

**Chalimbana University**

**Integrity. Service. Excellence**

**DIRECTORATE OF DISTANCE EDUCATION**

***BBE 2201: FINANCIAL ACCOUNTING***

**First Edition 2018**

Chalimbana University

Private Bag E1

Lusaka

Zambia

Website: [www.chau.ac.zm](http://www.chau.ac.zm/)

**Author**

Matthew Ntabo

Martin Kabwe

**Chalimbana University © 2018**

**All rights reserved**. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic or mechanical, including photocopying, recording or otherwise without the permission of the copyright owners.

**ACKNOWLEDGEMENTS**

The Directorate of Distance Education wishes to thank Mr. Ntabo Matthew and Mr Martin Kabwe for writing the module on Financial Accounting.

**MODULE OVERVIEW**

**Pre-requisite: None**

**Introduction**

Welcome to the course for ‘Financial Accounting.’ The course intends to explain the theoretical concepts of Accounting, preparation of accounts and reporting financial information. You will also learn how to record transactions as they occur on a daily basis, and be able to prepare reports that will assist users of financial information to determine whether the business made a profit or not. You will also be able to prepare reports that show the value of assets and liabilities that has at the end of a defined reporting period. Finally, you will learn how to analyse the trading results of the business in order to assess whether the business is doing well or not.

**Rationale**

Understanding the environment within which the business has to operate is very important for running a business unit successfully at any place. Environmental factors influence almost every aspect of business, be it its nature, location, the prices of products, the distribution system, or personnel policies. This course will therefore, enable learners to be aware of the various components of the business environment, which consists of the economic aspect, the socio-cultural aspects, the political framework, the legal aspects and the technological aspects etc.

Outcomes**Aim**

The aim of this course is to equip learners with the necessary knowledge about various factors that influence business operations.

Outcomes**Learning Outcomes**

At the end of this course, students should be able to:

* Explain the context and purpose of accounting framework of business entities.
* Record transactions and events.
* Demonstrate the use of the double - entry system of accounting and prepare a trial balance including identifying and correcting errors
* Account for assets and liabilities
* Prepare basic financial statements for incorporated and unincorporated entities.
* Evaluate financial performance of an organisation through calculation and analysis of basic ratios

**Summary**

The module looks at accounting framework, record transactions events, double entry accounting systems, how to account for assets and liabilities and preparation of financial statement.



**Prescribed Reading**

BPP(2011) Paper T1 Financial Accounting, 1st Edition. London: BPP Learning Media.

BPP(2013) FIA FFA Financial Accounting,2nd Edition. London: BPP Learning Media.

Wood,F. and Sangster, A.(2011) Business Accounting 1, 11th Edition. London: Pearson



**Recommended Readings**

Millichamp,A.H.(1997) Foundation Accounting.DP Publications

Clark,P.J (1990) Financial Accounting.Gill&Macmillian

**STUDY SKILLS**

As an adult learner, your approach to learning will be different to that of your school days: you will choose when you want to study, you will have professional and/or personal motivation for doing so and you will most likely be fitting your study activities around other professional or domestic responsibilities.

Essentially you will be taking control of your learning environment. As a consequence, you will need to consider performance issues related to time management, goal setting, stress management, etc. Perhaps you will also need to acquaint yourself with areas such as essay planning, searching for information, writing, coping with examinations and using the internet as a learning resource.

Your most significant considerations will be *time* and *space* i.e. the time you dedicate to your learning and the environment in which you engage in that learning.

It is recommended that you take time now —before starting your self-study— to familiarise yourself with these issues. There are a number of excellent resources on the web. A few suggested links are:

<http://www.how-to-study.com/>

The “How to study” website is dedicated to study skills resources. You will find links to study preparation (a list of nine essentials for a good study place), taking notes, strategies for reading text books, using reference sources, test anxiety.

<http://www.ucc.vt.edu/stdysk/stdyhlp.html>

This is the website of the Virginia Tech, Division of Student Affairs. You will find links to time scheduling (including a “where does time go?” link), a study skill checklist, basic concentration techniques, control of the study environment, note taking, how to read essays for analysis, memory skills (“remembering”).

Time

**TIMEFRAME**

You are expected to spend at least 18 hours of study time on this module. In addition, there shall be arranged contact sessions with lecturers from the University during residential possibly in April, August and December. You are requested to spend your time judiciously so that you reap maximum benefit from the course.

Help**NEED HELP?**

In case you have difficulties during the duration of the course, please get in touch with your lecturer for routine enquiries during working days **(Monday-Friday)** from 08:00 to 17:00 hours on Cell: +260963804004**; E-mail:** [**adsikalumbi@gmail.com**](mailto:adsikalumbi@gmail.com)**; website:** [**www.chau.ac.zm**](http://www.chau.ac.zm/)**.**You can also see your lecturer at the office during working hours as stated above.

You are free to utilise the services of the University Library which opens from 07:00 hours to 20:00 hours every working day.

It will be important for you to carry your student identity card for you to access the library and let alone borrow books.

**LIST OF EQUIPMENT**

In this module you will need the following tools;

a scientific calculator.



**ASSESSMENT**

In this course you will be assessed on the basis of your performance as follows:

**Continuous Assessment 50%**

Assignment 10%

Project 15%

2 Tests of equal weight 25%

**Final Examination 50%**

**Total 100%**

Table of Contents

[**UNIT 1: PREPARATION OF PARTNERSHIP ACCOUNTS** 8](#_Toc531947748)

[**1.1 Unit Introduction** 8](#_Toc531947749)

[**1.2 Unit Aim** 8](#_Toc531947750)

[**1.3 Unit Objectives** 8](#_Toc531947751)

[**1.4 Time Required** 9](#_Toc531947752)

[**1.5 Unit Topics** 9](#_Toc531947753)

[**1.5.1 The need for partnerships** 9](#_Toc531947754)

[**1.5.2 Nature of a partnership** 9](#_Toc531947755)

[**1.5.3 Limited partnerships** 10](#_Toc531947756)

[**1.5.4 Partnership agreements** 11](#_Toc531947757)

[**1.5.5 Financial Statements of a Partnership** 11](#_Toc531947758)

[**1.5.6 Fixed and fluctuating capital accounts** 12](#_Toc531947759)

[**1.5.7 Where no partnership agreement exists** 13](#_Toc531947760)

[**1.5.7 Nature of goodwill** 14](#_Toc531947761)

[**1.5.8 Revaluation of Partnership Assets** 16](#_Toc531947762)

[**1.5.9 Need for dissolution** 17](#_Toc531947763)

[**UNIT 2: AN INTRODUCTION TO THE FINANCIAL STATEMENTS OF LIMITED LIABILTY COMPANIES** 23](#_Toc531947764)

[**2.1 Unit Introduction** 23](#_Toc531947765)

[**2.2 Unit Aim:** 23](#_Toc531947766)

[**2.3 Unit Objectives:** 23](#_Toc531947767)

[**2.4 Time Frame:** 23](#_Toc531947768)

[**2.5: Unit Topics** 24](#_Toc531947769)

[**2.5.1 Legal Nature of a Limited Company** 24](#_Toc531947770)

[**2.5.2 Perpetual life** 25](#_Toc531947771)

[**2.5.3 Limited liability** 25](#_Toc531947772)

[**2.5.4 Public and private companies** 25](#_Toc531947773)

[**2.5.5 Taxation** 26](#_Toc531947774)

[**2.5.6 Share capital** 26](#_Toc531947775)

[**2.5.7 Types of share capital** 27](#_Toc531947776)

[**2.5.8 Debenture** 27](#_Toc531947777)

[**2.5.9 Directors’ remuneration** 27](#_Toc531947778)

[**2.6.0 Purchase of Existing Partnership and Sole Traders Businesses** 31](#_Toc531947779)

[**2.6.1 Value of assets bought in purchaser’s books** 31](#_Toc531947780)

[**UNIT 3: IAS 7 STATEMENTS OF CASHFLOWS & RATIO ANALYSIS** 35](#_Toc531947781)

[**3.1 Unit Introduction** 35](#_Toc531947782)

[**3.2 Unit Aim** 35](#_Toc531947783)

[**3.3 Unit Objectives** 35](#_Toc531947784)

[**3.4 Time Required** 35](#_Toc531947785)

[**3.5 Unit Topics** 36](#_Toc531947786)

[**3.5.1 Purpose of Statement of Cash Flow** 36](#_Toc531947787)

[**3.5.2 Ratio Analysis** 39](#_Toc531947788)

[**UNIT 4: PREPARATION OF SPECIAL ACCOUNTS** 52](#_Toc531947789)

[**4.1 Unit Introduction** 52](#_Toc531947790)

[**4.2 Unit Aim** 52](#_Toc531947791)

[**4.3 Unit Objectives** 52](#_Toc531947792)

[**4.4 Time required** 53](#_Toc531947793)

[**4.5 Unit Topics** 53](#_Toc531947794)

[**4.5.1 Nature of Incomplete Records** 53](#_Toc531947795)

[**4.5.2 Approach to dealing with Incomplete Records** 54](#_Toc531947796)

[**4.5.3 Not-For-Profit Making Organisations (NFP)** 61](#_Toc531947797)

[**4.5.4 Manufacturing Accounts** 66](#_Toc531947798)

[**4.5.5 Nature of joint ventures** 70](#_Toc531947799)

[**4.5.6 Accounting for joint ventures** 70](#_Toc531947800)

[References 75](#_Toc531947801)

# **UNIT 1: PREPARATION OF PARTNERSHIP ACCOUNTS**

## **1.1 Unit Introduction**

Welcome to Unit 1 of this Module (2). In the previous Module (1) you looked at the preparation of financial statements of a sole trader where an individual owns a business. In this unit, we are going to look a business which is owned by two people or more. We will discuss how two or more people share profits when they contribute capital to form one business. In the previous unit you saw that the profit made by a sole trader is all added to his capital and only drawings reduce capital contributed. The preparation of financial statements for partnerships is done in the same way as for a sole trader, except that the report includes and extension outlining how the profits were shared before increasing their individual capital amounts. You will need to know why certain forms of profit sharing are adopted by partners. You should also take note of the difference between the contents of the Partnership Act of 1890 and the provisions made by partners in their Partnership Agreement for administering their business. In this unit, we will demonstrate only the calculation and accounting that is required at the time of preparing financial statements.

Outcomes

## **1.2 Unit Aim**

The aim of this Unit is to equip you with knowledge and understanding of how profit or loss made by a partnership business is shared between partners, and how the accounting is done to increase their individual capital values.

Outcomes

## **1.3 Unit Objectives**

At the end of this unit you should be able to do the following

1. Prepare a Profit and Loss Appropriation Accounts.
2. Prepare Partnership Current Accounts and Capital Accounts.
3. Outline how account balances on the capital and current accounts are reported on the statement of financial position.
4. Prepare the partnership revaluation account following revaluation of assets.
5. Prepare the partnership realisation account following the dissolution of partnership.
6. Explain the characteristics and contentsof the partnership agreement.

Time

## **1.4 Time Required**

You need to spend about five hours to complete this unit. Afterward you should be able to attempt questions requiring you to prepare full financial statements from recommended text books.

## **1.5 Unit Topics**

## **1.5.1 The need for partnerships**

**Reflection**

Think for a moment: in what respects do financial statements of partnership business differ from those of a sole trader? Let us see if you can pick up the similarities and differences from the discussion below.

**Discussion**

As you may have observed, we have mainly considered so far businesses owned by only one person. However, you may wish to know that two or more people may form themselves into a **partnership**. This is a long-term commitment to operate in business together. The people who own a partnership are called **partners**. They do not have to be based or work in the same place, though most do. However, they maintain one set of accounting records and share the profits and losses.

