops for ₦30,000, ₦35,000 and ₦40,000 respectively. He bought a special cabinet costing ₦7500, which he fixed for one of the laptops. On 31st October 2014, he sold two of the sets for ₦60,000 each paying the proceeds into his private bank account.

On 15th November, 2014, he sold the other set for ₦50,000 which amount he paid over to Ali who paid it into his Bank Account.

On 6th October, 2014, Ali purchased a laptop set for ₦35,000 having incurred expenditure of ₦2000 on repairing sold it on 14th October 2014 for ₦42,000 paying the proceeds into his own bank account. This set developed mechanical trouble and on 26th October, 2014, Ali agreed to take the set back at a price of ₦28,000 which he paid out of his bank account. The set was still unsold at 30th November, 2014 and it was agreed that Ali should take it over for his personal use at a valuation of ₦25,000.

Mohsin incurred ₦3000 as showroom charges and Ali incurred ₦2250 as travelling and postage.

You are required to prepare (a) the account of joint venture with Mohsin and it would appear in the books of Ali and (b) Memorandum Joint Venture Account showing the net profit.

7.0 References/Further Reading

Adebayo, P.A.(2011). Financial Accounting and Reporting Standards for Students and Professionals, Abuja: Rainbow Graphic Printers and Publishers

Bello, S. O. & Barnabas, S. A. (2017).Advanced Financial Accounting, Bida, 9ICE LINK Production

IAS 31 Interests in Joint Ventures and IFRS 11 Joint Arrangements

UNIT TWO: HIRE PURCHASE

1.0 Introduction
2.0 Objectives
3.0 Main Content
3.1 Definition of Hire Purchase
3.2 Differences between Hire Purchase and Credit Sales
3.3 Apportionment of Interest on Hire Purchase
3.4 Disclosure Requirements
3.5Methods of Accounting for the Hire Purchase transactions
4.0 Conclusion
5.0 Summary
6.0 Tutor-Marked Assessment
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1.0 Introduction

The purchase of expensive fixed assets can cause serious cash flow problems for businesses. However, if a business wishes to remain viable, fixed assets must be replaced or added to from time to time. To ease cash flow, rather than purchasing for cash or on normal trade terms, assets may be acquired under a hire purchase contract.Hire purchase transaction is a form of extended credit agreement and there are two parties to hire purchase agreement; they are buyer or user and vendor or finance company, although sometimes the vendor and finance company may be different parties. In law, ownership of the item subject to hire purchase is retained by the vendor or finance company until the fulfillment of a certain condition usually payment of all installments. However, using substance over form, the items are treated as if ownership was given to the buyer immediately.

2.0 Objectives

After studying this chapter, you should be able to:

- Differentiate between credit purchase and hire purchase.
- Know the entries for the different method of accounting for hire purchase
- Pass entries for hire purchase transactions.

3.0 Main Content

3.1 Definition of Terms

Hire purchase:A hire purchase contract is a contract for the hire of an asset that contains a provision giving the hirer an option to acquire legal title to the asset upon fulfillment of certain condition stated in the agreement. These conditions are usually the payment of an agreed number of installments or the payment of a notional sum at the end of the contracted hire period.

During the period of the contract, legally the asset remains the property of the supplier. The payments made are technically hire charges.

Cash Sales Price: This is the purchase price at which the goods/property should have been sold to the buyer had the transaction is not on hire purchased (cash price). This will be greater than cost price hut less than the hire purchase price.

Hire purchase price (HPP): Cash Price plus Hire Purchase Interest.

Hire purchase interest: This is also known as finance charges. It is the excess of the hire purchase price over the cash price.

Initial deposit: This is the initial amount payable by the hire purchase buyer at the inception of the hire purchase transaction.

Installments: This is the sum payable by hire purchase buyer at specific intervals to liquidate the balance of the purchase price after the payment of the initial deposit.

3.2 Difference between Hire Purchase and Credit Sales

Although hire purchase system could ultimately result in sale of goods, the sale in normal sense and sale under hire purchase system are not the same. The following are the differences between sale and hire purchase.

Credit Sale	Hire Purchase
1. A 'sale' is governed by the sale of Goods Act, 1930.	1. Hire purchase is governed by the Hire Purchase Act, 1972.
2. In case of sale, the ownership of the goods is transferred to the buyer immediately.	2. In case of Hire purchase, the ownership of goods is transferred to buyer on payment of all installments.
3. In case of sale, the buyer makes payment in lumpsum. (if the lumpsum payment is made immediately on transfer of ownership and possession of goods, it is called Cash Sale and if the payment is made on a specified future date, it is called credit sale.	3. In case of hire purchase, the payment is made in installments.
4. The buyer pays only for the price of goods.	4. The hire purchaser pays for the price of goods and also some amount of interest.
5. On non-payment of the consideration the seller cannot take back the goods, but can only take legal action on buyer.	5. On non-payment of any installment, the seller can re-possess the goods.
6. Once a sale has taken place, neither the seller, nor the buyer can terminate the contract (unless it is for genuine reason like damage of goods etc.)	6. Either the buyer or the seller can terminate the contract at any point of time, until the payments of last installment.
7. When the buyer becomes insolvent, the seller has to undertake the risk of loss.	7. When the hire purchaser becomes insolvent, the seller can reposes the goods, and hence need not undertake the risk of loss.
8. A sale is subject to levy of Value Added tax at the time of contract of sale.	8. In this case, the Value Added tax will be leviable at the time of ownership (i.e. on payment of last installment).

3.3 Apportionment of interest on Hire Purchase Transactions

There are several methods available by which interest charged on a credit sale may be apportioned over the period of the payment. These include:

- The straight-line method the total interest charge is spread equally over the accounting periods.
- The reducing balance method interest charged to an accounting period is calculated by basing it on the amounts outstanding.
- Sum of the digits method interest charged to an accounting period is calculated by basing it on the number of outstanding periods in relation to the total period of credit:

Year	Outstanding	Proportion of interest
1	5	5/15
2	4	4/15
3	3	3/15
4	2	2/15
5	1	1/15

- *in proportion to cash received* interest charged to an accounting period is calculated by basing it on the amount of cash received relative to the total price. This method is sometimes easier to apply by first taking credit for all the interest and then transferring that proportion out to a suspense account relative to the amount not yet received.
- *actuarial method* this method will be described in case-study about typical hire purchase contract.

Illustration 1

The following example illustrates the different results that may be obtained from some of the above methods.

Basic Data:

Cash price of goods: ₦9,600
Number of installments: 3 years
Amount of each installment: ₦4,000 per annum
Without consideration of time-value, combine the three installments together as its hire purchase price and then:
Amount of interest: ₦4,000×3 -₦9,600=₦2,400

1 *Straight line*

Year	Interest ₦
1	800
2	800
3	800
	₦ 2,400

2 *Sum of the digits*

	Year	Outstanding	Interest ₦
1	3	3/6 × ₦2,400	1,200
2	2	2/6 × ₦2,400	800
3	1	1/6 × ₦2,400	400
			₦ 2,400

3 *In proportion to cash received*

Year	Received Cash	Interest ₦

1	₦ 4,000	
2	₦ 4,000	$\frac{4,000}{12,000} \times$ =₦2,400,800
3	₦ 4,000	$\frac{4,000}{12,000} \times$ =₦2,400,800

Illustration 2

Ijeshatedo Limited acquired a car on 1 January 2003 under a two-year hire purchase agreement. An initial deposit of ₦160,000 and four half-yearly installments of ₦160,000 commencing on 1 July 2003 are required. The cash price is ₦754,400 and the company's year ends every 30 September.

Calculate the hire purchase interest

Solution

₦160,000 + (₦160,00 x 4) - ₦754,400 = ₦45,600

Illustration 3

White sold a machine to Green on hire purchase basis. You are given the following information:

Cash price ₦2,800,000
Initial Deposit ₦1,000,000
A yearly installment of ₦750,000 payable on 31 December for 4 years, was agreed. The company makes up its accounts to 31 December.

(a) Calculate the hire purchase price.
(b) Calculate the hire purchase interest attributable to each year using straight line method.

1 ₦1,000,000 + (₦750,000 X 4 yrs) = ₦4m

2 $\frac{₦4,000,000 - 2,800,000}{4}$ = ₦300,000

Illustration 4

Calculate the hire purchase interest attributable to each year using straight line

Using the sum-of-the-year digit in hire-purchase agreement, calculate the finance charge in the income statement in the third year if the total finance charge for five years is ₦72,000.

$^3/_{15}$ x 72,000 = ₦14,400

3.4 Disclosure requirements

Income Statement

The hire purchase interest due is charged to income statement and it is treated as part of the Financial charges.
Depreciation for the year on the fixed asset is also charged to the profit & Loss Account.

Statement of Financial Position

The cost of the fixed assets acquired on hire purchase is disclosed as 'fixed assets' in the balance sheet. The relevant accumulated depreciation charged is also shown to determine the net book value of the asset.

Similarly liabilities outstanding on the asset which is due to the vendor is also disclosed as 'current liabilities' or creditors failing due within one year or falling due after one year, as the case may be.

Illustration 5

On 1 January 20x1 Homenda Ltd sold a machine, costing ₦15,000, to Bus Transportation Ltd under a hire purchase agreement requesting a deposit of ₦5,000 and three equal instalments of ₦6,000 per annum payable at the end of each year. Interest in the contract is at 9.7% per annum and cash price is₦20,000.

Cash price	20,000	
Cost	15,000	
Profit	5,000	
Hire purchase price	(5,000+(3×6,000)	23,000
Cash price	20,000	
Interest	3,000	

3.5 Methods of Accounting for The Hire Purchase

Hire purchase interest method

Under this method, the hire purchase buyer will debit the asset account and credit vendor or finance company account with the cash price of the of it the item. The interest element is only recognized as it falls due.

Hire purchase interest suspense method

This method involves debiting the asset account with 'cash price' of the item and hire purchase interest suspense account is debited with the total hire purchase interest or finance charges while the vendor or finance company is credited with total hire purchase price. When an installment falls due, the appropriate amount of the hire purchase interest that is due is charged to profit & loss account from hire purchase interest suspense account.

Accounting Methods Entries (In Seller's Books) For Small Items

Small items sold on hire purchase are counted for using different methods from those earlier highlighted for large items.

There are two methods that are used for accounting for hire purchase of small items in the seller's or vendor's books. The two recognized methods are:

- Stock on hire method
- Provision for unrealized profit method.

Accounting Entries In Hire Purchase Buyer's Books Using Hire Purchase Interest Account Method

S/N	Nature of Transaction	Account to be debited or credited	
		DR	**CR**
1	With cash price asset acquired on hire purchase terms	Fixed Asset Account	Hire purchase ven Account
2	Deposit/ Installment paid	Fixed Asset Account Vendor Account	Bank Account
3	Accounting for H.P. interest included in the installment paid	H.P. interest Account	H.P. Vendor Account

4	At the end of the accounting year H.P. interest due should be transferred to profit and loss Account	Profit & Loss Account	Hire purchase interest account
5	At the end of the accounting year depreciation due on asset should be charged to profit and loss account	Profit & Loss Account	Provision for depreciation Account

Accounting Entries in H.P Buyers Books Using H.P Interest Suspense Method

S/N	Nature of Transaction	Account to debit or credited	
		DR	CR
1	On acquisition of asset, (and with the purchase price)	(i) Fixed asset A/c (Cash price) (ii) H.P interest suspense (total H.P Interest) (iii) -	- - H.P. Vendor A/c (Hire purchase price)
2	To account for deposit and installments paid	H.P. Vendors Account	
3	To recognise H.P interest due included in installment payment	H.P Interest Account	H.P. Interest Account
4	To transfer H.P. interest due for the year to profit & Loss Account at year end	Profit & Loss Account	Hire purchase interest Account
5	To recognize the depreciation on the asset for the year	Profit & Loss Account	Provision for depreciation Account

Accounting Entries for Accounting For Large Items In Hire Purchase Vendor's Books Using Hire Purchase Interest Account Method

S/N	**Nature of transaction**	**Accounts to be Debited or Credited**	
		DR	**CR**
i	On selling large items on H.P (with cash price of the item)	H.P. Receivables Account	H.P Sales Account
ii	With the amount of installment or deposit received	Bank Account	H.P. Receivables Account
iii	To recognise the H.P Interest included in the installment received	H.P. Receivables Account	H.P. Interest received Account

iv	To recognise the cost of goods for large items sold in H.P Trading Account	H.P. Trading Account	General Trading or purchase Account
v	To recognise H.P. Sales Account in the H.P. Trading Account	H.P. Sales Account	H.P. Trading Account
vi	To recognize the H.P. Interest received in the H.P. trading	H.P. Interest received Account	H.P. Trading Account
vii	Account for unrealised profit(UP) and transfer to unrealised profit account from H.P. Trading Account UP = Bal. of cash price outstanding x (Cash price – Cost) Cash Price	H.P. Trading Account	Provision for unrealised profit
viii	Transfer of credit balance from H.P Trading Account to General Profit & Loss Account after accounting for steps (iv) to (vii)	H.P. Trading Account	General Profit & Loss Account

Accounting Entries for Accounting for Large Items In Hire Purchase Vendors Books Using H.P. Interest Suspense Method

S/N	**Nature of transaction**	**Accounts to be debited or credited**	
		DR	**CR**
i	On selling the large items o hire purchase	(a) H.P. Receivables (with H.P. Price)	
ii	On receipt of deposit/installment from the buyer	Bank Account	H.P. Sales (with cash price) H.P. Interest suspense (Total H.P. Interest)
iii	To recognize H.P. Interest included in the installment received	H.P. Interest Suspense Account	H.P. Interest received Account
vi	To recognize the H.P. Interest received in the H.P. trading	H.P. Interest received Account	H.P. Trading Account
vii	Account for unrealised profit and transfer to unrealised profit account from H.P. Trading Account UP = Bal. of cash price outstanding x (Cash price – Cost) Cash Price	H.P. Trading Account	Provision for unrealised profit
viii	Transfer of credit balance from H.P Trading Account to General Profit & Loss Account after accounting for steps (iv) to (vii)	H.P. Trading Account	General Profit & Loss Account

Illustration 6

Sabaka Prints Limited purchased a machine from Africanus Limited on hire purchase over a period of three years, paying ₦13,080 on 1 January 2006 and a further annual payment of ₦40,000 due on 31 December 2006, 2007 and 2008.