As you might be aware, when you form a business there is the fact that your business venture carry financial risk should you fail. By forming a partnership, the level of risk is reduced. Firstly, any loss can be shared by all the partners and, secondly, by involving more than one person’s expertise, the chances of failure are reduced.

There are two types of multiple ownership: partnerships and limited companies. In this unit we will deals only with partnerships.

### **1.5.2 Nature of a partnership**

Wood and Sangster (2005) noted the following characteristic of a partnership:

1. It is formed to make profits.
2. It must obey the law as given in the Partnership Act 1890. If there is a **limited partner** (as described in Section 41.3 below), it must also comply with the Limited Partnership Act of 1907.
3. Normally there can be a minimum of two partners and a maximum of twenty partners.
4. Exceptions are banks, where there cannot be more than ten partners; and there is no maximum for firms of accountants, solicitors, stock exchange members, surveyors, auctioneers, valuers, estate agents, land agents, estate managers, or insurance brokers.
5. Each partner (except for limited partners described below) must pay their share of any debts that the partnership could not pay. If necessary, they could be forced to sell all their private possessions to pay their share of the debts. This can be said to be unlimited liability.
6. Partners who are not limited partners are known as **general partners**.

### **1.5.3 Limited partnerships**

You may wish to know that Limited partnerships are partnerships containing one or more limited partners. Limited partnerships must be registered with the Registrar of Companies. Limited partners are not liable for the debts. Limited partners have the following characteristics and restrictions on their role in the partnership:

1. Their liability for the debts of the partnership is limited to the capital they have put in. They can lose that capital, but they cannot be asked for any more money to pay the debts unless they contravene the regulations relating to their involvement in the partnership (see 2 and 3 below).
2. They are not allowed to take out or receive back any part of their contribution to the partnership during its lifetime.
3. They are not allowed to take part in the management of the partnership or to have the power to make the partnership take a decision. If they do, they become liable for all the debts and obligations of the partnership up to the amount taken out or received back or incurred while taking part in the management of the partnership.
4. All the partners cannot be limited partners, so there must be at least one general partner with unlimited liability.

### **1.5.4 Partnership agreements**

Agreements in writing are not necessary. However, it is better if a written agreement is drawn up by a lawyer or an accountant. You will find that where there is a proper written agreement there will be fewer problems between partners. A written agreement means less confusion about what has been agreed.

**Contents of partnership agreements**

The written agreement can contain as much, or as little, as the partners want. The law does not say what it must contain. Wood and Sangster (2005) notes the following usual accounting contents:

1. The capital to be contributed by each partner.
2. The ratio in which profits (or losses) are to be shared.
3. The rate of interest, if any, to be paid on capital before the profits are shared.
4. The rate of interest, if any, to be charged on partners’ drawings.
5. Salaries to be paid to partners.
6. Arrangements for the admission of new partners.
7. Procedures to be carried out when a partner retires or dies.

### **1.5.5 Financial Statements of a Partnership**

You may wish to know that when preparing the financial statements of a partnership, the Trading Account and profit or loss account will be the same as for the sole trader). However, a partnership includes Profit and Loss Appropriation Account in addition.

Let us now consider an example adapted form wood and Sangster (2005) of when profits are distributed among partners below.

**Example 3.1**

Taylor and Clarke have been in partnership for one year sharing profits and losses in the ratio of Taylor 3/5, Clarke 2/5. They are entitled to 5 per cent per annum interest on capitals, Taylor having K20,000 capital and Clarke K60,000. Clarke is to have a salary of K15,000. They charge interest on drawings, Taylor being charged K500 and Clarke K1,000. The net profit, before any distributions to the partners, amounted to K50,000 for the year ended 31 December 2017.

**Solution**

K K K

Net profit 50,000

*Add* Charged for interest on drawings:

Taylor 500

Clarke 1,000

1,500

51,500

*Less* Salary: Clarke 15,000

Interest on capital:

Taylor 1,000

Clarke 3,000

4,000

(19,000)

Balance of profits 32,500

Shared:

Taylor 3/5 19,500

Clarke 2/5 13,000

32,500

The K50,000 net profits have therefore been shared:

*Taylor Clarke*

K K

Balance of profits 19,500 13,000

Interest on capital 1,000 3,000

Salary – 15,000

20,500 31,000

*Less* Interest on drawings ( 500) ( 1,000)

20,000 30,000

### **1.5.6 Fixed and fluctuating capital accounts**

You may wish to know that apartnership may choose to either maintain afixed capital accounts plus current accounts or fluctuating capital accounts (Wood and Sangster (2005).

**1.5.6.1 Fixed capital accounts plus current accounts**

The capital account for each partner remains year by year at the figure of capital put into the firm by the partners. The profits, interest on capital and the salaries to which the partner may be entitled are then credited to a separate current account for the partner, and the drawings and the interest on drawings are debited to it. The balance of the current account at the end of each financial year will then represent the amount of undrawn (or withdrawn) profits. A credit balance will be undrawn profits, while a debit balance will be drawings in excess of the profits to which the partner was entitled.

**1.5.6.2 Fluctuating capital accounts**

The distribution of profits would be credited to the capital account, and the drawings and interest on drawings debited. Therefore, the balance on the capital account will change each year, i.e. it will fluctuate.

According to Wood and Sangster (2005), the keeping of fixed capital accounts plus current accounts is considered preferable to fluctuating capital accounts. When partners are taking out greater amounts than the share of the profits that they are entitled to, this is shown up by a debit balance on the current account and so acts as a warning.

### **1.5.7 Where no partnership agreement exists**

As you might be aware, where there is no partnership agreement which exists, express or implied, Section 24 of the Partnership Act 1890 governs the situation. The accounting content of this section states:

(*a*) Profits and losses are to be shared equally.

(*b*) There is to be no interest allowed on capital.

(*c*) No interest is to be charged on drawings.

(*d*) Salaries are not allowed.

(*e*) Partners who put a sum of money into a partnership in excess of the capital they have agreed to subscribe are entitled to interest at the rate of 5 per cent per annum on such an advance.

Section 24 applies where there is no agreement. There may be an agreement not by a partnership deed but in a letter, or it may be implied by conduct, for instance when a partner signs a Statement of Financial Position which shows profits shared in some other ratio than equally (Wood and Sangster, 2005). As you may be aware, where a dispute arises as to whether an agreement exists or not, and this cannot be resolved by the partners, only the courts are competent to decide.

Using the example above, the capital part of the Statement of Financial Position for the partnership will appear as follows:

**Statement of Financial Position as at 31 December 2017 (extract)**

K K

Capital accounts Taylor 20,000

Clarke 60,000

80,000

Current accounts *Taylor Clarke*

K K K K

Salary – 15,000

Interest on capital 1,000 3,000

Share of profits 19,500 13,000

20,500 31,000

*Less* Drawings 15,000 26,000

Interest on drawings 500 1,000

(15,500) (27,000)

5,000 4,000

9,000

### **1.5.7Nature of goodwill**

**Reflection**

Suppose you have been running a business for some years and you wanted to sell it. How much would you ask as the total sale price of the business?

Let us assume that you decide to list how much you could get for each asset if sold separately and your list appears as follows:

K

Buildings 300,000

Machinery 79,000

Debtors 65,000

Stock 50,000

494,000

Less: Liabilities (100,000)

Net assets 394,000

If there are any liabilities, you would deduct them from the total value of the assets to arrive at the value of the net assets, which is the net amount you would have left if you sold all the assets and paid off all the creditors. Therefore, if a buyer pays more than K494,000 say K550,000 then goodwill be K56,000.

**Purchased Goodwill** = **Total Price *less* value of net identifiable assets.**

You may wish to know that goodwill is an intangible asset. It can only exist if the business was purchased and the amount paid was greater than the value of the net assets. In many cases, goodwill represents the value of the reputation of the business at the time it was purchased.

**1.5.7.1 Reasons for payment of goodwill**

If you are buying an existing business which has been established for some time there may be quite a few possible advantages. Wood and Sangster identified some of advantages as follows:

1. A large number of regular customers who will continue to deal with the new owner.
2. The business has a good reputation.
3. It has experienced, efficient and reliable employees.
4. The business is situated in a good location.
5. It has good contacts with suppliers.
6. It has well-known brand names that have not been valued and included as assets.

None of these advantages is available to completely new businesses. For this reason, many people are willing to pay an additional amount for goodwill when they buy an existing business.

**1.5.7.2 Existence of goodwill**

Goodwill does not necessarily exist in a business. If your business has a bad reputation, an inefficient labour force or other negative factors, it is unlikely that you as a owner would be paid for goodwill on selling your business.

**1.5.7.3 Methods of calculating goodwill**

As you may be aware, there is no single way of calculating goodwill on which everyone can agree. You will find that the seller will probably want more for the goodwill than the buyer will want to pay. All that is certain is that when agreement is reached between buyer and seller concerning how much is to be paid for a business, the amount by which the agreed price exceeds the value of the net assets represents the goodwill. Various methods are used to help buyer and seller come to an agreed figure for a business.

### **1.5.8 Revaluation of Partnership Assets**

As you might be aware, when a business is sold, and the sale price of the assets differs from their book values, there will be a profit or loss on the sale. This profit or loss will be shared between the partners in their profit and loss sharing ratios (Wood and Sangster, 2005).

This sharing of profits and losses on changing asset values doesn’t just need to be done when a partnership is sold. It should also be done whenever any of the following happens:

* a new partner is admitted;
* a partner leaves the firm;
* the partners change profit and loss sharing ratios.

As no sale has taken place in any of these circumstances, the assets will have to be revalued to reflect what they are worth at the date when the change occurs, in order for the gains and losses to be identified.

**1.5.8.1 Accounting for revaluation**

The first thing you do upon revaluing partnership assets is to open a **revaluation account** and make the appropriate entries:

**1** *For each asset showing a gain on revaluation:*

Debit asset account with gain.

Credit revaluation account.

**2** *For each asset showing a loss on revaluation:*

Debit revaluation account.

Credit asset account with loss.

**3** *If there is an increase in total valuation of assets:*

Debit profit to revaluation account.

Credit **old** partners’ capital accounts in **old** profit and loss sharing ratios.

**4** *If there is a fall in total valuations of assets:*

Debit **old** partners’ capital accounts in **old** profit and loss sharing ratios.

Credit loss to revaluation account.

If current accounts are kept for the partners, the entries should be made in their current accounts.

### **1.5.9 Need for dissolution**

As you might be aware, partnerships do change when a partner leaves. And they do change when a new partner joins.

However, for accounting purposes, we only consider partnerships as changing sufficiently to merit treating them as ceasing to exist when the partners go their separate ways (Wood and Sangster, 2005). You may wish to know that when they do, this is known as partnership **dissolution** or the partnership has been dissolved.

According to Wood and Sangster(2005) the following are the reasons for dissolution:

(*a*) The partnership is no longer profitable, and there is no longer any reason to carry on trading.

(*b*) The partners cannot agree between themselves how to operate the partnership. They therefore decide to finish the partnership.

(*c*) Factors such as ill-health or old age may bring about the close of the partnership.

**1.5.9.1 What happens upon dissolution?**

As you may know, once the**dissolution has happened,**the partnership firm stops trading or operating. Then, in accordance with the Partnership Act 1890:

(*a*) the assets are disposed of;

(*b*) the liabilities of the firm are paid to everyone other than partners;

(*c*) the partners are repaid their advances and current balances – advances are the amounts they have put in above and beyond the capital;

(*d*) the partners are paid the final amounts due to them on their capital accounts.

Any profit or loss on dissolution would be shared by all the partners in their profit and loss sharing ratios. Profits would increase capitals repayable to partners. Losses would reduce the capitals repayable.

If a partner’s final balance on his capital and current accounts is in deficit, he will have to pay that amount into the partnership bank account.

**1.5.9.2 Accounting for partnership dissolution**

The main account around which the dissolution entries are made is known as the realization account. It is this account in which it is calculated whether the realization of the assets is at a profit or at a loss.

Let us look at an adopted illustration from Wood and Sangster (2005) below on how to account for partnership dissolution.

**Illustration**

The last balance sheet of X and Y, who share profits X two-thirds: Y one-third is shown below. On this date they are to dissolve the partnership.

**Balance Sheet at 31 December 2017**

K K

*Fixed assets*

Buildings 100,000

Motor vehicle 12,000

112,000

*Current assets*

Stock 6,000

Debtors 8,000

Bank 2,000

16,000

*Current liabilities*

Creditors (5,000)

11,000

123,000

Capitals: X 82,000

Y 41,000

123,000

The buildings were sold for K105,000 and the stock for K4,600. K6,800 was collected from debtors. The motor vehicle was taken over by X at an agreed value of K9,400, but he did not pay any cash for it. K5,000 was paid to creditors. The K400 cost of the dissolution was paid.

The accounting entries needed are:

(A) Transfer book values of all assets to the realization account:

Debit realisation account

Credit asset accounts

(B) Amounts received from disposal of assets:

Debit bank

Credit realisation account

(C) Values of assets taken over by partner without payment:

Debit partner’s capital account

Credit realisation account

(D) Creditors paid:

Debit creditors’ accounts

Credit bank

(E) Costs of dissolution:

Debit realisation account

Credit bank

(F) Profit or loss on realisation to be shared between partners in profit and loss sharing ratios:

If a profit: Debit realisation account

Credit partners’ capital accounts

If a loss: Debit partners’ capital accounts

Credit realisation account

(G) Pay to the partners their final balances on their capital accounts:

Debit capital accounts

Credit bank

**1.5.9.3 The *Garner* v *Murray* rule**

You might wish to know that sometimes it happens that a partner’s capital account finishes up with a debit balance. Normally the partner will pay in an amount to clear his indebtedness to the firm. However, sometimes the partner will be unable to pay all, or part, of such a balance. In the case of ***Garner* v *Murray*** in 1904 (a case in England) the court ruled that, subject to any agreement to the contrary, such a deficiency was to be shared by the other partners *not* in their profit and loss sharing ratios but in the ratio of their ‘last agreed capitals’. By ‘their last agreed capitals’ is meant the credit balances on their capital accounts in the normal balance sheet drawn up at the end of their last accounting period.

**1.5.9.4 Piecemeal realisation of assets**

Sometimes you may experience a situation where the frequently with which the assets are turned into cash may take a long time(i.e. ‘realised’). The partners will naturally want payments made to them on account as cash is received. They will not want to wait for payments until the dissolution is completed just for the convenience of the accountant.

There is, however, a danger that if too much is paid to a partner, and he is unable to repay it, then the person handling the dissolution could be placed in a very awkward position (Wood and Sangster, 2005).

To counteract this, the concept of prudence is brought into play. This is done as follows:

(*a*) Each receipt of sale money is treated as being the final receipt, even though more could be received.

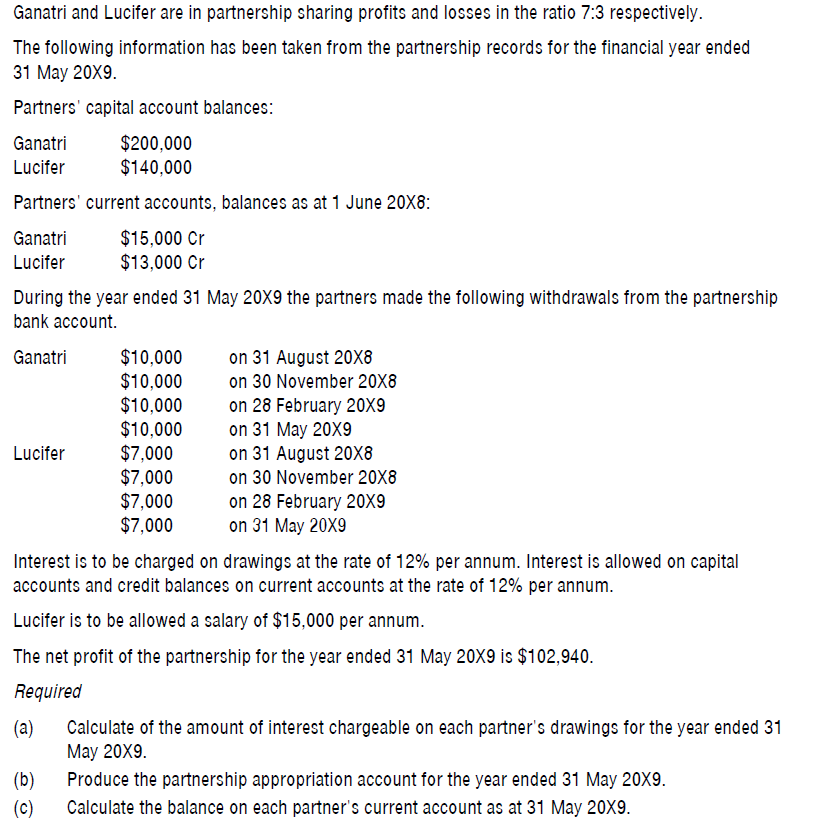
(*b*) Any loss then calculated so far to be shared between partners in profit and loss sharing ratios.

(*c*) Should any partner’s capital account after each receipt show a debit balance, then he is assumed to be unable to pay in the deficiency. This deficit will be shared (failing any other agreement) between the partners using the *Garner* v *Murray* rule.

(*d*) After payments of liabilities and the costs of dissolution the remainder of the cash is thenpaid to the partners.

(*e*) In this manner, even if no further money were received, or should a partner become insolvent, the division of the available cash would be strictly in accordance with the legal requirements.

**1.7 Unit Activity**



*Source: BPP: ACCA (F3: Financial Accounting)*

summary**1.8 Unit Summary**

In this unit, you have looked at how you may prepare the financial statements for a partnership and how to account for the dissolution of a partnership. You have seen that the terms under which the partnership operates are set out in the partnership agreement. The initialcapital put into the business by each partner is shown by means of a capital account for each partner. Thenet profit of the partnership is appropriated by the partners according to a previously agreed ratio. Eachpartner also has a current account to which their drawings are charged. Partners may be charged intereston their drawings and may receive interest on capital.

You have also seen that if a partner makes a loan to the business, he or she will receive interest on it in the normal way. Loan interest due, interest on capital and partners salaries are deducted and the remaining net profit is apportioned according to the profit sharing ratio.

In the next Unit, you are going to learn how to prepare the basic financial statements for a limited company.

# **UNIT 2: AN INTRODUCTION TO THE FINANCIAL STATEMENTS OF LIMITED LIABILTY COMPANIES**

## **2.1 Unit Introduction**

Welcome to Unit 2 of the Module (2). In the previous units you have considered the preparation of financial statements for two forms of businesses namely the Sole trader and Partnership. In this unit, you are going to look at the preparation of basic financial statements for the last form of business, the limited company (Corporate).

Outcomes

## **2.2 Unit Aim:**

The aim of this unit is to equip you with knowledge and skills of how to prepare the basic financial statements of a limited company

Outcomes

## **2.3 Unit Objectives:**

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

1. explain how limited companies differ from sole traders and partnerships
2. explain the differences between different classes of shares
3. calculate how distributable profits available for dividends are divided between the different classes of shares
4. explain the differences between shares and debentures
5. prepare the statement of profit or loss accounts for a company for internal purposes
6. Prepare the statement of financial position for a company for internal purposes

Time

**2.4 Time Frame:**

In order to successfully go through this unit, you will need to spend at least four hours on this unit.

## **2.5: Unit Topics**

### **2.5.1 Legal Nature of a Limited Company**

**Reflection**

Try to think of the possible differences between a company and other forms of businesses (Sole trader and Partnership)



**Discussion**

Let us begin our examination of limited companies by discussing their legal nature.As you wish to know, a limited company has been described as an artificial person that has been created by law. This means that a company has many of the rights and obligations that ‘real’ people have. For example, it can sue or be sued by others and can enter into contracts in its own name. This contrasts sharply with other types of businesses, such as sole proprietorships and partnerships (that is unincorporated businesses), where it is the owner(s) rather than the business that must sue, enter into contracts and so on, because the business has no separate legal identity.

With the rare exceptions of those that are created by Act of Parliament or by Royal

Charter, all UK companies are created (or *incorporated*) by registration (Wood and Sangster, 2005). You may wish to know that this is the case for Zambia as well.Now, for you to create a company as a person or persons (usually known as *promoters*) wishing to create it, you will need to fill in a few simple forms and pay a registration fee. After having ensured that the necessary formalities have been met, the Registrar of Companies, a government official, enters the name of the new company on the Registry of Companies.

As you might be aware, the owners of a company are usually known as members or shareholders. The ownership of a company is normally divided into a number, frequently a large number, of shares, each of equal size. Each owner, or shareholder, owns one or more shares in the company. Large companies typically have a very large number of shareholders.

As we have already mentioned, a limited company has its own legal identity and therefore, it is regarded as being quite separate from those who own and manage it. This fact leads to two important features of the limited company: perpetual life and limited liability. These are now explained.



**Discussion**

### **2.5.2 Perpetual life**

You need to know that a company is normally granted a perpetual existence and so will continue even where an owner of some, or even all, of the shares in the company dies. The shares of the deceased person will simply pass to the beneficiary of his or her estate.

### **2.5.3 Limited liability**

Since the company is a legal person in its own right, it must take responsibility for its own debts and losses. As you might know this means that once the shareholders have paid what they have agreed to pay for the shares, their obligation to the company, and to the company’s creditors, is satisfied. Thus shareholders can limit their losses to that which they have paid, or agreed to pay, for their shares

Contrast this with the position of sole proprietors or partners. They cannot ‘ring fence’ assets that they do not want to put into the business. If a sole proprietary or partnership business finds itself in a position where liabilities exceed the business assets, the law gives unsatisfied creditors the right to demand payment out of what the sole proprietor or partner may have regarded as ‘non-business’ assets. Thus the sole proprietor or partner could lose everything including personal properties.

### **2.5.4 Public and private companies**

When a company is registered with the Registrar of Companies, it must be registered either as a public or as a private company. The main practical difference between these is that a public company can offer its shares for sale to the general public, but a private company is restricted from doing so.

### **2.5.5 Taxation**

Another consequence of the legal separation of the limited company from its owners is that companies must be accountable to the Inland Revenue for tax on their profits and gains. This introduces the effects of tax into the accounting statements of limited companies. The charge for tax is shown in the income statement (profit and loss account). The tax charge for a particular year is based on that year’s profit. Companies are charged corporation tax on their profits and gains.

### **2.5.6 Share capital**

As you may be aware, shareholders of a limited company obtain their reward in the form of a share of the profits, known as a **dividend**. There are two types of shareholders; Preference and ordinary shareholders.

**Preference shares.** Holders of these shares get an agreed percentage rate of dividend before the ordinary shareholders receive anything. If shareholder have invested in a 10% preference share, it means they are entitled to a fixed dividend of 10%. There are two main category of preference shares you may need to know:

1. **1 Non-cumulative preference shares.** These can receive a dividend up to an agreed percentage each year. If the amount paid is less than the maximum agreed amount, the shortfall is lost by the shareholder. The shortfall cannot be carried forward and paid in a future year.
2. **2 Cumulative preference shares.** These also have an agreed maximum percentage dividend. However, any shortfall of dividend paid in a year can be carried forward. These arrears of preference dividends will have to be paid before the ordinary shareholders receive anything.