The cash price of the machine was ₦120,000. The supplier charges interest at 6% per annum on outstanding balances.

Depreciation at 20% per annum straight line is to be charged.

Required:

(a) UsingHire purchase interest method, writeup the following ledger accounts for the three years in the books of Sabaka Prints Limited:
    (i) Machinery
    (ii) Africanus Limited
    (iii) Provision for Depreciation – Machinery
(c) Show the relevant extracts from the Statement of Financial Position (Balance Sheet) as at 31 December 2006

Suggested Solution

MACHINERY ACCOUNT

	₦		₦
1/1/06 Africanus Ltd	120,000	31/12/06 Balance c/d	120,000
1/7/07 Balance b/d	120,000	31/12/07 Balance c/d	120,000
1/1/08 Balance b/d	120,000	31/12/08 balance c/d	120,000
1/1/09 Balance b/d	120,000		

AFRICANUS (HP PAYABLE) ACCOUNT

	₦		₦
1/1/06 Bank a/c- deposit	13,080	1/1/06 Machinery a/c	120,000
31/12/06 Bank a/c – installment	40,000	31/12/06 H/P interest a/c	6,415
31/12/06 Balance c/d	73,335		
	126,415		126,415
31/12/07 Bank a/c – installment	40,000	1/1/07 Balance b/d	73,335
31/12/06 Balance c/d	37,735	31/12/07 H/P interest a/c	4,400
	77,735		77,735
31/12/08 Bank a/c- installment	40,000	1/1/08 Balance b/d	37,735
		31/12/08 H/P interest a/c	2,265
	40,000		40,000

Provision for Depreciation Account

	₦		₦
31/12/06 Balance c/d	24,000	31/12/06 P & L a/c	24,000
31/12/07 Balance c/d	48,000	31/12/07 Balance b/d	24,000
		31/12/07 P & L	24,000
	48,000		48,000

31/12/08 Balance c/d		31/12/08 Balance b/d	48,000
		31/12/08 P &L	24,000
			72,000
	72,000	1/1/09 Balance b/d	72,000

Sabaka Prints Limited

Statement of Financial Position (extracts) as at 31 December 2006

	₦	₦
Non-Current assets		
Machinery		120,000
Less accumulated depreciation		(24,000)
		96,000
Current liabilities		
H/P Payables (Africanus Ltd)	73,335	

Calculations of Interest

		₦	₦
01/01/06	Cash price	120,000	
01/01/06	Deposit	(13,080)	
		106,920	
31/12/06	Interest (6/100×₦106,920)	6,415	6,415
31/12/06	1st installment	(40,000)	
01/01/07	Outstanding balance	73,335	
31/12/07	Interest (6/100 ×73,335)	4,400	4,400
31/12/07	2nd installment	(40,000)	
01/01/08	Outstanding balance	37,735	
	Interest (6/100 ×37,735)	2,265	2,265
31/12/08			
31/12/08	3rd installment	(40,000)	
	Total	NIL	

4.0 CONCLUSION

Hire purchase is a specialised transaction that requirescomputing and charging to respective periods, finance charges and hire purchase interest.

5.0 SUMMARY

Hire purchase transaction is a form of extended credit agreement and there are two parties to hire purchase agreement; they are buyer or user and vendor or finance company, although sometimes the vendor and finance company may be different parties. In law, ownership of the item subject to hire purchase is retained by the vendor or finance company until the fulfillment of a certain condition usually payment of all installments. However, using substance over form, transactions on hire purchase the items are treated as if ownership was given to the buyer immediately.

There are two methods of accounting for the hire purchase transaction, Hire purchase Interest Account Method and Hire Purchase Interest Suspense Method. In Hire purchase Interest Account Method, interest paid or received is only accounted for when due. However, inHire Purchase Interest Suspense Method, total interest on the hire purchase transaction is recognized and realised on periodic basis.

6.0 TUTOR-MARKED ASSIGNMENT

Using the information in illustration 6, writeup the following ledger accounts (Using Hire purchase interest Suspense method) for the three years in the books of the buyer:

(i) Machinery

(ii) Africanus Limited

(iii) Provision for Depreciation – Machinery

7.0 REFERENCES/FURTHER READINGS

Accounting technicians scheme West Africa (ATSWA) ,(2009).principles and practice of financial accounting, second edition

Adebayo, P.A.(2011). Financial Accounting and Reporting Standards for Students and Professionals, Abuja: Rainbow Graphic Printers and Publishers

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UNIT THREE: GOODS ON SALE OR RETURN

1.0 Introduction
2.0 Objectives
3.0 Main Content
 3.1Types of Goods sent on Sale or Return
 3.2 Accounting Entries
4.0 Conclusion
5.0 Summary
6.0 Tutor-Marked Assessment
7.0 References/Further Reading

INTRODUCTION

There are times when goods are sold by the manufacturer (or wholesaler) to retailer on the agreement that should the retailer sells the goods; he will incur liability for them to the producer. If the retailer is unable to sell the goods, he/she then returns the goods back without incurring any liability on the goods. In a situation where part of the goods was sold, the retailer will only pay for the part sold while returning the part not sold.

Ii should be noted that goods are not effectively sold to the retailer until he/she sells it to someone else. When it happens, manufacturer's sales figure increases correspondingly. The part unsold should not be included as part of retailer stock at the end of the year but should form part of manufacturer's stock.

2.0 Objectives

After studying this chapter, you should be able to:

- Prepare journal for goods on sale or return
- Prepare relevant account for goods on sale or return

3.0 Main Content

3.1 Types of Goods sent on Sale or Return

There are three main types of Goods sent on sale or Return. These are:

(a) Where the number of Sale or Return Transactions is small
(b) Where the number of sale or Return Transaction is large and the goods are of considerable value

3.2 Accounting Treatment

Where the number of Sale or Return Transactions is small

In the case where the transaction is small, the double entry system is not used, only memorandum records are kept. It is usually to record these transactions by using a specially ruled form of day book as shown below.

Date	Particulars	Goods sent on Sale or Return	Date	Goods returned	Goods sold	Sale ledger
(1)	(2)	(3)	(4)	(5)	(6)	(7)

(a) **Where the number of sale or return transactions is large and the goods are of considerable value**

In circumstances where the number of "Sale or return" transactions is high and the goods involved are of considerable value, it is better to have a separate set of books kept on double entry principles. Three books will be needed. These are i. Sales or return Ledger, ii. Sale or Return day Book, Sale or Return Journal. A separate double entry type sale or return ledger may be continued with the usual sale or return day book.

This set of books makes it easy to ascertain at any given time, the total selling value of goods sent out on "sale or return".

The recording procedure is as follow:
When goods are sent out on sale or return;
Record in sale or return day book as usual and post there from as follows:

Debit: Customers Personal Account in a Sale or Return
Credit: Turnover/Sales or Return Total Account Ledger at selling price

When the customer signifies acceptance of the goods, a sale is deemed to have been made. An entry is therefore required to reduce the sale or return total account balance to the value of goods not yet accepted and to change the status of the customer from a prospective buy to a debtor. To achieve that:

Debit: Turnover /Sales or Return Total Account } in a Sale or Return
Credit: Customers Personal Account } Ledger with selling value of

The goods at the stage is now set for recording the sale transaction in the normal double entry system

Debit: Customer's Personal Accounting Sales Ledger
Credit: Turnover /Sale Account in the General Ledger

When goods are returned
Debit: Turnover /Sale or return Total Account
Credit: Customers Personal Account With the selling value of the goods returned

Illustration 1

AGBELOBA's year end is December 2005. When he sent goods on sales or return to retailers he charges them out as ordinary sales. The following information is relevant to his end of the year position.

	₦
Inventory (at factory) at cost-31 December 2005	104,000
Turnover	600,000
Trade Receivable at 31 December 2005	88,000

1. Turnover included goods on sales or return of NI 50,000 of which N30,000 have not yet been sold by the retailer as at the end of the year.

2. Trade Receivable figure also included goods booked out on sale or return
3. The goods sent on sales or returns were at cost price plus 25% mark-up.
You are required to calculate the following as they will be shown in AGELOBA's financial statement at the end of the year:

a. Turnover figure
b. Inventory figure
c. Trade Receivable's figure

Suggested Solution

Turnover Figure:	**₦**
Total figure	600,000
Value of goods on sale or return not yet sold	(30,000)
Figure to be included in the trading account	570,000

Inventory Figure	**₦**
Inventory figure before accounting for goods on sale or return	104,000
Cost of goods on sale or return not yet sold	24,000
Figure to be included in the Financial Statement	128,000

Trade Receivable Figure	**₦**
Trade Receivable including goods or sale or return	88,000
Value of goods on sale or return not yet sold	(30,000)
Figure to be included in the Financial Statement	58.000

4.0 CONCLUSION

Goods sent on Sale or Return is similar in some ways to consignment. However, the accounting treatments are quite different

5.0 SUMMARY

Goods sent on Sale or Return is a method used to boost sales by sending goods to be trusted. In this instance, the transfer of goods to the customer does not amount to sale, since the right of ownership has not passed to the customer. In other words, the ownership of the goods vests with the sender, until the expiration of time within which the goods are to be returned.

Until the passage of time and the acceptance of the goods are signified, it would be incorrect to debit customer's accounts and credit sales account.

6.0 TUTOR-MARKED ASSIGNMENT

Adaku sent to Amina , a regular customer 500 calculators each costing Adaku₦2,000 at an invoiced price of ₦ 2,500 per set on Goods sent out on sale or return on the 1st of October 2007. Amina returned fifty five sets to Adaku on 15th October and sixty five sets on 5th November. On 31st December 2007, Adaku received an amount of ₦735,000 from Amina as sales during the period.

Required:

(a) Show the necessary recording in sale or return day book

(b) Determine the closing stock i.e. Goods sent on sale or return for financial reporting purpose

7.0 REFERENCES/FURTHER READINGS

Accounting technicians scheme West Africa (ATSWA) ,(2009).principles and practice of financial accounting, second edition

UNIT FOUR: ROYALTY ACCOUNTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
3.1 Types of Royalties
3.2 Terms Used in Royalty Agreements
4.0 Conclusion
5.0 Summary
6.0 Tutor-Marked Assessment
7.0 References/Further Reading

1.0 INTRODUCTION

Royalty is the remuneration payable to a person in respect of the use of an asset or right like mine, copyright or patent to its owner. Calculated by reference to and varying with quantities produced or sold as a result of the use of the asset. The owner of the asset is generally referred to as landlord while the user of the right is referred to as the tenant. There are times the main tenant will sub-let the right to another person who is generally referred to as the Sub-Tenant.

2.0 Objectives

Upon completion of this chapter, students should have learnt:

- The nature of royalty arrangements;
- Key terms associated with royalty contracts, such as 'lessor', 'lessee', short-workings and dead rent;
- Accounting for royalty transactions in the books of the 'lessor' of legal rights,
- Accounting for royalty transactions in the books of the 'lessee' of legal rights,

3.0 Main Content

3.1 Types of Royalties

Mining royalty

It is a periodical payment generally based on output, made by lessee of a mine or quarry to the lessor or the landlord (i.e., owner of the mine or quarry).

Patent royalty

It is the periodical payment based on output, made by the lessee of a patent or patent right to be lessor or the patentee (i.e., the holder of the patent right).

Copyright royalty

It is also the periodical payment based on sales,made by the lessee of a copyright (i.e. the publisher) to the lessor (i.e. the author).

3.2 Terms Used in Royalty Agreements

There are some special terms which generally are used in royalty agreements. The meaning of such terms must be clear to the reader. The special terms are:

Landlord
The persons who gives out his some special rights over something say mining rights or patent rights or copyrights, on lease to another person for a consideration is called the landlord, or 'lessor' or 'patentee' or 'an author'.

Lessee (Tenant)
The person who takes out the special rights from its owner on lease for consideration is called lessee or patent or publisher.

Minimum rent or Dead rent
It has been stipulated that in case of low output or low sales, a certain sum of money will be payable in any case-even if the royalties based on output or sales are lower. Implying thereby, that the sum payable is the minimum amount or actual royalties; whichever is higher. The minimum sum is known as minimum rent or deeds rent. E.g. if **A**, patentee, allows **B** to use his patent on a royalty of ₦2/unit Produced subject, to minimum of ₦10000 then incase the output is 7000 units; it will be ₦14000.

Short-working
The excess of minimum rent over actual royalty calculated on the basis of output or sales is termed as short-working. Normally short-working are during gestation period or due to abnormal working condition during the early periods of lease as the activity level is low in that period.

Recouping short-working-
Most of the times, along with the stipulated for a minimum rent, there is a condition that if actual royalties are less than the minimum rent, the excess paid will be recoverable out of any surplus that there may be, over the minimum rent in subsequent years. The right of getting back the excess made by the lessee in earlier years is called the right of recoupment of short-working. The right of recoupment of short-working can be:
Restricted (i.e. fixed):-Recoupment only in the first few years of the agreement.
Unrestricted (i.e. floating):-Recoupment in the year/few years, following the year in which the short working occurs.

Ground or surface rent
It is the fixed yearly or half yearly rent payable by the lessee to the landlord in addition to the minimum rent.

Royalty payable
This is the amount calculated based on the quantities produced or sold. The higher the quantities sold or produced, the higher the royalties payable. In other words, if the Landlord receives the royalty without minimum rent, royalty payable will be applicable.

Royalty paid
This is the amount actually paid to the landlord in any month, which is the higher of the ROYALTY PAYABLE and the MINIMUM RENT. The process of getting the amount to be paid to the landlord in a particular period therefore is (in the absence of any previous short workings to be recouped) to compare the royalty payable as calculated above with the minimum rent specified in the agreement. THE HIGHER will be paid to the Landlord.

Illustration 1

Ehidiamenon January 2005 granted a copy right to a publisher to print his textbook whereby she is to receive N2, 000 per book published. The minimum amount payable by the publisher per month is N200, 000.
The number of books published for the first six months is:

January	60 copies February	80 copies	March 110 copies
April	120 copies May	150 copies	June 200 copies

Required

(a) Compute the Royalty Payable (b) Royalty Paid (c) The minimum rent and
(d) The short workings

Suggested Solution

(a) Royalties payable for the six months are:

	Copies published	Price/copy	Royalty Payable
		₦	₦
January	60	2,000	120,000
February	80	2,000	160,000
March	110	2,000	220,000
April	120	2,000	240,000
May	150	2,000	300,000
June	200	2,000	400,000

(b) The minimum rent
The minimum rent from the above illustration is N200,000. Meaning there is no month the Landlord will receive an amount less than N200,000.

(c) The royalties paid to the landlord for each of the month (assuming no short working is recoverable) are:

	Copies published	Price/copy	Royalty Payable	Minimum Rent	Royalty paid
		₦	₦	₦	₦
January	60	2,000	120,000	200,000	200,000
February	80	2,000	160,000	200,000	200,000
March	10	2,000	220,000	200,000	220,000
April	120	2,000	240,000	200,000	240,000
May	150	2,000	300,000	200,000	300,000
June	200	2,000	400.000	200,000	400,000

(d) Short workings are:

	Copies published	Price/copy	Royalty Payable	Mm. Rent	Royalty paid	Short workings
	₦	₦	₦	₦	₦₦	
January	60	2,000	120,000	200,000	200,000	80,000
February	80	2,000	160,000	200,000	200,000	40,000
March	110	2,000	220,000	200,000	220,000	0
April	120	2,000	240,000	200,000	240,000	0
May	150	2,000	300,000	200,000	300,000	0
June	200	2,000	400,000	200,000	400,000	0

Illustration 2

AsejereMultilinks Limited acquired the rights to remove soft sand deposits from the land owned by Morning Stars Limited of Gidimo Village. The rights were granted on the following terms:

(a) The payment of a royalty of ₦625 per tonne of sharp sand extracted.

(b) A minimum payment of ₦6,250,000 per annum on 31 December every year
(c) Short-workings are to be recouped from the royalties' payable in excess of the minimum rent in the two years following

During the first four years of the contract, the following quantities of sharp sand were extracted:

Year 1	-	8,000 tonnes
Year 2	-	9,500 tonnes
Year 3	-	12,000 tonnes
Year 4	-	16,000 tonnes

You are required to show the ledger accounts needed to record the above transactions in the books of AsejereMultilinks Limited for each of the four years.

IN THE BOOKS OF ASEJERE MULTILINKS LTD

MORNING STARS LTD A/C

	₦		₦
YEAR 1		YEAR 1	
Dec 31 Bank	6,250,000	Dec 31 Royalties payable	5,000,000
		Short Workings	1,250,000
	6,250,000		6,250,000
YEAR 2		YEAR 2	
Dec 31 Bank	6,250,000	Dec 31 Royalties payable	5,937,500
		Short Workings	312,500
	6,250,000		6,250,000
YEAR 3		YEAR 3	
Dec 31 Short Workings	1,250,000	Dec 31 Royalties payable	7,500,000
Bank	6,250,000		
	7,500,000		7,500,000
YEAR 4		YEAR 4	
Dec 31 short Workings	312,500	Dec 31 Royalties payable	10,000,000
Bank	9,687,500		
	10,000,000		10,000,000

ROYALTIES PAYABLE A/C

	₦		₦
YEAR 1		YEAR 1	
31 Dec morning stars ltd	5,000,000	31 Dec Operating A/C	5,000,000
YEAR 2		YEAR 2	
31 Dec Morning stars	5,937,500	31 Dec operating A/c	5,937,500
YEAR 3		YEAR 3	
31 Dec Morning stars ltd	7,500,000	Dec Operating A/c	7,500,00
YEAR 4		YEAR 4	
31 Dec Morning Stars Ltd	10,000,000	31 Dec operating A/c	10,000,000

SHORT WORKINGS RECOVERABLE A/C

	₦		₦
YEAR 1		YEAR 1	
31 Dec Morning Stars Ltd	1,250,000	31 Dec Morning Stars Ltd	1,250,000
YEAR 2		YEAR 2	
31 Dec Morning Stars Ltd	1,250,000	31 Dec Balance c/d	1,562,500
	312,500		
	1,562,500		1,562,500
YEAR 3		YEAR 3	
1 Jan Bal b/d	1,562,500	31 Dec Morning Stars Ltd	1,250,00
		Bal c/d	312,500
	1,562,500		1,562,500
YEAR 4		YEAR 4	
1 Jan Bal b/d	312,500	31 Dec Morning Stars Ltd	312,500

4.0 CONCLUSION

Royalty Account is accounting in respect of the remuneration payable to a person in respect of the use of an asset or right like mine, copyright or patent to its owner.

5.0 SUMMARY

Royalty is the consideration paid by a lessee, to the lessor of legal rights, for utilizing the lessor's rights. In straight forward cases royalty arrangements involve two parties, the lessor (or landlord) and the lessee (or tenant). In such cases the accounts required to rcord the transactions in the books of the lessee are usually:

- Royalties Payable
- Landlord Account
- Short Workings Recoverable A/C

Sub-royalty arrangements occur in slightly more complicated cases, where the original lessee (tenant) in turn sub-lets the acquired rights to a sub-lessee. Sub-royalty is the payment made by the sub-lessee to the original lessee (tenant). Here three parties are involved viz:

- Landlord (Lessor)
- Tenant (Lessee)
- Sub-Tenant (Sub-lessee).

6.0 TUTOR-MARKED ASSIGNMENT

Ramesh wrote a book on Financial Accounting and got it published with Himalaya Publishing House on the terms that royalties will be paid at ₦5 per copy sold, subject to a minimum rent of ₦.15,000 p.a., with a right of recoupment of short workings over the first four years of the royalty agreement. The details are as under:

Years	No. of copies printed	No. of copies in closing stock

1996	1,500	100
1997	2,000	200
1998	3,000	300
1999	4,000	400
2000	5,000	500

Prepare Minimum Rent A/c., Royalties A/c., Shortworkings A/c. & Ramesh's A/c. in the books of Himalaya Publishing House.

7.0 REFERENCES/FURTHER READINGS

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UNIT FIVE: CONTAINER ACCOUNT
CONTENTS

1.0 Introduction
3.0 Objectives
3.0 Main Content
    3.1 Purpose of Containers Account
    3.2 Key Terms
    3.3 Methods
4.0 Conclusion
5.0 Summary
6.0 Tutor-Marked Assessment
7.0 References/Further Reading

INTRODUCTION

Container or package is anything in which product is packed for sale. It may be a packet, bottle tube drum cylinder jar or any other item. Packet or container may be of two type , viz.. Primary or secondary. The former is related to those packages which form type of products. The cost of such containers is included in the cost of the product. The other type is related to those containers which are required for distribution of goods to the customers. Such types of containers are usually Returnable to the seller within a stipulated period of time by the buyer.

2.0 OBJECTIVES

At the end of this unit, you should be able to discuss the accounting arrangement for the different types of containers and to be able to prepare container accounts.

3.0 MAIN CONTENT

3.1 Purpose of Containers Account

- to exercise control on movements of containers to ensure that containers are properly returned by customers and due credit is given to them are charged separately.
- To see that there is no misappropriation of containers.
- To find out profit or loss on containers separately from the main product when a separate charge is made for containers.

3.2 Key Terms

1. Purchase Price (PP):- This is the Price at which the issuers of containers purchase them.
2. Charged-out-price (COP):- This is the price at which containers are issued out to the customers. The containers should he returned within the specified /agreed time.
3.Credit-back- price (CBP):- This is the price at which customers will be credited back (refunded) provided containers are returned within the stipulated period.
4. Valuation price *(VP):* This is the price at which container are included in the stock. To take care of depreciation. Valuation price is normally less that, purchase price.
5. Profit on hiring:- This is the excess of charged- out price over the credit- back- price multiplied by the number of containers invoiced to the customer during the period. i.e. (COP-CBP) x no of containers invoiced to customers.
6. Profit on containers retained by customers;- This is the excess of credit - back —price over the valuation price multiplied by the number of container retained by the customers.
i.e. (CBP-VP) x No of containers retained by customer.

7. In a particular question number of containers retained by customer (i.e. those containers not returned within the stipulated period) may not be given. This is computed as follows:

Units		
Balance b/d(opening Bal)		XX
Invoiced during the period		XX
		XXX
Returned		XX
Closing balance	(XX)	
Number of container returned by customers		XXX

If the closing balance in the hand of customers is not given, this is computed thus:

		Units
Balance at the beginning		XX
Invoiced during the period		XX
		XXX
Returned	XX	
Retained	XX	(XX)
		XXX

In the container stock, record will be taken as touching containers in the factory's warehouse and in the hand of the customer. At times, the closing balance in the warehouse may not be given; this will be the balancing figure having known the number of containers with customers at the end of the period. This can be computed thus;

				Units
Bal b/d — Factory's warehouse		XX		
- In the hand of customers				XX
Purchase during the period				XX
				XX
Containers destroyed	XX			
Containers scrapped	XX			
Containers retained by customers	XX			
Containers with customer at closing	XX	(XX)		
			XXX	

3.3 Methods

Method 1: ACCOUNTS REQUIRED

- Container Inventory A/c
- Container Suspense A/c

The container Inventory / stock account usually shows the profit or loss arising on containers. When a period ends, accounts are prepared, the derived figure of profit or loss on containers is transferred to profit and loss account.

a. Dr. Container Suspense a/c
   Cr. Cash/Bank (with Purchase Price)

b. Dr. Container Suspense a/c
   Cr. Customers' a/c (with the number of container returned at the credit back price).

c. Dr. Customers a/c
   Cr. Container suspense a/c (with the number of container issued out at the charged out price)

d. Dr. container suspense a/c
   Cr. Container Inventory / stock a/c (with the number of container retained at the credit back price)

e. Dr. Container suspense a/c
   Cr. Containers Inventory /stock a/d (with the profit on hiring i.e. difference between the charged out

price and credit back price X by the number of containers issued out).

f. Dr. Cash / Bank a/c
Cr. Container Inventory /stock a/c (with proceeds realized on the number of container disposed off).

Container stock a/c CR. Cash / bank (with any repairs on containers).

CONTAINER SUSPENSE A/C

	Unit	Rate	Amt		Unit	Rate	Amt.
Container (returned)	XX	CBP	XX	Bal. B/d	XX	CBP	XX
Cont. retained	XX	CBP	XX	Invoice	XX	COP	XX
Profit on hiring	XX	CBP	XX				
Bal. c/d			XX				
	XXX		XXX		XXX		XXX

CONTAINER STOCK / INVENTORY A/C

	Unit	Rate	Amt		Unit	Rate	Amt.
Bal. b/d – warehouse	XX	VP	XX	Bal. B/d	XX	SV	XX
- With	XX	VP	XX	Invoice	XX	CBP	XX
customers	XX	VP	XX	Profit	XX	-	XX
Purchase	_		XX	Bal C/d-	XX	VP	XX
Repairs	_		XXX	Factory	XX	VP	XX
P & L a/c	XXX		XXX	- Custo mer	XXX		XXX

Illustration 1

A farmer used aluminum containers to sell his product in the following pattern:

Containers b/f	133,600
Containers charged out	217,100
Containers returned	158,650
Containers returnable	116,900

Calculate the quantity of containers retained by customers

Solution

Container with customs b/f			133,600	
Charge out		217,100		
				350,700
Less:				
Returned	158,650			
Returnable	116,900	275,550		
Retained				75,150

s

Illustration 2

The Ogiso Company supplies gas in expensive containers, which are returnable after use. These containers cost ₦20.00 each and are charged out to customers on sale return with six months at ₦26.00 each. Provided they are returned within six months period they are credited at ₦23.00 each. As each container is retuned, it is inspected and overhauled at a cost of ₦2.00.

At the end of the year the company values all returnable containers in customer hands and container held in stock at ₦l6.00 each.

You are advised that:

During the year 3,100 new containers were purchased, 20,620 were invoiced to customers and 1 7,960 were returned.