**Ordinary shares.** Holders of these shares receive the remainder of the total profits available for dividends. There is no upper limit to the amounts of dividends they can receive.

### **2.5.7 Types of share capital**

You need to be aware of the following types of share capital:

1. **Authorised share capital:** Sometimes known as registered capital or nominal capital. This is the total of the share capital which the company is allowed to issue to shareholders.
2. **Issued share capital:** This is the total of the share capital actually issued to shareholders.If all of the authorised share capital has been issued, then 1 and 2 above would be the same amount.
3. **Called-up capital:** Where only part of the amount payable on each issued share has been asked for, the total amount asked for on all the issued shares is known as the called-up capital.
4. **Uncalled capital:** This is the total amount which is to be received in future relating to issued share capital, but which has not yet been asked for.
5. **Calls in arrears:** The total amount for which payment has been asked for (i.e. ‘called for’), but has not yet been paid by shareholders.
6. **Paid-up capital:** This is the total of the amount of share capital which has been paid for by shareholders.
7. Bonus shares are ‘free’ shares issued to shareholders without their having to pay anything for them.

### **2.5.8 Debenture**

The term **debenture** is used when a limited company receives money on loan, and certificates called debenture certificates are issued to the lender. Interest will be paid to the holder, the rate of interest being shown on the certificate. They are not always called debentures; they are often known as loan stock or as loan capital or even bonds. Debenture interest has to be paid whether profits are made or not.

### **2.5.9 Directors’ remuneration**

As directors exist only in companies, this type of expense is found only in company accounts.

Directors are legally employees of the company, appointed by the shareholders. Their remuneration is charged to the profit and loss account.

Let us now look at a adapted worked example from Wood and Sangster(2005) for the preparation of financial statements of limited companies.

**Example 4.1**

The following trial balance is extracted from the books of F W Ltd as on 31 December 2017:

**Trial balance as on 31 December 2017**

*Dr Cr*

K K

10% preference share capital 200,000

Ordinary share capital 700,000

10% debentures (repayable 2021) 300,000

Goodwill at cost 255,000

Buildings at cost 1,050,000

Equipment at cost 120,000

Motor vehicles at cost 172,000

Provision for depreciation: buildings 1.1.2017 100,000

Provision for depreciation: equipment 1.1.2017 24,000

Provision for depreciation: motor vehicles 1.1.2017 51,600

Stock 1.1.2017 84,912

Sales 1,022,000

Purchases 439,100

Carriage inwards 6,200

Salaries and wages 192,400

Directors’ remuneration 123,000

Motor expenses 3,120

Business rates and insurances 8,690

General expenses 5,600

Debenture interest 15,000

Receivables 186,100

Payables 113,700

Bank 8,390

General reserve 50,000

Share premium account 100,000

Interim ordinary dividend paid 35,000

Profit and loss account 31.12.2016 43,212

2,704,512 2,704,512

The following adjustments are needed:

1. Stock at 31.12.2017 was K91,413.
2. Depreciate buildings £10,000; motor vehicles K18,000; equipment K12,000.
3. Accrue debenture interest K15,000.
4. Provide for preference dividend K20,000 and final ordinary dividend of 10 per cent.
5. Transfer K10,000 to general reserve.
6. Write off goodwill K30,000.
7. Authorised share capital is K200,000 in preference shares and £1 million in ordinary shares.
8. Provide for corporation tax K50,000.

Solution

**Statement of Profit or Loss for the year ended 31 December 2017**

K K K

Sales 1,022,000

*Less* Cost of goods sold:

Opening stock 84,912

*Add* Purchases 439,100

*Add* Carriage inwards 6,200

530,212

*Less* Closing stock (91,413)

(438,799)

Gross profit 583,201

*Less* Expenses:

Salaries and wages 192,400

Motor expenses 3,120

Business rates and insurances 8,690

General expenses 5,600

Directors’ remuneration (A) 123,000

Depreciation: Buildings 10,000

Equipment 12,000

Motor vehicles 18,000

(372,810)

Profit for the year before taxation 210,391

Debenture interest (B) (30,000)

Profit Before Tax 180,391

*Less* Corporation tax (50,000)

Profit for the year after taxation 130,391

*Add* Retained profits from last year 43,212

173,603

*Less* Appropriations:

Transfer to general reserve 10,000

Goodwill part written off 30,000

Preference share dividend 20,000

Ordinary share dividends:

Interim 35,000

Final (C) 70,000

105,000

(165,000)

Retained profits carried forward to next year 8,603

*Notes*:

(A) Directors’ remuneration is shown as an expense in the profit and loss account itself.

(B) Debenture interest is an expense to be shown in the profit and loss account itself.

(C) The final dividend of 10 per cent is based on the issued ordinary share capital and *not* on the authorised ordinary share capital.

**(b)**

**F W Ltd**

**Statement of Position as at 31 December 2017**

*Non-Current assets* K K K

Intangible assets

Goodwill 225,000

Tangible assets (A)

Buildings 940,000

Equipment 84,000

Motor vehicles 102,400

1,126,400

1,351,400

*Current assets*

Stock 91,413

Debtors 186,100

Bank 8,390

285,903

*Creditors: amounts falling due within one year*

Creditors 113,700

Proposed dividend 90,000

Debenture interest accrued 15,000

Taxation 50,000

(268,700)

*Net current assets* 17,203

*Total assets less current liabilities* 1,368,603

*Creditors: amounts falling due after more than one year*

10% Debentures (300,000)

1,068,603

*Capital and reserves* (B)

Called-up share capital (C) 900,000

Share premium account 100,000

Other reserves

General reserve 60,000

Retained Profit and loss 8,603

1,068,603

(A) Notes to be given in an appendix as to cost, acquisitions and sales in the year and depreciation.

(B) Reserves consist either of those unused profits remaining in the appropriation account, or those transferred to a reserve account appropriately titled, e.g. general reserve, fixed assets replacement reserve, etc.

One reserve that is in fact not labelled with the word ‘reserve’ in its title is the share premium account. This is shown with the other reserves in the balance sheet.

The closing balance on the profit and loss appropriation account is shown under reserves. These are profits not already appropriated, and therefore ‘reserved’ for future use.

(C) The authorised share capital, where it is different from the issued share capital, is shown as anote. Notice that the total figure of K1,200,000 for authorised capital is not included when adding up the balance sheet sides. Only the issued capital amounts are included in statement of financial position totals.

### **2.6.0 Purchase of Existing Partnership and Sole Traders Businesses**

### **2.6.1 Value of assets bought in purchaser’s books**

**Reflection**

Do you think when a business for sole trader or partnership is bought the assets will show a different value?

You must not think that because the assets bought are shown in the selling firm’s books at one value and the purchaser must record the assets taken over in its own books at the samevalue.When a business is sold, the seller has no need to revalue the assets and adjust the values shown in the balance sheet. However the buyer really ought to show the assets (and liabilities) of the business it has taken over at their current values.

We are going to look at the accounting treatment of sole traders being taken over as going concerns. While we will focus on sole traders, everything you will learn in this unitapplies also to partnerships when they are taken over as going concerns.

There are many ways in which a sole trader or a partnership may be taken over as a going concern. For example, an individual may purchase the business of a sole trader or a sole trader may take over a partnership.

**Taking over a sole trader’s business**

Let us look at an example where a sole trader business is taken over below:

**Example**

**Zulu Enterprise**

**Statement of Financial Position as at 31 December 2016**

*Non-Fixed assets* K K

Fixtures 30,000

*Current assets*

Stock 8,000

Debtors 7,000

Bank 1,000

16,000

*Less: Current liabilities*

Creditors (3,000)

13,000

43,000

*Capital* 43,000

You may assume that the assets and liabilities of Zulu enterprise, with the exception of the bank balance, are taken over by Bwalya and sons general dealers. He is to take over the assets and liabilities at the valuations as shown in Zulu’s Statement of Financial Position. The price to be paid is K52,000.

The opening statement of financial position of Bwalya will be as shown as follows:

**Bwalya and Sons General Dealers**

**Statement of Financial Position as at 1 January 2017**

*Non-Fixed assets* K K

Goodwill 10,000

Fixtures 30,000

40,000

*Current assets*

Stock 8,000

Debtors 7,000

15,000

*Less: Current liabilities*

Creditors (3,000)

12,000

52,000

*Capital* 52,000

As K52,000 has been paid for the net assets (assets less liabilities) valued at K30,000 + K8,000 +

K7,000 − K3,000 = K42,000, the excess K10,000 represents the amount paid for goodwill.

2.7 Unit Activity

The Trial balance of Kakason Ltd as at 31 December 2015 was as follows:

Dr Cr

K’000 K’000

Turnover 850

Purchases 450

Inventory at 1 January, 2015 80

Distribution costs 80

Administration expenses 105

Returns inwards 5

Receivables 150

Payables 32

Returns outwards 3

Carriage inwards 10

Cash at bank 85

Carriage outwards 2

Ordinary shares 50 ngwee per share 100

10% irredeemable preference shares K1 90

10% loan notes 80

Non-current assets at cost 368

Accumulated depreciation 1 January, 2015 140

Share premium 30

Accumulated profits at 1 January, 2015 30

Loan note Interest 4

Interim preference dividend 6

Interim ordinary dividend 10

1,355 1,355

The following is to be taken into account.

1. The depreciation is charged on non-current assets at the rate of 20% on a reducing balance basis per year. Depreciation is charged to the administrative expenses. Corporate tax payable is at the rate of 30% per year.
2. Rent paid in advance amounting to K5, 000 was charged to administrative expenses.
3. There is an outstanding transport cost amounting to K4, 000. Transport costs are charged to the distribution costs.
4. Final ordinary dividend of 20 ngwee per share is proposed.
5. Closing inventory is K40, 000.

**Required:**

1. Prepare the statement of profit or loss and other comprehensive income for the year ended 31stDecember 2015.
2. Prepare the statement of Financial Position as at 31st December, 2015.

summary**2.8 Unit Summary**

In this unit, you have learnt that there are some important differences between the accounts of a limited liability company and those of sole traders or partnerships. As you prepare a statement of financial position you must be able to deal with ordinary and preference share capital, reserves and loan stock. Share capital and reserves are 'owned' by the shareholders. They are known collectively as 'shareholders' equity'. A company can increase its share capital by means of a bonus issue or a rights issue.

In the next unit, you are going to learn how to prepare the statement of cash flows and to interpret financial statements using ratios.

## **UNIT 3: IAS 7 STATEMENTS OF CASHFLOWS& RATIO ANALYSIS**

## **3.1 Unit Introduction**

Welcome to Unit 5! Congratulations for completing the unit for preparation of financial statements. There arises a need for you the accountant to explain the figures in the statements to non-accounting members of management, and later on as a requirement by law, to present the financial statements to members of the company at an annual general meeting. At that time you will have to interpret the financial statements to these users. Statements of cashflows and ratio analysis are the tools for assisting in interpreting the results and position of the organization as portrayed by the financial statements. In this unit, wewill discuss preparation of statements of cash flows in line with the provisions of IAS 7 and analysis of financial ratios.

Outcomes

## **3.2 Unit Aim**

The aim of unit is to equip you with the knowledge and skills to prepare the statement of cash flows in line with IAS 7 and analyse the financial statements.