On inspection 260 required additional repairs costing ₦325 and 56 to he sold as scrap for ₦60.00

From the information given above prepare:

(a) Returnable containers suspense account:

(b) Container stock account:

CONTAINER SUSPENSE A/C

	Qty	Rate	Amt		Qty	Rate	Amt.
Debtors (returned)	17,960	23	413,080	Bal. B/d	4,790	23	110,170
Retained	4,540	23	104,420	Invoice	20,620	26	536,120
Profit on hiring	-	-	61,860				
Bal. c/d	2,910	23	66,930				
							646,290
	25,410		646,290		25,410		

CONTAINER STOCK A/C

	Qty	Rate	Amt		Qty	Rate	Amt.
Bal. b/d – factor	2,760	16	44,160	Scrapped	56		60
Containers	4,790	16	76,640	Retained	4,540	23	104,420
Purchase	3,100	20	62,000	Profit on hiring	-	23	61,860
Repairs			36,245	Bal. c/d – factory	3,144	-	50,304
P & L a/c			44,159	Container	2,910	16	46,560
	10,650		263,204		10,650	16	263,204

Working 1. **Calculation of containers retained**

			Units
Bal. b/d			4,790
Invoice to customers			20,620
			25,410
Returned		17,960	
Bal. c/d	2,910		(20,870)
		4,540	

Working 2. Profit on hiring

(26-23 x 20,620

= N3 x 20,620 =N61,860

Method 2

It involves recording transactions in the following account:

1. Container Stock Account, which keeps records of stocks of containers alone. Stocks are recorded at value except purchases, which is recorded at cost of purchases, and depreciation, which is credite cost of purchase.
2. Container suspense account: This is basically used to monitor the movement of containers in customers and recorded at refundable amount/price.
3. Container sent to customers account: This is a total account used in monitoring debtors' balan transactions at charge out price.
4. Container profit and loss account: This is used to ascertain profit or loss on all the transactions.

CONTAINER SENT TO CUSTOMER A/C

	Unit	Rate	Amt		Unit	Rate	Amt.
Bal. c/d	XX	COP	XX	Returned	XX	COP	XX
Invoice	XX	CBP	XX	Retained	XX	COP	XX
				Bal. B/d		COP	XXX
	XXX		XXX		XXX		XXX

CONTAINER SUSPENSE A/C

	Unit	Rate	Amt		Unit	Rate	Amt.
Returned	XX	CBP	XX	Bal. b/d	XX	COP	XX
Retained	XX	CBP	XX	Invoice	XX	COP	XX
Bal. C/d	XX	CBP	XXX				
	XXX		XXX		XXX		XXX

CONTAINER STOCK A/C

	Unit	Rate	Amt		Unit	Rate	Amt.
Bal. b/d factory	XX	VP	XX	Returned to scrap	XX	VP	XX
- Customer	XX	VP	XX	Depreciation	-	-	XX
Purchase	XX	PP	XX	Destroyed	XX	VP	XX
P & L a/c			XX	Scrapped	XX	-	XX
				Retained	XX	VP	XX
				Factory	XX	VP	XX
				Scrap value	XX	-	XX
				Bal. c/d factory	XX	VP	XX
				- Customer	XX	VP	XX
	XXX		XXX		XXX		XXX

P & L ON CONTAINER

	₦		₦
Dep6reciation on containers	XX	Profit on hiring	XX
Containers destroyed (VP	XX	Profit on containers retained	XX

s

Container scrapped (VO) other expenses	XX	Proceed on scrapped container (con. Stock	XX
	XX		
General P && L a/c	XXX		XXX

Accounting Entries

a. Dr. container stock a/c
   Cr. Cash / Bank a/c (with purchase price)
b. Dr. P & L on containers
   Cr. Containers stock a/c (with depreciation value i.e. the difference between valuation price and purchase price X by the net numbers of container purchased)
c. Dr. Suppliers a/c
   Cr. Containers stock a/c (with containers returned to suppliers)
d. Dr. P & L on containers
   Cr. Containers stock (with containers destroyed/scraped at valuation price)
c. Dr. cash / bank a/c
   Cr. Containers stock a/c (with the proceeds realized on the containers disposed of)
f. Dr. container sent to customer a/c (at the charged Out price)
   Cr. Containers suspense a/c (at the credit back price)
   Cr. P & L a/c (with the profit on hiring out to customers)
g. Dr. containers suspense a/c (with the containers returned at credit back price)
   Dr. cash bank (with net proceeds on containers returned i.e. COP — CBP)
   Cr. Containers sent to customer a/c (with he containers returned at charged out price)
h. Dr. containers suspense ale (with the number of containers retained at the credit back price)
   Cr. Container stock a/c (with the number of containers retained at the valuation price)
   Cr. P & L a/c on containers (with profit on container retained i.e. the difference between credit back price arid the valuation price MULTIPLY by the number of containers retained)

Illustration 3.2

Using the information in illustration 3.1, prepare the following account:

- Container Stock A/c
- Container Suspense A/c
- Container sent to customer A/c
- Profit and loss on Container.

CONTAINER SENT TO SUSTOMERS A/C

	Qty	Rate	Amt		Qty	Rate	Amt.
B/d	4,790	26	124,540	Returned	17,960	26	466,960
Invoice	20,620	26	536,120	Retained	4,540	26	118,040
				Bal. c/d –factory	2,910	26	75, 660
	25,410		660,660		25,410		660,660
bal. b/d	2, 910		75, 660				

CONTAINER SUSPENSE A/C

	Qty	Rate	Amt		Qty	Rate	Amt.
Returned	17,900		413,080	Bal. b/d	4,790		110,170
Retained	4,540	23	104,420	Invoice	20,620		474,260
Bal. c/d	2,910	23	66,930				
	25,410		584,430		25,410		584,430
				Bal. b/d	2,910		66,930

CONTAINER STOCK A/C

	Qty	Rate	Amt		Qty	Rate	Amt.
Bal b/d factory-	2,760	16	44,160	Returned to scrap		-	
Customer	4,790	16	76,640	Depreciation P & L	-	-	12,400
Purchase	3,100	20	62,000	retained	4,540	16	72,640
P & L a/c			60	Scrapped P & L	56	16	896
				Scrap value			
				Destroyed P & L	XX	VP	60
				Bal. c/d – factory-	3,144	16	50,304
				ustomer	2,910	16	46,560
	10,650		182,860		10,650		182,860

P & L ON CONTAINER

	₦		₦
Value price of container scrapped	896	Profit on hiring	61,860
Depreciation	12,400	Profit on containers retained	31,780
Repairs	36,245	Scrap value on containers	60
Net profit	44,159		
	93,700		**93,700**

4.0 CONCLUSION

Most manufacturers or producers of goods/products package their products in one form or the other, using different forms of material enclosure. The packages used in dispatching goods to customers are referred to as containers. For example, drum for chemicals or liquid products, case or wooden/plastic crate for eggs and other breakable products, packets for cigarettes, bottles, cartons, and cans. Containers make it very convenient to move goods from one location to another and also form the basis for monitoring the movement of such containers, both in the warehouse and in the customers' hands. In accounting literature, a container is looked at from two main standpoints – either as non-returnable or returnable.

5.0 SUMMARY

This study unit has:

- Defined a container
- Discussed how containers are accounted for in accounting
- Showed accounting entries to be made in financial records.

6.0 TUTOR -MARKED ASSIGNMENT

1. What the problems associated with returnable containers? Enumerate eight of such problems.
2.Agunbiade& Co. Limited is a chemical manufacturing company. These chemicals are stored in containers before sales are made to customers. Each container cost N4,000 and invoiced to customers at N7.000 on three basis of sale or return within three months. The following transactions took place during six months ended 30th June 1998.

Opening Stock:

A warehouse	100 containers
With customers	80 containers
Sent to customers	450 containers
Returned by customers	350containers
Paid for by customers	50 containers
Purchases	140 containers
Scrapped at NI .500 each	36 containers
Repairs to containers	₦38. 000

Required:

Prepare container stock account and container suspense account showing profit to be taken in the company's profit and loss account.

7.0 REFERENCES/FURTHER READING

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UNIT SIX: CONSIGNMENT ACCOUNTS

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
3.1 Key term
3.2 Valuation of Stock and Format
3.3Accounting Entries
4.0 Conclusion
5.0 Summary
6.0 Tutor-Marked Assessment
7.0 References/Further Reading

1.0 Introduction

If the owner of the goods does not have retail outlets, he can consign the goods to an agent who will sell and receive a commission in return. In Accounting, the term "consignment account" relates to accounts dealing with a situation where one person (or firm) sends goods to another person (or firm) on the basis that the goods Will be sold on behalf of and at the risk of the former.

2.0 Objectives

After studying this unit, students will be able to:

- Define consignment and understand key terms pertaining to such transactions:
- Prepare necessary accounts in the books of the consignor
- Prepare necessary accounts in the books of the consignee

3.0 Main Content

3.1 key Terms

Consignment Account

Consignment Account relates to accounts dealing with such business where one person sends goods to another person on the basis that such goods will be sold on behalf of and at the risk of the former.

Consignment

Where a trader, i.e. the consignor, sends goods to his agent, i.e. the consignee to sell and collect the money from customers for him, the goods are said to be sent on consignment. Goods are usually sent on consignment to an agent in a different country. Goods sent on consignment belong to the sender, i.e. the consignor, until that are sold.

A consignor

A consignor is a trader who (as principal) sends goods to another (the agent) to sell them on his behalf for a reward, that is for commission.

A consignee

A consignee is the agent to whom goods are sent on consignment. His job n is to sell the goods, collect the money from customers and to remit the money to the consignor after deducting an agreed remuneration called commission.

Commission

Commission is the remuneration paid by the consignor to the consignee for the services rendered to the former for selling the consigned goods. Three types of commission can be provided by the consignor to the

consignee, as per the agreement, either simultaneously or in isolation. They are:

Ordinary Commission: The term commission simply denotes ordinary commission. It is based on fixed percentage of the gross sales proceeds made by the consignee. It is given by the consignor regardless of whether the consignee is making credit sales or not. This type of commission does not give any protection to the consignor from bad debts and is provided on total sales.

Del-credere commission: To increase the sale and to encourage the consignee to make credit sales, the consignor provides an additional commission generally known as del-credere commission. This additional commission when provided to the consignee gives a protection to the consignor against bad debts (i.e. bad debts is no more the loss of the consignor. It is calculated on total sales unless there is any agreement between the consignor and the consignee to provide it on credit sales only.

Over-Riding Commission: It is an extra commission allowed by the consignor to the consignee to promote sales at higher price then specified or to encourage the consignee to put hard work in introducing new product in the market. Depending on the agreement it is calculated on total sales or on the difference between actual sales and sales at invoice price or any specified price.

An **account sale**
The periodical summary statement sent by the consignee to the consignor
It contains details regarding -
(a) sales made,
(b) expenses incurred on behalf of the consignor,
(c) commission earned,
(d) unsold stock left with the consignee,
(e) advance payment or security deposited with the consignor and the extent to which it has been adjusted,
(f) balance payment due or remitted. It is a summary statement and is different from Sales Account

Pro Forma invoice
Since the goods on consignment are not deemed to have been sold to the agent, he is not invoiced for them. Instead, a pro forma invoice is used for a form's sake when the goods are sent.

A proforma is not a charge but only used to provide information on the goods and to indicate the price at which the consignee is expected to sell them.

3.2 Valuation of Inventory
The principle is that Inventory should be valued at cost or net realizable value whichever is lower, the same principle as is practiced for preparing final accounts. In the case of consignment, cost means not only the cost of the goods as such to the consignor but also all expenses incurred till the goods reach the premises of the consignee. Such expenses Include packaging, freight, cartage, insurance intransit, etc. But expenses incurred after the goods have reached the consignee's (such as rent, insurance, delivery charges) are not treated as part of the cost of purchase for valuing stock on hand.
= Consignor's Cost +Consignee's Expenses
Consignor's cost
= Total consignor's cost * Units of closing Inventory / Total units of goods SENT on consignment
= [Cost of goods on consignment + Consignor's expenses] * Units of closing Inventory / Total units of goods SENT on consignment
Consignee's expense
= Total consignees expenses (excluding marketing expenses) * Units of closing Inventory / Total units of

goods RECEIVED by consignee (after normal loss)

Marketing expenses e.g. advertising expenses,ordinary commission,del-credere commission, salesmen's salaries, bad debts, discounts allowed, delivery charges(to customers), selling expenses, distribution expenses.

3.3 Accounting Entries

Consignor's Books

Transactions	Double entries
1. Goods sent on consignment	Dr Consignment Cr Goods sent on consignment
2. Expenses incurred by the consignor.	Dr Consignment Cr Bank
3. Expenses incurred by the consignee and the commission payable to the consignee.	Dr Consignment Cr Consignee
4. Sales recorded on the account sales	Dr Consignee Cr Consignment
5. Normal loss Normal loss of stock of the consignment which was not insured. (Normal loss: damaged stock, obsolete stock)	No entry
6. Insurance claim received for normal stock loss	Dr Bank Cr Consignment
7. Abnormal loss Abnormal stock loss credited to consignment account. (Abnormal loss: fire loss, burglary loss, stolen in transit)	Dr Bank/Insurance company Dr Profit and Loss Cr Consignment(Total loss)
8. Payment from the consignee by cheque or bill	Dr Bank/Bills receivable Cr Consignee
9. Cost of goods sent on consignment credited to trading account.	Dr Goods sent on consignment Cr Trading account
10. Profit on the consignment is transferred to the profit and loss account. (Reverse the entries if it is a loss.)	Dr Consignment Cr Profit and loss

Consignee's books

Transactions	Double entries
1. Goods received form consignor.	No entry
2. Expenses paid by the consignor.	No entry
3. Commission received (ordinary and del-credere commission).	Dr Consignor Cr Commission Received

4. Expenses paid on behalf of the consignor.	Dr Consignor Cr Bank
5. Discounts allowed to customers/	Dr Consignor Cr Debtors
6. Bad debts borne by the consignor.	Dr Consignor Cr Debtors
7. Bad debts borne by the consignee personally. (When the consignee receives a del credere commission, he should bear all losses from bad debts)	Dr Profit and Loss/Bad Debt Cr Debtors
8. Cash sales	Dr Bank/Cash Cr Consignor
9. Credit sales	Dr Debtors Cr Consignor
10. Payment to the consignor by cheque or bill	Dr Consignor Cr Bank/Bill payable

Illustration 1

On 21 February. 1997 Peter consigned to his agent James 95 tricycle which cost ₦2.700 each. Insurance and freight amounted to ₦I 6,200. James is entitled to a commission of I 0% of gross sales. A bill was drawn and accepted by James for N200.000.

Five(5) tricycles were destroyed in transit. James immediately returned 10 of the tricycles, which were of the wrong description and paid return freight and insurance of ₦3,000. peter whose financial year ended on 3O' June, 1997 received from James an account of sales, made up to that date this showed that James has sold 60 tricycles for ₦324.000 and that he had paid warehouse charges on the Consignment N4.800 (less returns) and carriage on the tricycles sold for *₦4,500.* the bill matured and was paid accordingly. James sent a sight draft in settlement of the balance due on which Peter incurred bank charges of N900. The insurance claim on Tricycles destroyed of ₦12.00 was received.

James sold the remaining Tricycles for ₦96.000 incurring expenses of ₦2,400. He sent Peter a second account of sales made up to 30th September. 1997 accompanied by a sight draft for the balance due on which Peter incurred bank charged of ₦600.

You are required to:

(a) Write up (for the period of 30/9/97) the Consignment account and consignee's a/c in Peter's books.

(b) Consignor's account in James book.

Suggested Solution

(a) IN THE BOOKS OF PETER

CONSIGNEE (JAMES) A/C

	N		N
Consignment a/c 24.000		Bill receivable	200,000
Warehouse exp.	4.800		
Carriage outwards	4,500		
Commission	32.400		
Bank	82,300		
	324.000		324,000

s

Consignment a/c	96.000	Expenses	2,400
Commission	9,600		
Bank	84.000		
96.00096,000			

(b) **CONSIGNMENT TO JAMES A/C**

		₦		₦
Consignment outwards		256,500	Insurance claim	12,000
Insurance		16.200	Consignment out.(Ret)	27.000
Insurance		3,000	James Sales	324.000
Consignment warehouse		4.800	Closing Stock a/c	59,242
Carriage out.		4.500		
Bank charges		900		
Commission 10%		32,400		
P&L Profit	103.942			
		422,242		422,242
Bal. b/d		59,242	James - Sales	96,000
Bank charges		600		
Commission : 10%	9,600			
Expenses		2,400		
P&L-Profit	24,158			
		96.000		96.000

IN THE BOOKS OF' JAMES
CONS1GNOR'S (PETER A/C

		₦		₦
Bill Payable		200,000	Bank Sales	324.000
Bank - warehouse exp.	4.800			
- Commission		32.400		
- Carriage out.	4.500			
-Draft		82,300		
		324.000		324.000
Expenses		2,400	Bank — Sales	96.00
Commission		``9,600		
Bank		84,000		
		96.000		**96.000**

4.0 CONCLUSION

Consignment accounts are usually necessary where a business is separated from its customers or client either as a result of geographical separation or some other factors. These goods are usually dispatched to the consignee. The goods never become the property of the consignee. Therefore, he incurs no liability as a result of the transaction until the goods are sold, when he becomes liable for payment of the proceeds. He is paid by a commission. The consignor and consignee will both keep their separate records.

5.0 SUMMARY

This study unit has Explained the arrangement involved in consignment accounts; Discussed the basic terms in consignment accounting; Outlined the accounting entries needed to be made in the books of the consignor and consignee. Discussed how stocks are valued; Discussed how losses are treated. Prepared consignment account both in the books of the consignor and the consignee.

Goods are normally consigned to agents abroad. When sent, the goods continue to belong to the principal (consignor), until they are sold. It is for this reason that the goods are not invoiced to the agent (consignee) and the consignment is not recorded in the double entry accounts of the consignee.

The consignment is only accompanied by a Proforma Invoice indicates the price at which the goods are expected to be sold.

After selling the goods the agent submits an Account Sales to the principal which sates total proceeds from sales. All expenses incurred by the agent and the agent's commission(s) are shown as a deduction from income on the Account Sales.

In valuing unsold stock, account is taken of only expenditure concerning the Whole consignment up to the stocktaking date.

6.0 TUTORS MARKED ASSESSMENT

ALABO LTD is a retailer trading in Portharcourt using agents to sell goods in Ibadan.The arrangement is that the agent sells goods at cost plus one - third and earns a commission of 2/2% on all sales. The necessary expenses incurred by the agent are deductible from sales proceeds. Transactions during the year ended 3l December, 1999 were:
Goods costing N 126,000 were consigned to LAM Ltd the agent in Ibadan. ALABA Ltd paid N2,600 and N200 for freight and insurance respectively on this consignment. An account of sales received LAM Ltd showed gross sales of NI 34,400. warehousing and insurance expenses of N3,200 and selling expenses of N 1,300 LAM Ltd. Also deducted their commission entitlement.

Required:

(a) Show the necessary ledger accounts in the book of ALABO Ltd.
(b) Show ledger accounts in the books of LAM Ltd.
(c) Prepare account sales for LAM Ltd. (HINT: An account sales is normally prepared by the consignee This shows the sales value, the expense, the commission and the balance to be remitted to the consignor (if any).

7.0 REFERENCES/FURTHER READING

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UNIT SEVEN: INVESTMENT

CONTENTS

1.0 Introduction
4.0 Objectives
3.0 Main Content

3.1 Purpose of Maintaining Investment Account
3.2 Key Concepts
3.3 Investments without Fixed Interest
3.4 Fixed Interest Security

4.0 Conclusion
5.0 Summary
6.0 Tutor-Marked Assessment
7.0 References/Further Reading

INTRODUCTION

Investments are assets (Shares, **Bonds)** held by an enterprise for earning income by way of dividends, interests and rentals, for capital appreciation, or for other benefits to the investing enterprise. An investment could be on either fixed interest securities (Debentures/Loan stocks) or equities. Investment in fixed interest securities attracts fixed interest on the NOMINAL VALUE of the Investment. The interest may be paid annually semi-annually or quarterly.

Value of the investment is the (QUOTED price x Nominal value) Plus other cost (If purchases) or LESS other cost (if sales)

2.0 OBJECTIVES

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

- Explain the theoretical aspects of investment accounting;
- Prepare investment accounts.

3.0 MAIN CONTENT

3.1 Purpose of Maintaining Investment Accounts

- It helps in keeping a record of each security separately.
- It helps to ascertain the value of securities at the end of the accounting period.
- It is helpful in collection of interest and dividend as and when they become due.
- It is helpful in ascertaining the amount of accrued income at the end of the accounting period.
- It facilitates the determination of the profit or loss on sale of any security.

3.2 Key Concepts

A. Profit or Loss on the Disposal of Investments

Profit or loss on disposal of investments is calculated by this equation:
Profit on disposal = (Selling price-Selling expense) – Cost of investment sold

B. Cost of investment

There are 2 methods for calculating the cost of the investments:

1. Weighted average method

- Using this method, the cost of the investment sold is determined by the average of investment held.

2. First-in-first-out method
   - Using this method, the cost of the investment sold is determined by the unit price of the investment that is purchased earliest.

3. When two prices are quoted, for example 60k to 75k. the lower is the purchase price and the higher being the sale price. For balance sheet purpose the mid-market prices is taken. Investment account will be prepared for each security.
4. Investment account is prepared for each security

INVEST A/C

	Nominal	Income	Capital		Nominal	Income	Capital

3.3 Investments without Fixed Interest

These are mainly ordinary shares.

Accounting Procedures

Transactions	Accounting entries
1. Cost of investment purchased (cost + other acquisition cost, e.g. brokerage fees, commission and stamp duty)	Dr Investments (Capital+nominal) Cr Bank
2. Receipt of dividend	Dr Bank Cr Investment Income
3. Sale of investment (proceeds – other selling expenses e.g brokerage fees, commission and stamp duty)	Dr Bank Cr Investments (capital+nominal)
4. Profit on sale on investment (reverse the entries for a loss on the sale of the investment)	Dr Investments (Capital) Cr Profit and Loss
5. Transfer of income to the profit and loss account at the end of the accounting year	Dr Investment Income Cr Profit and Loss

Illustration 1

On 1 January 1996, Fortune Ltd. Purchased 1,000 ₦1 ordinary shares in Lucky Ltd. At 96. The brokerage fee incurred was ₦100. On 30 June 1996, Fortune Ltd. Received a dividend of ₦0.1 per share. On 31 December 1996, Fortune Ltd. Sold 500 shares at 120. A ₦30 brokerage fee was paid.

Investment – Ordinary Shares in Lucky Ltd.

Date	Particulars	N	I	C	Date	Particulars	N	I	C
1996		₦	₦	₦	1996		₦	₦	₦
1/1	Bank – purchase				30/6	Bank – dividend			
	(1000*0.96)+100	1000		1060		(1,000 x 0.1)	100		
31/12	P&L – gain				31/12	Bank – sale			

570-(1060*500/100)			40	(500*1.2-30)	500		570
31/12 P&L-dividend		100		31/12Bal. c/f	500		530
	1,000	100	1100		1000	100	1100

3.4 Fixed Interest Security

The investment can be purchased/sold cum-Div/INT (including dividend) or ex-Div/INT) (excluding dividend).

They can be preference shares, debentures and government stocks. Investment income is distributed once or twice a year at given date.A company is only entitled to income from an investment for the exact period that the investment is held.

If the acquisition occurs between 2 payments dates, either the seller or the buyer will have the rights to receive interest. However some interest belongs to the seller and some belongs to the buyer; adjustments are to be made for the accrued income.

Ex. Div./Ex. Int.(excluding dividend)
When the price of the investment does not include the right to the next installment of dividend or interest, …..ex div…..
Cum. Div./ Cum. Int. (including dividend)
Where it does include the right to receive the next installment of interest
Prices are cum div. Unless stated the otherwise.

Purchase at Cum. Div / Cum. Int.
The buyer of investments has the rights to receive the entire income payable on the first payment date after acquisition.
The extra income for the period from last payment to acquisition reduces the cost of the investments.

Cost of investment		₦
Purchase price		x
Add Brokerage fee / Commission		x
	x	
Less Accrued income given up by seller		
(Nominal value*Interest rate*No. of months from the last payment date to acquisition) / 12		x
		x

Accounting entries

Dr Investment (N+C) Dr Investment Income (I) Cr Bank	With the cost of the investment With the excess income receivable With the total amount paid

Illustration 2
On 31 April 1994, Gordon Ltd. purchased ₦10,000 of 12% preference shares in Joyce Ltd. cum. div. at 90. A ₦200 brokerage fee was paid. Interest was paid on 31 December and 30 June every year.

Investment – Ordinary Shares in Lucky Ltd.

Date	Particulars	N	I	C	Date	Particulars	N	I	C
1996		₦	₦	₦	1996		₦	₦	₦
1/1	Bank – purchase				30/6	Bank – dividend			
	(1000*096)+100	1000	400	8800		(10000*12%*1/2)			

31/12 P&L – gain				31/12 Bank – sale		600	
31/12 P&L-dividend		800		31/12Bal. c/f	10000		800
	10,000	1200	8800		10,000	1200	800

Dividend given up bu seller (from the last payment date to acquisition)
=₦ 10,000 x 12% x 4/12 = ₦400

Purchase at Ex. Div. / Ex. Int.

The buyer of investments does not have the rights to receive any interest / dividend income payable on the first payment date after acquisition.

The income given up should be included in the cost of the investments.

Cost of investment		₦
Purchase price		x
Add Brokerage / commission		x
Dealing Price	X	
Add interest given up to seller		
(Nominal value*interest rate*no. of months from		x
acquisition to the coming payment date/12)	X	

Accounting entries

Dr Investment (C+N) Cr Bank	Dealing price
Dr Investment (C) Cr Investment Income	Interest given up for the period from acquisition to the coming payment date

Illustration 3

The facts are the same as illustration 2, except that the investment was purchased at ex. div.

Investment – Ordinary Shares in Joyce Ltd.

Date	Particulars	N	I	C	Date	Particulars	N	I	C
1996		₦	₦	₦	1996		₦	₦	₦
1/1	Bank – purchase (1000*09+200)	10,000		9,200	30/4	Investment – ex. div.		200	
					31/12	Bank – dividend		600	
30/4	Investment Income -ex. div.		200		31/12	Bal. c/f	10,000		9,400
31/12	P&L-dividend		800						
		10,000	800	9,400			10,000	800	9,400

Dividend given up seller (from acquisition to the coming payment date)
=₦ 10,000 x 12% x 2/12 = ₦200

Sell at Cum. Div. / Cum. Int.

The seller of investments gives up the rights to receive the income on the first payment date after sale.

The income given up reduces the net sale proceeds. The net sale proceeds should be calculated in the following way.