Outcomes

## **3.3 Unit Objectives**

At the end of this unit you should be able to do the following

1. Reconcile retained earnings to cash flow from operating activities.
2. Compile cash flow from investing activities.
3. Compile cash flow from investing activities.
4. Compile cash flows from financing activities.
5. Reconcile cash and cash equivalent balances for two successive years.
6. Calculate profitability ratios and explain their significance.
7. Calculate efficiency ratios and explain their significance.
8. Calculate short term solvency (liquidity) ratios and explain their significance.
9. Calculate long term solvency ratios and explain their significance.
10. Calculate shareholders’ investment ratios and explain their significance

Time

## **3.4 Time Required**

You should be able to spend two hours to complete studying this unit.

## **3.5 Unit Topics**

### **3.5.1 Purpose of Statement of Cash Flow**

Reflection

Did you notice when you prepared financial statements, whether for a sole trader or a limited liability company that the operating profit reported was not equal to the cash and bank balances at the end of the period? What do you think is the explanation for this difference?

Statements of cash flows effectively provide a reconciliation of the profit made for a period to the cash and bank balances reported in the statement of financial position. To accomplish this task cash inflows and cash outflows are extracted from the accounts and arranged in the appropriate classification of sources and uses of cash in the period. You do remember from your previous lessons that when you pay wages from the cash book, the amount will be increased by wages owing to an employee before you charge it as an expense in the statement of profit or loss. Taking into account accruals and prepayments is what changes cash flow figures from the cash book to incomes and expenses recorded in the financial statements. Therefore, reported profit differs from the cash and bank balances because of the application of the accruals concept to preparation of accounts.

The exercise of preparing a statement of cash flows is largely the reversing of accruals that are handled when the financial statements were first prepared. The accounts are reconstructed and identifying cash flow figures is done as if you are peeling a banana, removing the accruals which are the opening and closing balances on each account. The following illustration demonstrates how this is done.

**ILLUSTRATION**

Let us look at an example regarding the preparation of financial statements below:

TK Ltd income statement for the year ended 31 December 2015 and statements of financial position at 31 December 2014 and 31 December 2015 were as follows.

TK LTD

INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2015

K'000 K'000

Sales 720

Cost of sales (70)

Gross profit 650

Staff costs 94

Depreciation 118

Loss on disposal of non-current asset 18

(230)

Profit before interest & tax 420

Interest payable (28)

Profit before tax 392

Taxation (124)

Profit for the period 268

TK LTD

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER

*2015 2014*

K'000 K'000 K'000 K'000

*Assets*

Property, plant and equipment

Cost 1,596 1,560

Depreciation 318  224

1,278 1,336

Current assets

Inventory 24 20

Trade receivables 76 58

Bank 48 56

148 134

*Total assets* 1,426 1,470

*Equity and liabilities*

Capital and reserves

Share capital 360 340

Share premium 36 24

Retained earnings 716 514

1,112 878

Non-current liabilities

Non-current loans 200 500

Current liabilities

Trade payables 12 6

Taxation 102 86

114 92

1,426 1,470

During the year, the company paid K90, 000 for a new piece of machinery.

Dividends paid during 2015 totalled K66, 000.

***Required***

Prepare a statement of cash flows for TK Ltd for the year ended 31 December 2015, using the indirect method. *(Please attempted to use the format given in your notes)*

**Solution**

When preparing the statement of Cash Flows, you follow the procedures below:

**Step 1:Set out the proforma statement of cash flows** with the headings as given in your lecture notes. It is obviously essential to know the formats very well.

**Step 2:** Begin with the **reconciliation of profit before tax to net cash from operating activities** as far as possible. When preparing the statement from statements of financial position, you will usually have to calculate such items as depreciation, loss on sale of non-current assets, profit for the year and tax paid (see Step 4). Note that you may not be given the tax charge in the income statement. You will then have to assume that the tax paid in the year is last year's year-end provision and calculate the charge as the balancing figure.

**Step 3**: Calculate the cash flow figures for **dividends paid, purchase or sale of non-current assets, issue of shares and repayment of loans** if these are not already given to you (as they may be).

**Step 4**: If you are not given the profit figure, open up a **working for the trading, income and expense account**. Using the opening and closing balances, the taxation charge anddividends paid and proposed, you will be able to calculate profit for the year as thebalancing figure to put in the net profit to net cash flow from operating activities section.

**Step 5**: You will now be able to **complete the statement** by slotting in the figures given or calculated.

TK LTD

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 2015

K'000 K'000

*Net cash flow from operating activities*

Profit before tax 392

Depreciation charges 118

Loss on sale of property, plant and equipment 18

Interest expense 28

Increase in inventories (4)

Increase in receivables (18)

Increase in payables 6\_

Cash generated from operations 540

Interest paid (28)

Dividends paid (66)

Tax paid (86 + 124 – 102) (108)

*Net cash flow from operating activities* 338

*Cash flows from investing activities*

Payments to acquire property, plant and equipment (90)

Receipts from sales property, plant and equipment 12

*Net cash outflow from investing activities* (78)

*Cash flows from financing activities*

Issues of share capital (360 + 36 - 340 - 24) 32

Long-term loans repaid (500 - 200) (300)

*Net cash flows from financing* (268)

Decrease in cash and cash equivalents (8)

Cash and cash equivalents at 1.1.15 56

Cash and cash equivalents at 31.12.15 48

*Working: property, plant and equipment*

COST

DR CR

K'000 K'000

At 1.1.15 1,560 At 31.12.15 1,596

Purchases 90 Disposals (balance) 54

1,650 1,650

ACCUMULATED DEPRECIATION

DR CR

K'000 K'000

At 31.1.15 318 At 1.1.15 224

Depreciation on disposals Charge for year 118

(balance) 24 \_\_\_

342 342

NBV of disposals 30

Net loss reported (18)

Proceeds of disposals 12

## **3.5.2 Ratio Analysis**

You wish to know that financial ratios can assist you to measure (assess) the financial performance of a company. However, it is important that you do not fall into the trap of simply calculating every ratio imaginable for every year available. What is expected of you is being able to determine the key measures and to comment adequately.

**You should consider the following points:**

* ***What is it that you are being asked to comment on?***

For example, if you are looking at the information from the shareholders perspective, then growth (or otherwise) in the share price will be of great interest.

However, if you are looking at how well the managers are performing, the growth (or otherwise) in the profit (to the extent to which they control it) is perhaps of more importance.

* ***Growth:***

You should always make some comment as to the level of growth. The amount of detail required depends on the information available, but growth in turnover, in profit, and in share price are all potentially relevant. Look at the overall level of growth and look for any trends, do not waste time doing detailed year-by-year analysis.

* ***Areas for analysis:***

Subject again to exactly what you are being asked to comment on, the following areas are likely to be worthy of consideration:

* **Profitability** – how well a company performs, given its asset base
* **Liquidity** – the short term financial position of the company
* **Gearing** – the long-term financial position of the company
* **Investors ratios** – how well investors will appraise the company

**You are advised to revise on the computation of financial ratio analysis from fundamentals of finance module one. However, the information below will help you to remember:**

Financial ratios are grouped into the following categories:

* *Leverage ratios* show how heavily the company is in debt.
* *Liquidity ratios* measure how easily the firm can lay its hands on cash.
* *Efficiency* or *turnover ratios* measure how productively the firm is using its assets.
* *Profitability ratios* are used to measure the firm’s return on its investments.
* *Investors ratios* are used to measure the performance of a share on the stock exchange market
* ***Leverage ratios***

Leverage ratios are concerned with how much financial leverage (debt) the company has taken on. You may wish to know that when a company borrows money, it promises to make a series of interest payments and also repay the amount it borrowed. These payments will be made from the profits generated by the company. A company that is heavily in debt (and seems to be getting more debt) and not making enough profit might face the following situations:

1. Banks and other would be lenders will most likely refuse further borrowing and the company will be trouble
2. There will be very little profit left over (if any) for shareholders after the interest have been paid.
3. The company will then become bankrupt and shareholders lose their entire investment

Financial leverage is usually measured by the ratio of long-term debt to total long-term capital. Here “long-term debt” should include not just bonds or other borrowing, but also the value of long-term leases. Total long-term capital, sometimes called *total capitalization,* is the sum of long-term debt and shareholders’ equity.

**Long-term debt ratio = long-term debt**

**Long-term debt + equity**

Another way to express leverage is in terms of the company’s debt-equity ratio:

**Debt-equity ratio = long-term debt**

**Equity**

**Interest Cover Ratio.** Another way you might measure the financial leverage is the extent to which interest is covered by earnings. Banks prefer to lend to firms whose earnings are far in excess of interest payments. Therefore, analysts often calculate the ratio of earnings before interest and taxes (EBIT) to interest payments.

**Interest cover ratio = EBIT**

**Interest payments**

* ***Liquidity ratio***

If you are extending credit to a customer or making a short-term bank loan, you are interested in more than the company’s leverage. You want to know whether it will be able to lay its hands on the cash to repay you. That is why credit analysts and bankers look at several measures of **liquidity.** Liquid assets can be converted into cash quickly and cheaply. There are basically two liquidity ratios namely the current asset and the quick asset ratios.

**Current assets ratio or working capital ratio**

**This ratio is given by the formula:**

**Current assets**

**Current liabilities**

It’s usually expressed as a ratio e.g. 4:1. As you may observe from the formula, it indicates the number of times the current liabilities are covered by current assets. As a rule of thumb, a ratio of 2:1 is generally considered satisfactory i.e. Current assets covering liabilities twice as much. Therefore, if all our current liabilities fall due at same time, we would be able to settle without financial challenges. However, a ratio of less than 2:1 is usually an indication of serious financial problems, especially if the current assets consist of a very high proportion of stock. You should note that this will also depend on the nature of the business and industry.

**Quick Assets ratio or Acid test**

This gauges the business’s ability to meet its current liabilities should they demand payments simultaneously from its liquid assets. The quick asset ratio is given by the formula below:

**Current assets – Stock**

**Current liabilities**

The stock figure is subtracted from current assets because it may not be easy to dispose of stocks in the short term especially in times of crisis. In other words, stock cannot always be readily turned into cash in the short term. As a rule of thumb, a ratio of 1:1 is generally considered satisfactory i.e. current assets covering liabilities. Again as we have mentioned above, this may depend on the nature of the business and industry.

As you may have learnt from above, the two ratios are a good indicator of the company’s liquidity position. However, for a company selling slow moving stocks, the quick asset ratio provides a more realistic measure of liquidity.

* ***Efficiency Ratios***

These ratios are used to measure the efficiency of the business and include the following:

**Stock turnover ratio**

Stock turnover ratio shows how many times a company's stock is sold and replaced over a period. You can also calculate the number of days it takes to sell the inventory on hand i.e. the stock days.

Generally it is calculated as:

**Stock Turnover = Sales**

**Closing stock or Average stock**

However, it may also be calculated as:

**Stock Turnover = Cost of Goods Sold**

**Closing stock or Average stock**

*Note that this is expressed as X times*

**Stock days = Closing stock or average stock X 365 days**

**Sales or Cost of goods sold**

**Fixed assets turnover ratio**

This ratio indicates the number of times that fixed assets are covered by the sales revenue. The more times that fixed assets are covered by the sales, the greater the recovery of the investment in fixed assets.

The fixed asset turnover ratio is given by the formula below:

**Fixed assets turnover ratio= Total sales revenue**

**Fixed assets at net book value**

**Trade debtors’ collection period**

This measures the period that its takes for trade debtors to settle their accounts or credit period given to customers. The less the number of debtor collection days (normally measured in days or months) the more efficient the debt collection is.