Net sale proceeds: ₦

Selling price		x
Less Brokerage fee/ Commission		x
		x
Less Accrued income given up by seller		
(Nominal value*Interest rate*No. of months from last	x	
payment date to date/12)		x

Accounting entries

Dr Bank Cr Investment Income (I) Cr Investment (C+N)	With the total sale proceeds With accrued income given up With the net sale proceeds

Illustration 4

The facts are the same as in Illustration 3. On 1 Feb 1995, Gordon Ltd. sold ₦5,000 12% preference shares in Joyce Ltd. cum. div. At 95. A ₦250 commission was paid.

Investment-Ordinary Shares in Joyce Ltd

Date	Particulars	N	I	c	Date	Particulars	N	I	C
1995					1995				
1/1	Bal b/f	10,000		8,800	½	Bank-sales (5000x095-250-50)	5000	50	4450
31/12	P&L – dividend		650		30/6	Bank-dividend		300	
31/12	P&L – Profit on disposal (4450-8800x5000/10000)			50	31/12	Bank-dividend		300	
					31/12	Bal c/f	5000		4400
		10,000	650	8850			10,000	650	8850

Dividend given up by seller (from the last payment date to the date of sale)

= **₦5,000 x 12% x 1/12 = ₦50**

Sell at Ex. Div./Ex. Int.

The seller will receive the income on the first payment date after sale.

The extra income increases the total sale proceeds.

Total Sales Proceeds		₦
Selling Price	x	
Less brokerage fee / commission	x	
Dealing Price	X	
Add Dividend given up by buyer		
(**Nominal value*Interest rate*No. of month from acquisition To the coming payment date)**		X

Accounting entries

Dr Bank Cr Investment Dr Investment Income Cr Investment	Dealing price Excess income receivable for the period from sale to the coming payment date

4.0 CONCLUSION

Investment accounting is a very important aspect of accounting and as such, thorough understanding of the theoretical aspect of it is indeed very beneficial.

5.0 SUMMARY

In this unit, details of the double entry principles and related books of accounts maintained by the operators of investment, underwriting and stock broking firms were extensively discussed and practical solutions were made to some examples.

6.0 TUTOR-MARKED ASSIGNMENT

1. Distinguish between investment purchased or sold Cum– Div and Ex – Div.

2Akinloye Ltd raises additional capital to carry out is budgeted expansion plan. The economic situation, however, has made it advisable for the company to postpone its plans until a more favourable time, and in consequence the company has surplus funds for temporary investment. The following transaction took place during the year ended 30 September, 1996.

1995:

Oct 1:	Purchased =N+100,000 9% Treasury Bill at 68. Interest payable- 1 January and 1 July.
	Purchased =N=100,000 10% FRN 21st Development stock at 98. Interest payable- 31 March and 30 September.
	Purchased 50,000 Union Bank =N= 1 ordinary shares at 280.
Dec 31:	Sold =N+ 50,000 10% FRN 21st Development Stock 1t 97.
	Purchased =N=50,000 9% Treasury Bill 1992-1996 at 70 ex div.

1996

Jan 1:	Received interest on 9% Treasury Bill
Mar 31:	Received interest on 10% FRN 21st Development Stock
	Received interest dividend on Union Bank shares at 4k per share.
July 1:	Received interest on 9% Treasury Bill 1992-1996
Sept 15:	Received final dividend of 6k per share on Union Bank shares.
30	Received interest on 10% FRN 21st Development stock 19X9.

At 30 September 1996, the market values of the securities were:

9% Treasury bill 1992-1996	66
10% FRN 21st Development stock 19 x 7 99	
Union Bank shares	270

(Ignore taxation, brokerage and other fees.)

You are required to prepare the investment accounts of Akinloye Ltd in respect of the year ended 30 September 1997.

7.0 REFERENCES/FURTHER READINGS

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UNIT EIGHT BILL OF EXHANGE

CONTENTS

1.0 Introduction
2.0 Objectives

3.0 Main Content
3.1 Definition of Bill of Exchange
3.2 Types of Bill of Exchange
3.3 Characteristic/features of Bill of Exchange
3.4 Parties to Bill of Exchange
3.5 Advantages of Bill of Exchange
3.6 Important Terms
3.6 Discounting Bill
3.8 Accounting Treatment of Bill of Exchange
4.0 Conclusion
5.0 Summary
6.0 Tutor-Marked Assignment
7.0 References/Further Readings

1.0 INTRODUCTION

Under normal trading arrangements, the period of time which elapses between goods and services being supplied and being paid for can vary from two weeks to six months or even longer. The supplier may not wish to wait so long for payment because he may need the cash to finance his current operations. One way in which the supplier can obtain payment at an early stage whilst at the same time allowing the purchaser the benefit of the full credit period, is for the parties to agree to the use of a bill of exchange to finance the transaction.

5.0 OBJECTIVES

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

- define a bill of exchange
- explain the types of bills of exchange available
- enumerate the main parties to a bill of exchange state how the accounting entries are made in the books
- prepare bills of exchange accounts.

3.0 MAIN CONTENT

3.1 Definition of Bill of Exchange

A bills of exchange is 'An unconditional order in writing addressed by one person to another signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a sum certain in money, or to the order of a specified person, or to bearer' (A bills of exchange Act, 1882).

A cheque is a specialized form of bill of exchange, drawn on a banker and payable on demand.

3.2 Types of Bills of Exchange

(i) Inland Bill: This is a bill of exchange drawn and payable in Nigeria.

(ii) Foreign Bill: This is a bill drawn in Nigeria and payable in another country.

(iii) Accommodation Bill: An accommodation bill is a bill of exchange, which has been accepted, drawn or endorsed by a person, known as accommodation party, not for valuable consideration but for the sole purpose of lending his name/reputation to another person, known as accommodation party, so that the accommodated party can enjoy some benefits which he could not have enjoyed otherwise. Such benefits, of course, depend on the exact nature of the accommodation bill. They include, but are not limited to the following:
The accommodated party can enjoy credit facility from his supplier because the latter would be reassured by the reputation of the accommodated party;
The accommodated party can raise funds by discounting the accommodation bill, with a financial institution because, with the reputation of the accommodation party, the financial institution is reasonably assured that it can recover the debt.

3.3 Characteristics/Features Of A Bill Of Exchange Are

1.It is a written order.
2.It is an unconditional document.
3.The amount of bill must be certain.
4.The date of payment, place and period must be fixed.
5.It must signed by the maker.
6.It must be signed by the acceptor.
7. The amount written in the bill either on demand or expiry of fix period.

3.4 Parties to abill of exchange

- DRAWER:A person who draws (writes) a bill is called drawer.

- DRAWEE: Drawee is the person on whom the bill of exchange is drawn for acceptance. Drawee is the person to whom credit has been granted by thedrawer. The drawee is liable to pay money to the creditor/drawer.
- PAYEE: Payee is the person who receives the payment from the drawee. Usually the drawer and the payee are the same person. In the following cases. drawer and payee are two different persons
  When the bill is discounted by the drawer from his bank- payee is the bank.
  When the bill is endorsed by the drawer to his creditors: payee is the endorsee.

3.5 Advantages of bill of exchange

1. It helps in purchases and sales of goods on credit basis.
2. It is a legally valid document in the eyes of law.
3. A bill can be discounted from the bank before its date of maturity.
4. It can be easily transferred from one person to another by endorsement.
5. It helps in recovery of debt without sending reminders to the debtor.
6. It assures the seller about the timely recovery of debt.

3.6 Important Terms

Term of Bill: The period intervening between the date on which a bill is drawn and the date on which it becomes due for payment is called 'Term of Bill'.

Due Date: Due date is the date on which the payment of the bill is due.Due date is ascertained in the following manner:
(i) In case of 'Bill at sight' -
Due date is the date on which a bill is presented for the payment.
(ii) In case of 'Bill after Date' -
Due Date = Date of Drawing + Term of Bill.
(ii) In case of ' Bill after sight' –
Due date = Date of Acceptance + Term of Bill.

Days of Grace:
Drawee is allowed three extra days after the due date of bill for making payments. Such 3 days are known as 'Days of Grace'. It is a custom to add the days of grace.

Date of Maturity:
The date which comes after adding three days of grace to the due date of a bill is called 'Date of maturity'.

Endorsement of Bill:
Endorsement of a bill: "Process of transferring the title of bill from the drawer or holder to their creditors."

- The person transferring the title is called "Endorser" .
- The person to whom the bill is transferred called 'Endorsee'.

NOTE: The endorsee can further endorse the bill infavor of his creditors.
Endorsement is executed by putting the signature at the back of the bill.

Dishonour of Bill:
When the drawee (or acceptor) of the bill fails to make payment of the bill on the date of maturity, it is called 'Dishonour of Bill.

Noting of Bill:
To obtain the proof of dishonour of a bill, it is re-sent to the drawee through a legally authorized persons called Notary Public. Notary Public charges a small fee for providing this service known as noting charges.
Noting charges are paid to the Notary Public first by the holder of the bill but are ultimately recovered from the drawee, because he is the person responsible for the dishonour.

Retirement of a Bill:
When the drawee makes the payment of the bill before its due date,it is called 'Retirement of a bill'.In such a case, holder of the bill usually allows a certain amount as Rebate to the drawee.
Amount of rebate is calculated at a fixed percentage for the unexpired period only.

3.7 Discounting of Bill:
When the bill is encashed from the bank before its due date**,** it is known as discounting of bill. Bank deducts its charges from the amount of bill and disburses the balance amount.

Illustration 1
Deeksha sold goods to Khushi for ₦15,000 at credit on 1st April, 2013. Deeksha discounted the bill with his bank on 4th May 2013 @ 9% per annum find out :
(i) The amount of discounting charges.
(ii) The amount that Deeksha will receive from his bank at the time of discounting the bill.

Solution :
(i) Discounting Charges =

$$\text{Amount of Bill Discounted} \times \frac{\text{Rate}}{100} \times \text{Unexpired Period}$$

$$= 15{,}000 \times \frac{9}{100} \times \frac{2}{12} = \text{Rs. } 225$$

(ii) Ram will receive from his bank Rs. 14,775 (i.e., ₦15,000 - 225) at the time of discounting the bill.

3.8 Accounting Treatment of Bill Transactions

A. On the Due Date bill is Honoured –

The accounting treatment under this heading is based on the assumption that bill is duly honoured at maturity of the bill. The drawer can treat the bill in the following ways:

Case - I Bill is retained by the drawer till date of maturity:

Transaction	In the books of DRAWER	In the books of DRAWEE
1. When Goods are sold on credit	Drawee A/c Dr. To Sales A/c (Being goods Sold on credit)	Purchases A/c Dr. To Drawer A/c (Being goods purchased from Drawer)
2. When Bill is Drawn	Bills Receivable A/c Dr. To Drawee A/c (Being acceptance received from drawee)	Drawer A/c Dr. To Bills Payable A/c (Being acceptance given to drawer)
3. When Bill is Honored on Date of Maturity	Cash/Bank A/c Dr. To Bills Receivable A/c (Being payment of bill received from Drawee)	Bills Payable A/c Dr. To cash/Bank A/c (Being payment of bill made to drawer)

Case II : When the bill is discounted from the Bank by the Drawer

Transaction	In the books of Drawer	In the books of Drawee
1. When the bill is discounted from Bank	Bank A/c Dr. Discounting Charges A/c Dr. To Bills Receivables A/c (Being bill discounted for the Bank)	No Entry
2. When the bill is honored on date of maturity	No Entry	Bills Payable A/c Dr. To Cash/Bank A/c (Being the payment of bill made)

Case III : When bill is endorsed in favour of a creditor

Transaction	In the books of Drawer/ Endorser	In the books of Drawee
1. When bill is endorsed	Endorsee A/c Dr. To Bills Receivable A/c (Being bill receivable endorsed)	No Entry
2. When bill is honored on date of maturity	No Entry	Bills Payable A/c Dr. To Cash/Bank A/c (Being the payment of bill made)

Transaction	In the Books of Endorse
1. When bill is endorsed	Bills Receivable A/c Dr. To Endoreser (Being bill received from debtor through endorsement)

2. When bill is honoured on date of maturity	Cash/Bank A/c Dr. To Bills Receivable (Being Bill realised on date of maturity)

Case - IV When Bill is sent to the Bank for collection

Transaction	In the books of Drawer	In the books of Drawee
1. When bill is sent collecting to Bank	Bills sent for Collection A/c Dr. To Bills Receivable A/c (Being bill sent for collection)	No Entry
2. When the amount is realised on date of maturity	Bank A/c Dr. To Bill sent for collection A/c (Being the bill sent for collection realised on maturity)	Bill Payable A/c Dr. To Cash/Bank A/c (Being bill paid on date maturity)

Points to be Remember :

- Discounting charges are always recorded (i.e., debited) in the books of **Drawer.**
- In the books of Drawee, there is no effect of discounting charges.

Illustration 2

X sold goods to Y and drew a bill of Rs. 6,000 on Y which is accepted by the later. The bill is duly met on the due date by Y. What entries will be passed in the books of both the parties in the following cases:

1) If he retains the bill till due date
2) If he discounts it with his banker for Rs.5,800
3) If he endorses it to his creditor Z.

Journal Books of X

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
	Y A/c Dr.		6,000	
	To Sales A/c			6,000
	(Being goods sold to Y on credit)			
	Bills Receivable A/c Dr.		6,000	
	To YA/c			6,000
	(Being acceptance received from Y)			
	Case – I When bill is retained by X till the date of maturity			
	Cash/Bank A/c Dr.		6,000	
	To Bills Receivable A/c			6,000
	(Being amount received from B against bill)			
	Case – II When bill is discounted by X from his bank			
	Bank A/c Dr.		5800	
	Discounting Charges A/c Dr.		200	

To Bills Receivable A/c 6,000
(Being the bill discounted
from the bank, discounting Charges are

Case – III when bill is Endorsed in favour of Z

Z A/c	Dr.	6,000	
To Bills Receivable A/c			6,000
(Being bill endorsed in favour of Z)			

4.0 CONCLUSION

When goods are supplied to or services rendered on credit to a person, the supplier of the goods or services would normally wait for a considerable period of time before final payment is made. The supplier of these goods or services may be unwilling to wait till such a period when final payment is made as he/she may be in need of money to finance his/her current operations. He may, therefore, engage in any of the following:

5.0 SUMMARY

This study unit has: Defined a Bill of Exchange; Discussed the types of bills of exchange; Outlined the advantages of bills of exchange; Explained options available to the holder of a bill of exchange Explained the accounting entries in the books of both the drawer and drawee.

6.0 Tutor-Marked Assessment

BIMBO sells goods to John Ltd for N26,000 on January 1 2005.He drew bills of exchange which was accepted. He discounted the bills with the bank and suffered discounting charges of N8,000. On maturity, John Ltd met its liability. You are required to show the necessary accounts:

a. In the books of Bimbo
b. In the books of John Ltd.

7.0 REFERENCES/FURTHER READING

Jennings, A.R. (1993). Financial Accounting. London: Letts Educational.

UNIT NINE: PENSION ACCOUNTING

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1.0 Introduction

Employee compensation comes in many forms. Salaries and wages provide direct and current payment for services provided. However, it’s commonplace for compensation also to include benefits payable after retirement. Accounting for pension benefits recognizes that they represent deferred compensation for current service. Accordingly, the cost of these benefits is recognized on an accrual basis during the years that employees earn the benefits.

Pension plans are designed to provide income to individuals during their retirement years. This is accomplished by setting aside funds during an employee’s working years so that at retirement the accumulated funds plus earnings from investing those funds are available to replace wages. The basic nature of a pension plan is that the company and/or the employees make contributions to a fund manager. The manager invests the funds and makes payments to retired employees. The amount of the contributions to the fund manager is often determined by an actuary.

Corporations establish pension plans for a variety of reasons. Sponsorship of pension plans provides employees with a degree of retirement security and fulfills a moral obligation felt by many employers. This security also can induce a degree of job satisfaction and perhaps loyalty that might enhance productivity and reduce turnover. Motivation to sponsor a plan sometimes comes from union demands and often relates to being competitive in the labor market.

2.0 Objectives

After studying this unit, you should be able to:

- Understand the concept of pension
- Understand the different pension plans
- State the recognition, measurement, presentation and disclosure criteria of IAS 19: Employee benefits.
- Understand pension terminology
    - Know the provision major provision of the Pension Reform Act, 2004

3.0 Main Content

3.1 **Types of Pension Plans**

Defined Contribution Plans

Defined Contribution Pension Plan provides pension benefits in return for services rendered, provides an individual account for each participant, and specifies how contributions to the individual's account are to be determined instead of specifying the amount of benefits the individual is to receive. A participant's benefits depend solely on the amount contributed to the pension plan and the investment performance of the pension plan. *There are no particular accounting issues with this type of plan. Pension expense is equal to the employer contributions required.*

Employer contributes a defined sum (either a fixed sum or related to salary) to a third party
- – Ownership of plan assets assumed by plan trustee
- – Trustee is responsible for investment and distribution of plan assets

- Employee assumed the economic risk
  - – No guarantee made by employer as to benefits paid
- Cost of the plan in the current year is known with certainty
- Liability reported if contribution (funding) is less than required
- Asset reported if the amount contributed is more than required for the period
- When plan is first established or when there is an amendment to the plan, the employer may be obligated to make contributions for previous employee services (called prior or past service cost)

Defined Benefit Pension Plan

Defined Benefit Pension Plan defines an amount of pension benefit to be provided, usually as a function of one or more factors such as age, years of service, or compensation. *This type of plan requires complex accounting computations to compute pension cost (expense) and extensive footnote disclosures.*

Defined benefit plan promise fixed retirement benefits defined by a designated formula. Uncertainties complicate determining how much to set aside each year to ensure that sufficient funds are available to provide promised benefits. The employer bears all the risks of pension fund performance.

- It is a benefit plan that pension benefits to be received by employee after retiring
- The trust's main goal is to ensure there will be enough pension assets to pay employer's obligation to employees when they retire
- Example: employee will receive an annual pension benefit on retirement equal to 2% of average best three years of salary multiplied by years of service
- Pension benefits are based on a formula:
  - – Employee's years of service and expected salary level at retirement are usually key variables

- Employer is the *beneficiary* of a defined benefit trust
- Pension obligations belong to the employer
- The employer remains *liable* to ensure benefit payments, no matter what happens in the trust
- Employer assumes economic risks
- Cost of plan not known with certainty, as it depends on uncertain future variables (e.g. employee turnover, mortality, inflation)
- The pension expense is not same as cash funding contribution

- Actuarial assumptions used extensively in accounting for defined benefit plans

3.2 Key Concepts

Actuarial Assumptions are estimates of the occurrence of future events affecting pension costs (e.g., death rates, withdrawal, disability and retirement rates, changes in compensation and other benefits, and interest or discount rates).

Actuarial Funding Methodsare techniques used by an actuary to estimate the amounts and timing of employer contributions necessary to provide for pension benefits.

Actuarial Present Valueis the value, at a specific date, of an amount or series of amounts payable or receivable in the future. The present value is determined by discounting the future amount or amounts at a predetermined discount rate. The estimated future amounts are adjusted for changes in the likelihood of payment (e.g., death, disability, plan withdrawal).

Actual Return on Plan Assetsis the difference between the fair value of the plan assets at the end of the period and the fair value at the beginning of the period, adjusted for contributions by the company and payments of benefits to retired employees during the period.

Determination of Actual Return on Plan Assets	
Fair value of plan assets (end of year)	₦ from plan
Less: Fair value of plan assets (begin of year)	₦ from plan
Net change in fair value of plan assets	increase/decrease
Adjustments for contributions/withdrawals:	
Add: Payments to retirees	₦ paid out
Less: Contributions by employer	₦ paid in
Actual return on plan assets	₦ Net return

Amortization
Usually refers to the process of reducing a recognised liability systematically by recognizing revenues or reducing a recognized asset systematically by recognizing expenses or costs. In pension accounting, amortization is also used to refer to the systematic recognition in net pension cost over several periods of amounts previously recognized in other comprehensive income, that is, prior service costs or credits, gains or losses, and the transition asset or obligation existing.
Benefit formula: The basis for determining payments to which participants may be entitled under a pension plan. Pension benefit formulas usually refer to the employee's service or compensation or both.

Final-pay formula (Final-pay plan). A benefit formula that bases benefits on the employee's compensation over a specified number of years near the end of the employee's service period or on the employee's highest compensation periods. For example, a plan might provide annual pension benefits equal to 1 percent of the employee's average salary for the last five years (or the highest consecutive five years) for each year of service.

Flat-benefit formula (Flat-benefit plan).A benefit formula that bases benefits on a fixed amount per year of service, such as ₦ 30,000 of monthly retirement income for each year of credited service.

Contributory Pension Plan occurs when employees contribute part of the cost. In some plans, contributions are mandatory if they want pension coverage; in other plans, contributions lead to increased benefits.

Discount Rate or Interest Rate(used in actuarial computations of PBO and ABO) is the rate used to adjust for the time value of money.

Expected Long-term Rate of Return on Plan Assetsis an assumption as to the rate of return on plan assets reflecting the average rate of earnings expected on present and future pension assets.
Expected Return on Plan Assetsis an amount calculated as a basis for determining the extent of delayed recognition of the effects of changes in the fair value of assets. The expected return on plan assets is determined based on theexpected long-term rate of return on plan assets and the market-related value of plan assets.

Fair Value of Plan Assetsis the amount that a pension plan could reasonably expect to receive for investments in a current orderly sale. [Compare to market-related value of plan assets]

Gain or Loss
A change in the value of either the projected benefit obligation or the plan assets resulting from experience different from that assumed or from a change in an actuarial assumption. Gains and losses that are not recognized in net periodic pension cost when they arise are recognized in other comprehensive income. Those gains or losses are subsequently recognized as a component of net periodic pension cost based on the amortization provisions.

Amortisation of net gain or loss:Amortisation is included as a component of postretirement benefit cost for material gains or losses. The amortization period is the average remaining service life of active plan participants. To determine whether recognition is required, a corridor test is used. Amortise the portion of the gain or loss at the beginning of the year that exceeds 10% of the beginning of the year balance of (the greater of) the

Projected benefit obligation (PBO)
or
market-related value of plan assets

Interest costis the increase in the projected benefit obligation due to the passage of time (see discount rate). It is a component of pension cost.

Market-related value of plan assets
A balance used to calculate the expected return on plan assets. Market-related value can be either fair market value or a calculated value that recognizes changes in fair value in a systematic and rational manner over not more than five years. *For class purposes, we will assume that the fair market value of plan assets is equal to the market-related value of plan assets.*

Net periodic pension cost
The amount recognised in an employer's financial statements as the cost of a pension plan for a period. Components of net periodic pension cost are service cost, interest cost and actual return on plan assets, gain or loss, amortization of prior service cost or credit, and amortization of the net n asset or obligation.
Net Obligationis reported on the balance sheet when theProjected Benefit Obligation is greater than the related plan assets dedicated toward payment of pension benefits.
Plan Assets.– Usually stocks, bonds and other investments that have been segregated (usually in a trust) and restricted to provide pension benefits. Plan assets include amounts contributed by the employer (and by employees for a contributory plan) and amounts earned from investing the contributions, less benefits paid. Assets, which have not been segregated or otherwise effectively restricted for purposes other than pensions, *are not plan assets*. Plan assets do not appear on the books of the employer.
The following reconciliation schedule is provided in the notes to the financial statements and is also one of the columns of the pension worksheet.

Fair value of plan assets at beginning of year
+ Actual return on plan assets
+ Employer contribution
+ Plan participants' contributions
- Benefits paid
= Fair value of plan assets at end of year

Plan amendment
This is a change in the terms of an existing plan or the initiation of a new plan. A plan amendment may increase benefits, including those attributed to years of service already rendered. Such retroactive benefits generally give rise to prior service costs.

Plan curtailment
An event, that significantly reduces the expected years of future service of present employees or eliminates for a significant number of employees, the accrual of defined benefits for some or all of their future services. Curtailments include:

a. Termination of employees' services earlier than expected, which may or may not involve closing a facility or discontinuing a segment of a business
b. Termination or suspension of a plan so that employees do not earn additional defined benefits for future services. In the latter situation, future service may be counted toward vesting of benefits accumulated based on past service.

Prior Service Cost: is the cost of retroactive benefits granted in a plan amendment. Prior service costs are amortized over the remaining expected service life of the employees in the plan at the date it was amended. The recommended method is the years-of-service method, but straight-line is also acceptable as long as it does not result in less rapid amortization than the years of service method. The amount amortized during the period is a component of pension cost.

Years of Service Method (Recommended)
Assigns equal amount of prior service cost to each employee service year remaining.
Results in declining charge to expense.

Projected Benefit Obligation (PBO)is the actuarial present value at a specified date of all benefits attributed by the pension benefit formula to employee service rendered prior to the specified date. PBO is measured using assumptions as to future compensation levels if the pension benefit formula is based on those future compensation levels (pay-related, final pay, final pay average, or career-average-pay plans). The following schedule will be reported in employer’s footnote and is equivalent to the computations in the PBO column of the pension worksheet:

Projected benefit obligation at beginning of year
+ Service cost
+ Interest cost
+ Plan participants' contribution
+ Amendments (retroactive benefits)
+ Actuarial gain
- Actuarial loss
- Benefits paid
= Projected benefit obligation at end of year

Service Cost is the actuarial present of the benefits attributed by the pension benefit formula to services rendered by the employees during the current period. It is a component of pension cost.
Settlement. A transaction that (a) is an irrevocable action, (b) relieves the employer (or the plan) of primary responsibility for a pension benefit obligation, and (c) eliminates significant risks related to the obligation and the assets used to effect the settlement. Examples of transactions that constitute a settlement include (a) making lump-sum cash payments to plan participants in exchange for their rights to receive specified pension benefits and (b) purchasing nonparticipating annuity contracts to cover vested benefits.
Vested Benefitsrepresent the employee's right to receive present or future pension benefit without a requirement for additional service. The actuarial present value of vested benefits is part of the accumulated benefit obligation (ABO) but less than the total if some employees are not yet vested.

3.3 Recognition, Presentation and Disclosure requirement of IAS 19: *Employee Benefits*Accounting Standard 19: *Employee B*

3.3.1 Post-employment benefits: defined contribution plans

Accounting for defined contribution plans is straightforward because the reporting entity's obligation for each period is determined by the amounts to be contributed for that period. Consequently, no actuarial assumptions are required to measure the obligation or the expense and there is no possibility of any actuarial gain or loss. Moreover, the obligations are measured on an undiscounted basis, except where they are not expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service.

3.3.1.1 Recognition and measurement

When an employee has rendered service to an entity during a period, the entity shall recognise the contribution payable to a defined contribution plan in exchange for that service:

(a) as a liability (accrued expense), after deducting any contribution already paid. If the contribution already paid exceeds the contribution due for service before the end of the reporting period, an entity shall recognise that excess as an asset (prepaid expense) to the extent that the prepayment will lead to, for example, a reduction in future payments or cash refund.