The trade debtors’ collection period (debtor days) is given by the formula below

**Debtor (receivables) days= Average trade debtors or closing debtors X 365 days**

**Total credit sales**

**Trade creditor payment period**

Like the trade debtors period, it measures the period that it takes for the Business to pay its trade creditors. If it takes your company longer to pay its creditors or payables, it means you are stretching them as well using their money to finance the company’s operations. This might impact negatively on the relationship between you and your suppliers.

The trade creditors’ payment period (creditor days) is given by the formula below:

**Creditors (payables) days = Average trade creditors or closing creditors X 365 days**

**Total credit sales**

* ***Profitability ratio***

Profitability ratios help users of financial statements to know how much profit a Business has made and then compare it with the previous periods or with other businesses. You may wish to know that profitability is the end product of the policies and decisions made by any business and therefore, it’s the most important barometer of success (measure of performance). We are going to cover four main profitability ratios in this course namely return on capital employed (ROCE), return on equity(ROE), return on assets (ROA), gross profit margin and profit margin.

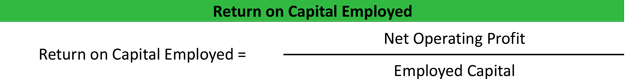
**Return on capital employed ratio (ROCE)**

Return on capital employed ratio measures how efficiently a company can generate profits from its capital employed by comparing net operating profit to capital employed. In other words, return on capital employed shows investors how much profit each kwacha (money) of capital employed generates.

This ratio is based on two important calculations: operating profit and capital employed. Net operating profit is often called PBIT or profit before interest and taxes which is generated from operations. You can also calculate PBIT by adding interest and taxes back to net income or profit if need be.

You must be aware that capital employed is a fairly complicated term because it can be used to refer to many different financial ratios. However, most often capital employed refers to the total assets of a company less all current liabilities or shareholders' fund plus long-term liabilities.

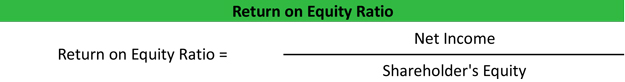
Therefore a return of 1 means that every kwacha (money) of Capital employed generates 1 kwacha of net income or profit. This is an important measurement for potential investors because they want to see how efficiently a company will use their money to generate net income. The formula for ROCE is given as follows:



**Return on equity (ROE)**

Just like ROCE, the return on equity ratio measures the ability of a firm to generate profits from its shareholders investments in the company. In other words, the return on equity ratio shows how much profit each kwacha (money) of ordinary shareholders' equity generates.

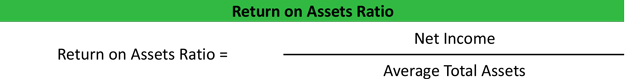
ROE is an important indicator for investors because it shows how effective management is using equity financing to fund operations and grow the company. The formula for ROE is given below:



When you want to measure the long-term profitability of your company, ROCE will be useful ratio because it shows how effectively assets are performing while taking into consideration long-term financing. This is why ROCE is a more useful ratio than return on equity to evaluate the longevity of a company

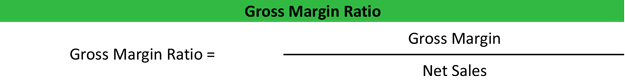
**Return on Assets (Total assets)**

You can use the return on assets ratio (ROA) to measures the net income produced by total assets during a period. You can do this by comparing net income to the average total assets. In other words, ROA measures how efficiently a company can manage its assets to produce profits during a period (It shows how profitable a company's assets are). The formula for ROA is given below:



**Gross profit margin ratio**

You can use the gross profit margin ratio to measures how much profit a company makes from selling its stock or merchandise. This is the pure profit from the sale of stock that can go to paying operating expenses. The formula for gross profit margin is given as follows;



**Profit margin ratio**

The profit margin ratio, also called the return on sales ratio measures the amount of net income earned with each kwacha (money) of sales generated by comparing the net income and net sales of a company. In other words, the profit margin ratio shows what percentage of sales are left over after all expenses are paid by the business.

As you may be aware investors want to know whether profits are high enough to distribute to dividends. An extremely low profit margin formula would indicate the expenses are too high and the management needs to budget and cut expenses. The formula for profit margin ratio is given below:  


You may confuse gross margin ratio with the profit margin ratio, but the two ratios are completely different. Gross margin ratio only considers the cost of goods sold in its calculation because it measures the profitability of selling inventory. Profit margin ratio on the other hand considers other expenses.

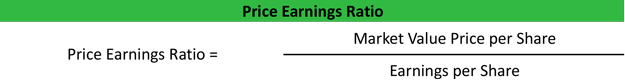
* ***Investors’ ratios***

These ratios are generally more important to shareholders, prospective investors and financial managers who are interested in the performance of shares on the stock exchange market. The ratios include, Price earnings ratio (P/E), Earnings per share (EPS), Dividend yield and Dividend pay-out ratio.

**Price earnings (P/E) ratio**

The P/E ratio is a market prospect ratio that calculates the market value of a stock relative to its earnings by comparing the market price per share by the earnings per share. In other words, the price earnings ratio shows you what the market is willing to pay for a stock based on its current earnings.

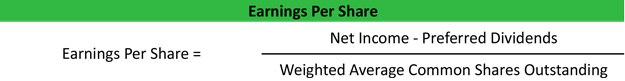
Investors often use this ratio to evaluate what a stock's fair market value should be by predicting future earnings per share. If your company indicate higher future earnings then investors will usually expect it to issue higher dividends or have appreciating stock in the future. As you may recall from unit one, you covered how the wealth of shareholders is measured. The formula for P/E ratio is given below:



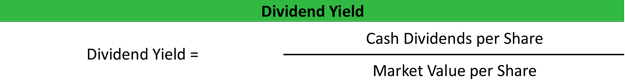
**Earnings per share (EPS) ratio**

EPS is a market prospect ratio that measures the amount of net income earned per share of stock outstanding. In other words, this is the amount of money each share of stock would receive if all of the profits were distributed to the outstanding shares at the end of the year.

Earnings per share or basic earnings per share is calculated by subtracting preferred dividends from net income (net profit) and dividing by the weighted average common shares outstanding. The formula for earnings per share is given below:

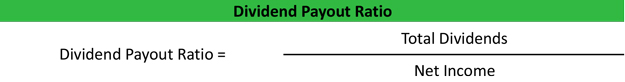


**Dividend Yield Ratio**

The dividend yield is a financial ratio that measures the amount of cash dividends distributed to ordinary shareholders relative to the market value per share. The dividend yield is used by investors to show how their investment in stock is generating either cash flows in the form of dividends or increases in asset value by stock appreciation. The formula for the dividend yield ratio is given below:  


**Dividend Payout Ratio**

The dividend payout ratio measures the percentage of net income that is distributed to shareholders in the form of dividends during the year. In other words, this ratio shows the portion of profits the company decides to keep in order to fund operations and the portion of profits that is given to its shareholders. Investors are particularly interested in the dividend payout ratio because they want to know if companies are paying out a reasonable portion of net income to investors. The formula for the dividend payout ratio is given below:



**Bases for comparison:**

You should be aware that most measures mean little on their own, and are only really useful when compared with something. You may wish to know that depending on the information given in the question, any comparison is likely to be one of the following:

* with previous years for the same company
* with other similar companies
* with industry averages

**3.6 Unit Activity**

Summary of financial information for Kaka Co. is given below, covering the last two years.

*2016 2015*

K’000 K’000

Revenue 74,521 68,000

Cost of sales 28,256 25,772

Salaries and wages 20,027 19,562

Other costs 11,489 9,160

Profit before interest and tax 14,749 13,506

Interest 1,553 1,863

Tax 4,347 3,726

Profit after interest and tax 8,849 7,917

Dividends payable 4,800 3,100

Shareholders’ funds 39,900 35,087

Long term debt 14,000 17,500

Current assets 20,000 19,700

Current liabilities 9,500 8,600

Receivables 15,500 16,300

Payables 8,000 7,900

Inventory 3,000 3,100

Number of shares in issue (‘000) 14,000 14,000

P/E ratio (average for year):

Kaka Co 14.0 13.0

Industry 15.2 15.0

***Required***

Using some profitability, efficiency, debt, and shareholders’ investment ratios, discuss the performance of Kaka Co over the last two years.

summary**3.7 Unit Summary**

The Statement of Cash Flows shows how the cash flows of a company were raised and used. It shows cash flows from operating activities, financing activities and investment activities. The report also provides financial information that should be interpreted together with ratios for a full understanding of the results and position of an entity for any one given period. It also serves as a reconciliation of profit reported to cash and cash equivalent that the entity has as at the end of the period.

In the next unit, you are going to learn how to prepare special accounts.

# **UNIT 4: PREPARATION OF SPECIAL ACCOUNTS**

## **4.1 Unit Introduction**

In the previous units, you have looked at the preparation of financial statements for profit making organisations who record their transaction using the double entry system. However, there are situations where businesses uses single entry to record their transaction (Sometime even missing) or their objectives is not to make profit. Therefore, this unit is going to address the preparation of financial statements from Incomplete records (single entry system) as well as preparation of financial statements for Not for Profit making Organisation(NGOs). In addition, this unit will also look at financial statements for a manufacturing company.

Outcomes

## **4.2 Unit Aim**

The aim of this unit is to equip you with the knowledge and skills to prepare specialised financial statements.

Outcomes

## **4.3 Unit Objectives**

By the end of this Unit, you should be able to:

1. Calculate the amount of cost of sales and gross profit, given a mark-up or margin ratio.
2. Identify and account for accruals and prepayments of expenses, including depreciation
3. To prepare a set of financial statements from the information in the reconstructed ledger accounts
4. Prepare an Income and Expenditure Account for a given period (equivalent to the statement of profit or loss for the organization)
5. Prepare a statement of financial position as at the end of the period (Balance sheet)
6. To calculate the accumulated fund of the club (equivalent to capital of the organization)
7. Calculate the profit or loss on any secondary activity that the club undertook in the period.
8. Identify and classify items of expenditure according to functions: manufacturing, trading, and office.
9. Identify items of expenditure at element level and handle them at the right stage in the process of preparing financial statements.
10. Calculate correctly the manufacturing cost of goods at transfer price.
11. Prepare the Statement of Profit or Loss and the Statement of Financial Position in line with the guidelines given in preceding units.

Time

## **4.4 Time required**

You should spent about ten hours studying this unit. Thereafter you should be able to attempt the same illustrative question and balance it perfectly correctly.

## **4.5 Unit Topics**

### **4.5.1 Nature of Incomplete Records**

**Reflection**

Imagine fire gutted the offices and destroyed inventory in the warehouse. An in order to resume trading it has become necessary to obtain a loan to re-finance the business. Would you be able to reconstruct accounts using information onstatements obtained from the bank, suppliers and customers? How would the estimate of profit mark-up be realistic? What matters do you think would make information unreliable?

As you may be aware, most small shopkeeper, market stall, Internet cafe, or other small business to keep its books using a full double entry system would be ridiculous. First of all, a large number of the owners of such firms would not know how to write up double entry records, even if they wanted to. It is more likely that they would enter details of a transaction once only, using a single entry system. Many of them would fail to record every transaction, resulting in incomplete records.

It is, perhaps, only fair to remember that accounting is supposed to be an aid to management – accounting *is not* something to be done as an end in itself. Therefore, many small firms, especially retail shops, can have all the information they want by merely keeping a cash book and having some form of record, not necessarily in double entry form, of their debtors and creditors.

However, despite many small businesses not having any need for accounting records, most do have to prepare financial statements or, at least, calculate their sales or profits once a year. How can these be calculated if the bookkeeping records are inadequate or incomplete?

In practice, part of the information relating to *cash* receipts or payments is often missing. If the missing information is in respect of one type of payment, then it is normal to assume that the missing figure is the amount required to make both totals agree in the *cash* column of the cash and bank summary. (This does not happen with bank items owing to the fact that another copy of the bank statement can always be obtained from the bank.)