(b) as an expense, unless another IFRS requires or permits the inclusion of the contribution in the cost of an asset.

When contributions to a defined contribution plan are not expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service, they shall be discounted.

Disclosure

An entity shall disclose the amount recognised as an expense for defined contribution plans.

3.3.2 Post-employment benefits: defined benefit plans

Accounting for defined benefit plans is complex because actuarial assumptions are required to measure the obligation and the expense and there is a possibility of actuarial gains and losses. Moreover, the obligations are measured on a discounted basis because they may be settled many years after the employees render the related service.

3.3.2.1 Recognition and measurement

Defined benefit plans may be unfunded, or they may be wholly or partly funded by contributions by an entity, and sometimes its employees, into an entity, or fund, that is legally separate from the reporting entity and from which the employee benefits are paid. The payment of funded benefits when they fall due depends not only on the financial position and the investment performance of the fund but also on an entity's ability, and willingness, to make good any shortfall in the fund's assets. Therefore, the entity is, in substance, underwriting the actuarial and investment risks associated with the plan. Consequently, the expense recognised for a defined benefit plan is not necessarily the amount of the contribution due for the period.

Accounting by an entity for defined benefit plans involves the following steps:

(a) determining the deficit or surplus. This involves:

  (ii) using an actuarial technique, the projected unit credit method, to make a reliable estimate of the ultimate cost to the entity of the benefit that employees have earned in return for their service in the current and prior periods. This requires an entity to determine how much benefit is attributable to the current and prior periods and to make estimates (actuarial assumptions) about demographic variables (such as employee turnover and mortality) and financial variables (such as future increases in salaries and medical costs) that will affect the cost of the benefit discounting that benefit in order to determine the present value of the defined benefit obligation and the current service cost.

  (iii) deducting the fair value of any plan assets from the present value of the defined benefit obligation.

(b) determining the amount of the net defined benefit liability (asset) as the amount of the deficit or surplus determined in (a), adjusted for any effect of limiting a net defined benefit asset to the asset ceiling (see paragraph 64).

(c) determining amounts to be recognised in profit or loss:

  (i) current service cost.

  (ii) any past service cost and gain or loss on settlement.

  (iii) net interest on the net defined benefit liability (asset).

(d) determining the re-measurements of the net defined benefit liability (asset), to be recognised in other comprehensive income, comprising:

  (i) actuarial gains and losses;

  (ii) return on plan assets, excluding amounts included in net interest on the net defined benefit liability (asset); and

  (iii) anychange in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset).

Where an entity has more than one defined benefit plan, the entity applies these procedures for each material plan separately.

An entity shall determine the net defined benefit liability (asset) with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the end of the reporting period.

This Standard encourages, but does not require, an entity to involve a qualified actuary in the measurement of all material post-employment benefit obligations. For practical reasons, an entity may request a qualified actuary to carry out a detailed valuation of the obligation before the end of the reporting period. Nevertheless, the results of that valuation are updated for any material transactions and other material changes in circumstances (including changes in market prices and interest rates) up to the end of the reporting period.

In some cases, estimates, averages and computational short cuts may provide a reliable approximation of the detailed computations illustrated in this Standard.

Statement of financial position

An entity shall recognise the net defined benefit liability (asset) in the statement of financial position.

When an entity has a surplus in a defined benefit plan, it shall measure the net defined benefit asset at the lower of:

(a) the surplus in the defined benefit plan; and

(b) the asset ceiling, determined using the discount rate.

A net defined benefit asset may arise where a defined benefit plan has been overfunded or where actuarial gains have arisen. An entity recognises a net defined benefit asset in such cases because:

(a) the entity controls a resource, which is the ability to use the surplus to generate future benefits;

(b) that control is a result of past events (contributions paid by the entity and service rendered by the employee); and

(c) future economic benefits are available to the entity in the form of a reduction in future contributions or a cash refund, either directly to the entity or indirectly to another plan in deficit. The asset ceiling is the present value of those future benefits.

Recognition and measurement: present value of defined benefit obligations and current service cost

The ultimate cost of a defined benefit plan may be influenced by many variables, such as final salaries, employee turnover and mortality, employee contributions and medical cost trends. The ultimate cost of the plan is uncertain and this uncertainty is likely to persist over a long period of time. In order to measure the present value of the post-employment benefit obligations and the related current service cost, it is necessary:

(a) to apply an actuarial valuation method

(b) to attribute benefit to periods of service

(c) to make actuarial assumptions

Actuarial valuation method

An entity shall use the projected unit credit method to determine the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost.

The projected unit credit method (sometimes known as the accrued benefit method pro-rated on service or as the benefit/years of service method) sees each period of service as giving rise to an additional unit of benefit entitlement and measures each unit separately to build up the final obligation. 69 An entity discounts the whole of a post-employment benefit obligation, even if part of the obligation is expected to be settled before twelve months after the reporting period.

Attributing benefit to periods of service

In determining the present value of its defined benefit obligations and the related current service cost and, where applicable, past service cost, an entity shall attribute benefit to periods of service under the plan's benefit formula. However, if an employee's service in later years will lead to a materially higher level of benefit than in earlier years, an entity shall attribute benefit on a straight-line basis from:

(a) the date when service by the employee first leads to benefits under the plan (whether or not the benefits are conditional on further service) until

(b) the date when further service by the employee will lead to no material amount of further benefits under the plan, other than from further salary increases.

The projected unit credit method requires an entity to attribute benefit to the current period (in order to determine current service cost) and the current and prior periods (in order to determine the present value of defined benefit obligations). An entity attributes benefit to periods in which

the obligation to provide post-employment benefits arises. That obligation arises as employees render services in return for post-employment benefits that an entity expects to pay in future reporting periods. Actuarial techniques allow an entity to measure that obligation with sufficient reliability to justify recognition of a liability.

Recognition and measurement: plan assets
Fair value of plan assets
The fair value of any plan assets is deducted from the present value of the defined benefit obligation in determining the deficit or surplus. When no market price is available, the fair value of plan assets is estimated, for example, by discounting expected future cash flows using a discount rate that reflects both the risk associated with the plan assets and the maturity or expected disposal date of those assets (or, if they have no maturity, the expected period until the settlement of the related obligation).
Plan assets exclude unpaid contributions due from the reporting entity to the fund, as well as any non-transferable financial instruments issued by the entity and held by the fund. Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits, for example, trade and other payables and liabilities resulting from derivative financial instruments.
Where plan assets include qualifying insurance policies that exactly match the amount and timing of some or all of the benefits payable under the plan, the fair value of those insurance policies is deemed to be the present value of the related obligations (subject to any reduction required if the amounts receivable under the insurance policies are not recoverable in full).

Current/non-current distinction
Some entities distinguish current assets and liabilities from non-current assets and liabilities. This Standard does not specify whether an entity should distinguish current and non-current portions of assets and liabilities arising from post-employment benefits.

3.3.2.2 Disclosure
An entity shall disclose information that:
(b) explains the characteristics of its defined benefit plans and risks associated with them
(b) identifies and explains the amounts in its financial statements arising from its defined benefit plans; and
(c) describes how its defined benefit plans may affect the amount, timing and uncertainty of the entity's future cash flows.

Explanation of amounts in the financial statements
An entity shall provide reconciliation from the opening balance to the closing balance for each of the following, if applicable:
(a) the net defined benefit liability (asset), showing separate reconciliations for:
  (i) plan assets.
  (ii) the present value of the defined benefit obligation.
  (iii) the effect of the asset ceiling.
(b) any reimbursement rights. An entity shall also describe the relationship between any reimbursement right and the related obligation.

3.4 Highlights of the Pension Reform Act, 2004
The collection of retirement benefits in Nigeria has continued to cause a lot of suffering to retirees (and their respective next-of-kin) especially the retirees in the public sector of the economy. There are reports of many beneficiaries who died in retirement benefit queues after waiting for days, without food or water, to collect their benefits. To remedy some of these problems, the Nigerian government recently passed into law the Pension Reform Act, 2004 ("the Pension Act").
Highlights Of The Pension Act

1. For the provisions of the Pension Act to apply to employees in the private sector, the employer must have 5 or more employees in its employment.
2. Every employee to the retirement scheme must have opened for him/her, by the Pension Fund Administrator chosen by the employee, a retirement savings account with a personal identification number (PIN).
3. Benefits/payments under the Pension Act are not taxable provided that voluntarily contributions are not withdrawn before the end of 5 years from the date the voluntary contributions are made.
4. Contributions by employers and employees are tax-deductible expenses when computing either Companies Income Tax or Personal Income Tax .
5. The initial rates, in percentages, of total contributions by employers and employees, to the contributory scheme are as follows: -

(a) Private and public sectors:
(i) Employer – minimum of seven and a half percent
(ii) Employee–minimum of seven and a half percent

(b) Military:
(i) Employer – minimum of twelve and a half percent
(ii) Employee – minimum of two and a half percent
A magnanimous employer is allowed by the Pension Act to bear the full contribution stated above provided it is not less than the 15% of the employee's total monthly emoluments.

6. The Pension Act has imputed on external Auditors, appointed by either the PFAs or the PFCs, a reporting obligation directly to the Pension Commission. Cases of suspected fraud or misappropriation of pension funds and assets are examples.
7. PFAs and PFCs are required by this Law to report to the Pension Commission all members of its staff whose employment were terminated or dismissed on grounds of fraud or misappropriation of funds. A data bank is to be maintained and information in it circulated to all PFAs and PFCs.
8. The Pension Act requires that all disputes arising from pension matters must be referred to the three stages of Alternative Dispute Resolution mechanism stated in this Act and these are reporting to the PFA, the Pension Commission and an Arbitration Panel or the Securities and Investment Tribunal. The Federal High Court has exclusive jurisdiction and enforces all judgments.

Retirement Account
An employee is required by the Pension Act to maintain a “Retirement savings Account” in his name with a Pension Fund Administrator (PFA) of his choice. This Law also allows the employee to transfer his retirement savings account from one PFA to another PFA provided the change is not done more than once in a year.

National Pension Commission
A National Pension Commission (the Pension Commission) is established as the Regulator for pension matters. It is a body corporate with perpetual succession and may be sued or sue in its own corporate name.

Pension Fund Administrators and Custodians
On the coming into effect of the Pensions Act, all pension funds and assets shall only be managed by Pension Funds Administrators (PFAs) licensed by the Pension Commission.

Pension Fund Custodians

Based on the wrong management and non-maximisation of previous pension schemes, the Pension Act separates the administration of the pension funds and assets from the actual custody and or safe keeping of the said funds and asset by the requirement of the licensing of Pension Funds Custodians (PFCs).

Illustration 1

Global Communications funds its defined benefit pension plan by contributing the years' service cost plus a portion of the prior service cost each year. Cash of ₦ 48 million was contributed to the pension fund in 2013.

Plan assets at the beginning of 2013 were valued at ₦ 300 million. The expected rate of return on the investment of those assets was 9%, but the actual return in 2011 was 10%. Retirement benefits of ₦ 38 million were paid at the end of 2013 to retired employees.

Required

Calculate the balance of the plan assets at the end of 2013

	₦million
Plan Assets at the beginning of the year	300
Actual return (10% of 300Million)	30
Contribution	48
Less retirement benefit (38)	
Plan assets at the end of the year	340

6.0 **Conclusion**

The main type of pensions plans are the defined benefits and defined contribution. Pension funds are invested in an asset to settle obligations when the need arises.

5.0 Summary

Pension plans are designed to provide income to individuals during their retirement years. This is accomplished by setting aside funds during an employee's working years so that at retirement the accumulated funds plus earnings from investing those funds are available to replace wages.

Projected Benefit Obligation (PBO) is the actuarial present value at a specified date of all benefits attributed by the pension benefit formula to employee service rendered prior to the specified date.

6.0 Tutor-Marked Assessment

The Board of Directors of Kenny Limited, a small company, decided on 30 April 2012 to introduce a contributory pension scheme for its staff. The Staff Pension Fund was contracted by a Trust Deed which provided for the payment of Pensions from 1 July 2012.

The following contributions are to be part of the Fund:

i.7½% of staff monthly salaries is to be deducted and paid to the trustees every month.

ii. The company's contributions to the Trust Fund are:

Five annual installments of ₦800,000 per annum to cover the pension liability in respect of past services, the first installments to be paid on 1 July 2012.

A sum equal to thrice the members‟ contributions is to be made at the same time members" contribution is paid over.

The Trustees received the first contribution on 1 July 2012. Members‟ contribution amounting to ₦120,000 for six-month period ended 31 December 2012, was received together with the monthly contributions due from the company as at when due. Trustees purchased the following investments:

(a) 2 July 2012: 4% ₦120,000 Enugu State Stock @ 88 Cum div. and incurred brokerage ₦3,120Interest days being 1 June & 1 December.

(b) 2 July 2012: 3% ₦120,000Sokoto State Stock @ 69Ex div.and incurred brokerage₦2,520Interest days being 1 July & 1 December.

The trustees resolved to make appropriate interest apportionment on all investments held and to accrue for all interest due.

The trustees paid pension of ₦100,000 and incurred sundry expenses of ₦8,000 during the six months period ended 31 December 2012.

You are required to:

1. Write up the Investment Accounts as they will appear in the Trustees‟ books.
2. Write up the Trustees‟ bank account.
3. Prepare the Trust Fund Revenue Account.

7.0 References/Further Reading

IAS 19: Employee benefits.