### **4.5.2 Approach to dealing with Incomplete Records**

As you may wish to know, the nature of the 'incompleteness' in the records will vary from problem to problem, but the approach, suitably applied, should be successful in arriving at the final accounts whatever the particular characteristics of the problem might be.

The approach is as follows.

**Step 1:** If possible, and if it is not already known, establish the opening statement of financial position and the proprietor's interest.

**Step 2:** Open up four accounts.

* Income and expense account
* A cash book, with two columns if cash sales are significant and there are payments in cash out of the till
* A trade receivables account
* A trade payables account

**Step 3**: Enter the opening balances in these accounts.

**Step 4**: Work through the information you are given line by line; and each item should be entered into the appropriate account if it is relevant to one or more of these four accounts.

You should also try to recognise each item as an 'income or expense item' or a 'closing statement of financial position item'. It may be necessary to calculate an amount for withdrawals on account and an amount for non-current asset depreciation.

**Step 5**: Look for the balancing figures in your accounts. In particular you might be looking for a value for credit sales, cash sales, purchases, the cost of goods sold, the cost of goods stolen or destroyed, or the closing bank balance. Calculate these missing figures, and make any necessary double entry (eg to the trading account from trade accounts payable for purchases, to the trading account from the cash book for cash sales, and to the trading account from trade accounts receivable for credit sales).

**Step 6**: Now complete the income statement and statement of financial position. Working T accounts might be needed where there are accruals or prepayments.

Let us look at an example (BPP, F3) below for you understand how you can approach questions on incomplete records.

**Example 5.1**

John Snow is the sole distribution agent in the Branton area for Diamond floor tiles. Under an agreement with the manufacturers, John Snow purchases the Diamond floor tiles at a trade discount of 20% off list price and annually in May receives an agency commission of 1% of his purchases for the year ended on the previous 31 March.

For several years, John Snow has obtained a gross profit of 40% on all sales. In a burglary in January 20X1 John Snow lost inventory costing $4,000 as well as many of his accounting records. However, after careful investigations, the following information has been obtained covering the year ended 31 March 20X1.

(a) Assets and liabilities at 31 March 20X0 were as follows.

$

Buildings: at cost 10,000

accumulated depreciation 6,000

Motor vehicles: at cost 5,000

accumulated depreciation 2,000

Inventory: at cost 3,200

Trade accounts receivable (for sales) 6,300

Agency commission due 300

Prepayments (trade expenses) 120

Balance at bank 4,310

Trade accounts payable 4,200

Accrued vehicle expenses 230

(b) John Snow has been notified that he will receive an agency commission of $440 on 1 May 20X1.

(c) Inventory, at cost, at 31 March 20X1 was valued at an amount $3,000 more than a year previously.

(d) In October 20X0 inventory costing $1,000 was damaged by dampness and had to be scrapped as worthless.

(e) Trade accounts payable at 31 March 20X1 related entirely to goods received whose list prices totalled $9,500.

(f) Discounts allowed amounted to $1,620 whilst discounts received were $1,200.

(g) Trade expenses prepaid at 31 March 20X1 totalled $80.

(h) Vehicle expenses for the year ended 31 March 20X1 amounted to $7,020.

(i) Trade accounts receivable (for sales) at 31 March 20X1 were $6,700.

(j) All receipts are passed through the bank account.

(k) Depreciation is charged annually at the following rates.

Buildings 5% on cost

Motor vehicles 20% on cost.

(l) Commissions received are paid directly to the bank account.

(m) In addition to the payments for purchases, the bank payments were:

$

Vehicle expenses 6,720

Drawings 4,300

Trade expenses 7,360

(n) John Snow is not insured against loss of inventory owing to burglary or damage to inventorycaused by damp.

*Required*

Prepare John Snow's income statement for the year ended 31 March 20X1 and a statement of financialposition on that date.

**Discussion and solution**

This is an incomplete records problem because we are told that John Snow has lost many of his accounting records. In particular we do not know sales for the year, purchases during the year, or all the cash receipts and payments.

The first step is to find the opening statement of financial position, if possible. In this case, it is. The proprietor's capital is the balancing figure.

JOHN SNOW

STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20X0

$ $

*Assets*

Non-current assets

Buildings: cost 10,000

accumulated deprecation 6,000

4,000

Motor vehicles: cost 5,000

accumulated depreciation 2,000

3,000

Current assets:

Inventory 3,200

Trade accounts receivable 6,300

Commission due 300

Prepayments 120

Balance of cash at hand 4,310

14,230

*Total assets* 21,230

*Capital and liabilities*

Proprietor's capital (balance) 16,800

Current liabilities

Trade payables 4,200

Accrued expenses 230

4,430

*Total capital and liabilities* 21,230

The next step is to open up an income and expense account, cash book, trade receivables account and trade payables account and to insert the opening balances, if known. Cash sales and payments in cash are not a feature of the problem, and so a single column cash book is sufficient.The problem should then be read line by line, identifying any transactions affecting those accounts.

I & E ACCOUNT

$ $

Sales (note (f)) 60,000

Opening inventory 3,200

Purchases (note (a)) 44,000

47,200

Less: damaged inventory written off (note (c)) (1,000)

inventory stolen (note (e)) (4,000)

42,200

Less closing inventory (note (b)) (6,200)

Cost of goods sold 36,000

Gross profit (note (f)) 24,000

CASH BOOK

$ $

Opening balance 4,310 Trade accounts payable

Trade accounts receivable (see below) 57,980 \_\_(see trade accounts payable) 39,400

Agency commission (note (g)) 300 Trade expenses 7,360

Vehicle expenses 6,720

Drawings 4,300

Balance c/f 4,810 \_\_\_\_\_\_

62,590 62,590

TRADE ACCOUNTS RECEIVABLE

$ $

Opening balance b/f 6,300 Discounts allowed (note (d)) 1,620

Sales (note (f)) 60,000 Cash received (balancing figure) 57,980

Closing balance c/f 6,700 \_\_\_\_\_\_

66,300 66,300

TRADE ACCOUNTS PAYABLE

$ $

Discounts received (note (d)) 1,200 Opening balance b/f 4,200

Cash paid (balancing figure) 39,400 Purchases (note (a)) 44,000

Closing balance c/f 7,600 \_\_\_\_\_\_

48,200 48,200

VEHICLE EXPENSES

$ $

Cash 6,720 Accrual b/f 230

Accrual c/f (balancing figure) 530 I & E account 7,020

7,250 7,250

The trading account is complete already, but now the income statement and statement of financial position can be prepared. Remember not to forget items such as the inventory losses, commission earned on purchases, discounts allowed and discounts received.

JOHN SNOW

INCOME STATEMENT FOR THE YEAR ENDED 31 MARCH 20X1

$ $

Sales (note (f)) 60,000

Opening stock 3,200

Purchases (note (a)) 44,000

47,200

Less: damaged inventory written off (note (c)) (1,000)

inventory stolen (4,000)

42,200

Less closing inventory (note (b)) 6,200

Cost of goods sold 36,000

Gross profit (note (f)) 24,000

Add: commission on purchases 440

discounts received 1,200

25,640

*Expenses*

Trade expenses (note (h)) 7,400

Inventory damaged 1,000

Inventory stolen 4,000

Vehicle expenses 7,020

Discounts allowed 1,620

Depreciation

Buildings 500

Motor vehicles 1,000

22,540

Net profit (to capital account) 3,100

JOHN SNOW

STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20X1

$ $

*Assets*

Non-current assets

Buildings: cost 10,000

accumulated depreciation 6,500

3,500

Motor vehicles: cost 5,000

accumulated depreciation 3,000

2,000

Current assets

Inventory 6,200

Trade accounts receivable 6,700

Commission due 440

Prepayments (trade expenses) 80

Balance at bank 4,810

18,230

*Total assets* 23,730

*Capital and liabilities*

Proprietor's capital

As at 31 March 20X0 16,800

Net profit for year to 31 March 20X0 3,100

Less drawings (4,300)

As at 31 March 20X0 15,600

Current liabilities

Trade accounts payable 7,600

Accrued expenses 530

8,130

*Total capital and liabilities* 23,730

*Notes*

(a) The agency commission due on 1 May 20X1 indicates that purchases for the year to 31 March 20X1 were: 100%/1% x $440 = $44,000

(b) Closing inventory at cost on 31 March 20X1 was $(3,200 + 3,000) = $6,200.

(c) Inventory scrapped ($1,000) is accounted for by:

CREDIT Cost of sales

DEBIT I & E account

(d) Discounts allowed are accounted for by:

DEBIT Discounts allowed account

CREDIT Trade accounts receivable

Similarly, discounts received are:

DEBIT Trade accounts payable

CREDIT Discounts received

*Note*. Discounts received represents settlement discounts, not *trade* discounts, which are not usually accounted for as they are given automatically at source.

(e) Inventory lost in the burglary is accounted for by:

CREDIT Cost of sales

DEBIT I & E account

(f) The trade discount of 20% has already been deducted in arriving at the value of the purchases.

The gross profit is 40% on sales, so with cost of sales = $36,000

Cost (60%) 36,000

Profit (40%) 24,000

Sales (100%) 60,000

(It is assumed that trade expenses are not included in the cost of sales, and so should be ignored in this calculation.)

(g) The agency commission of $300 due on 1 May 20X0 would have been paid to John Snow at that date.

(h) The I & E account expenditure for trade expenses and closing balance on vehicle expenses account are as follows.

TRADE EXPENSES

K

Prepayment 120 I & E account (balancing figure) 7,400

Cash 7,360 Prepayment c/f 80 \_\_\_\_\_

7,480 7,480

**11.8 SUMMARY**

In this unit I have discussed incomplete records as an exercise that can only be done with a perfect knowledge of accruals basis of preparing accounts. I have also illustrated how accounts are written in mathematical form straight on the face of the Statement of Profit or Loss and how closing balances are reported on the statement of Financial position. You need to undersatnd the logic of debiting and crediting in order to reconstruct accounts from a limited amount of information. In the next unit I will discuss preparation of financial statements of partnership businesses.

### **4.5.3 Not-For-Profit Making Organisations (NFP)**

As you may be aware, not-for-profit making organisations (**NFPs**) include non governmental agencies such as trade unions, pressure groups such as consumer protection communities, initiatives, schools, churches and clubs. Such organisation aim to provide a service to members who in turn contribute resources that form the capital base of the entity. Also new terms will be introduced, accounting for NFPs is the same as is done for organisations with a profit motive.

Reflection

What is the difference between NFPs and Business organisations?

As you may be aware, the main purpose of NFPs is not trading or profit-making. Therefore, charities, clubs, associations and other non-profit-oriented organisations do not prepare statement of profit or loss accounts. Instead, NFPs prepare the Income and expenditure report which shows whether they have made a surplus or deficit (and not profit or loss as it is with profit making organisations). In addition, just like profit making organisations, NFPs also prepare the statement of financial position because they have assets, liabilities and accumulated funds (similar to equity). They are run so that their members can do things such as play football, chess or dungeons and dragons.

Most of the financial information is initially recorded in the receipts and payment account before preparing the income & expenditure report and statement of financial position.

**Receipts and payments accounts** are a summary of the Cash Book for the period. For an organisation with no assets (other than cash) and no liabilities, a summary of the Cash Book reveals everything about what has happened financially during a period.

**Drawing up income and expenditure accounts**

For illustrative purposes we can now look at the preparation of an income and expenditure account and a statement of financial position of a club below. You may wish to know that a separate trading account is to be prepared for a bar, where refreshments are sold to make a profit.

The majority of clubs and associations keep their accounts using single entry methods. This example will therefore be from single entry records, using the principles described in the previous section on incomplete records.

**Example 5.2**

The treasurer of the Long Lane Football Club has prepared a receipts and payments account, but members have complained about the inadequacy of such an account. She therefore asks an accountant to prepare a trading account for the bar, and an income and expenditure account and a balance sheet. The treasurer gives the accountant a copy of the receipts and payments account together with information on assets and liabilities at the beginning and end of the year:

**Long Lane Football Club**

**Receipts and Payments Account for the year ended 31 December 20X6**

*Receipts* K *Payments* K

Bank balance at 1.1.20X6 524 Payment for bar supplies 38,620

Subscriptions received for Wages:

20X5 (arrears) 1,400 Grounds man and assistant 19,939

20X6 14,350 Barman 8,624

20X7 (in advance) 1,200 Bar expenses 234

Bar sales 61,280 Repairs to stands 740

Donations received 800 Ground upkeep 1,829

Secretary’s expenses 938

Transport costs 2,420

Bank balance at 31.12.20X6 6,210 \_\_\_\_\_

79,554 79,554

*Additional information: 31.12.20X5 31.12.20X6*

1) K K

Stocks in the bar – at cost 4,496 5,558

Owing for bar supplies 3,294 4,340

Bar expenses owing 225 336

Transport costs – 265

2) The land and football stands were valued at 31 December 20X5 at: land K40,000; football stands K20,000; the stands are to be depreciated by 10 per cent per annum.

3) The equipment at 31 December 20X5 was valued at K2,500, and is to be depreciated at 20 per cent per annum.

4) Subscriptions owing by members amounted to K1,400 on 31 December 20X5, and K1,750 on 31 December 20X6.

**Solution**

From this information, you may draw up the appropriate accounts and statements by following the stages given below

**Stage 1**: Draw up a Statement of Affairs at the end of the previous period.

**Statement of Affairs as at 31 December 20X5**

K K K

*Fixed assets*

Land 40,000

Stands 20,000

Equipment 2,500

62,500

*Current assets*

Stock in bar 4,496

Debtors for subscriptions 1,400

Cash at bank 524

6,420

*Less Current liabilities*

Creditors 3,294

Bar expenses owing 225

(3,519)

Net current assets 2,901

65,401

Financed by:

**Accumulated fund (difference) 65,401**

**Stage 2 :**Draw up a Bar Trading Account.

**Long Lane Football Club**

**Bar Trading Account for the year ended 31 December 20X6**

£ £

Sales 61,280

*Less* Cost of goods sold:

Stock 1.1.20X6 4,496

*Add* **Purchases (Note 1) 39,666**

44,162

*Less* Stock 31.12.20X6 (5,558)

(38,604)

Gross profit 22,676

*Less* **Bar expenses(Note 2) 345**

Barman’s wages 8,624

(8,969)

Net profit to income and expenditure account 13,707

**Notes:**

**1 Purchases Control**

£ £

Cash 8,620 Balances (creditors) b/d 3,294

Balances c/d 4,340 **Trading account (difference) 39,666**

42,960 42,960

**2 Bar Expenses**

£ £

Cash 234 Balance b/d 225

Balance c/d 336 **Trading account (difference) 345**

570 570

**Stage 3:** Draw up the financial statements.

**Long Lane Football Club**

**Income and Expenditure Account for the year ended 31 December 20X6**

Income £ £ £

**Subscriptions for 20X6(Note 1) 16,100**

Profit from the bar 13,707

Donations received 800

30,607

*Less* Expenditure

Wages – Groundsman and assistant 19,939

Repairs to stands 740

Ground upkeep 1,829

Secretary’s expenses 938

**Transport costs(Note 2) 2,685**

Depreciation

Stands 2,000

Equipment 500

2,500

(28,631)

Surplus of income over expenditure 1,976

**Notes:**

**1 Subscriptions Received**

£ £

Balance (debtors) b/d 1,400 Cash 20X5 1,400

**Income and expenditure** 20X6 14,350

**account (difference) 16,100** 20X7 1,200

Balance (in advance) c/d 1,200 Balance (owing) c/d 1,750

18,700 18,700

**2 Transport Costs**

£ £

Cash 2,420 **Income and expenditure**

Accrued c/d 265 **account (difference) 2,685**

2,685 2,685

Note that subscriptions received in advance are carried down as a credit balance to the following period.

**The Long Lane Football Club**

**Balance Sheet as at 31 December 20X6**

£ £ £

*Fixed assets*

Land at valuation 40,000

Football stands at valuation 20,000

*Less* Depreciation (2,000)

18,000

Equipment at valuation 2,500

*Less* Depreciation (500)

2,000

60,000

*Current assets*

Stock of bar supplies 5,558

Debtors for subscriptions 1,750

Cash at bank 6,210

13,518

*Less Current liabilities*

Creditors for bar supplies 4,340

Bar expenses owing 336

Transport costs owing 265

Subscriptions received in advance 1,200

(6,141)

Net current assets 7,377

67,377

*Financed by*:

Accumulated fund

Balance as at 1.1.20X6 65,401

*Add* Surplus of income over expenditure 1,976

67,377

### **4.5.4 Manufacturing Accounts**

Reflection

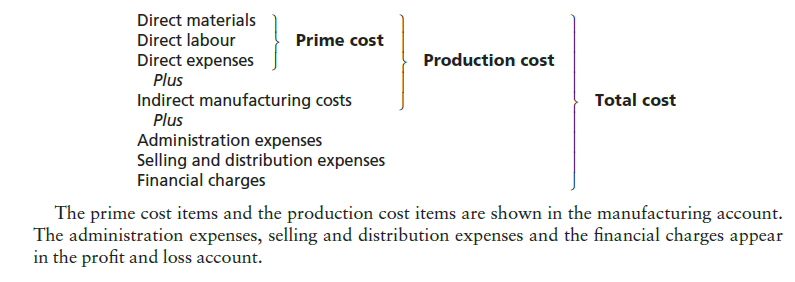
If you were working for a supermarket for, say, five years and you decide to join a manufacturer of washing detergents, what differences would there be in the format of financial statements?

We now have to deal with businesses which are manufacturers. For these businesses, a **manufacturing account** is prepared in addition to the trading and profit and loss accounts. It is producedfor internal use only. People other than the owners and managers of the organisationrarely see a manufacturing account (Wood and Sangster, 2005).

You may wish to know that if a business is using manufacturing accounts, instead of a figure for purchases (of finished goods) the trading account will contain the cost of manufacturing the goods that were manufactured during the period. The manufacturing account is used to calculate and show the cost of manufacturing those goods. The figure it produces that is used in the trading account is known as the **production cost**.

**Divisions of costs**

In a manufacturing business the costs are divided into different types. These may be summarised in chart form as follows:

The manufacturing account includes all purchases of raw materials, including the stock adjustments for raw materials. It also includes stock adjustments for **work in progress** (goods that are part-completed at the end of a period)

Let us look at an example (adapted from Wood and Sangster, 2005) below which illustrates how financial statement for a manufacturing business are prepared.

**Example**

**J Jarvis**

**Trial Balance as at 31 December 2017**

*Dr Cr*

K K

Stock of raw materials 1.1.2017 21,000

Stock of finished goods 1.1.2017 38,900

Work in progress 1.1.2017 13,500

Wages (direct K180,000; factory indirect K145,000) 325,000

Royalties 7,000

Carriage inwards (on raw materials) 3,500

Purchases of raw materials 370,000

Productive machinery (cost K280,000) 230,000

Administration computers (cost K20,000) 12,000

General factory expenses 31,000

Lighting 7,500

Factory power 13,700

Administration salaries 44,000

Sales reps’ salaries 30,000

Commission on sales 11,500

Rent 12,000

Insurance 4,200

General administration expenses 13,400

Bank charges 2,300

Discounts allowed 4,800

Carriage outwards 5,900

Sales 1,000,000

Debtors and creditors 142,300 64,000

Bank 16,800

Cash 1,500

Drawings 60,000

Capital as at 1.1.2017 \_\_\_\_\_\_\_\_ 357,800

1,421,800 1,421,800

*Notes at 31.12.2017:*

1 Stock of raw materials K24,000; stock of finished goods K40,000; work in progress K15,000.

2 Lighting, rent and insurance are to be apportioned: factory 5/6, administration 1/6.

3 Depreciation on productive and administration computers at 10 per cent per annum on cost.

**J Jarvis**

**Manufacturing, Trading and Profit and Loss Account for the year ending 31 December 2017**

K K K

Stock of raw materials 1.1.2017 21,000

*Add* Purchases 370,000Carriage inwards 3,500

394,500

*Less* Stock raw materials 31.12.2017 (24,000)

Cost of raw materials consumed 370,500

Direct labour 180,000

Royalties 7,000

Prime cost 557,500

*Indirect manufacturing costs:*

General factory expenses 31,000

Lighting 5/6 6,250

Power 13,700

Rent 5/6 10,000

Insurance 5/6 3,500

Depreciation of productive machinery 28,000

Indirect labour 145,000

237,450

794,950

*Add* Work in progress 1.1.2017 13,500

808,450

*Less* Work in progress 31.12.2017 (15,000)

Production cost of goods completed c/d 793,450

Sales 1,000,000

*Less* Cost of goods sold:

Stock of finished goods 1.1.2017 38,900

*Add* Production cost of goods completed 793,450

832,350

*Less* Stock of finished goods 31.12.2017 (40,000)

(792,350)

Gross profit 207,650

*Administration expenses*

Administration salaries 44,000

Rent 1/6 2,000

Insurance 1/6 700

General expenses 13,400

Lighting 1/6 1,250

Depreciation of administration computers 2,000

63,350

*Selling and distribution expenses*

Sales reps’ salaries 30,000

Commission on sales 11,500

Carriage outwards 5,900

47,400

*Financial charges*

Bank charges 2,300

Discounts allowed 4,800

7,100

(117,850)

Net profit 89,800

**J Jarvis**

**Balance Sheet as at 31 December 2017**

*Non- Fixed assets* K K

Productive machinery at cost 280,000

*Less* Depreciation to date (78,000)

202,000

Administration computers at cost 20,000

*Less* Depreciation to date (10,000)

10,000

212,000

*Current assets*

Stock

Raw materials 24,000

Finished goods 40,000

Work in progress 15,000

Debtors 142,300

Bank 16,800

Cash 1,500

239,600

*Less Current liabilities*

Creditors (64,000)

Net current assets 175,600

387,600

Financed by

*Capital*

Balance as at 1.1.2017 357,800

*Add* Net profit 89,800

447,600

*Less* Drawings (60,000)

387,600

### **4.5.5 Nature of joint ventures**

You may wish to know that sometimes a particular business venture can best be done by two or more businesses joining together to do it instead of doing it separately. The joining together is for that one venture only, it is not joining together to make a continuing business.

Such projects are known as **joint ventures**. For instance, a merchant might provide the capital, the transport to the markets and the selling skills. The farmer grows the produce. The profits or losses are then shared between them in agreed ratios. It is like a partnership, but only for this one transaction. There may be several joint ventures between the same businesses, but each one is a separate venture. The agreements for each venture may be different from each other.

### **4.5.6 Accounting for joint ventures**

In case where separate accounts are maintained between the parties, you may follow the stages as indicated by wood ad Sangster (2005) below to account for joint ventue:

**Stage 1**

White and Green will each have entered up their own part of the transactions. White will have opened an account named ‘Joint Venture with Green’. Similarly, Green will have opened a ‘Joint

Venture with White’ account. The double entry to these joint venture accounts will be:

*In White’s books*:

Payments by White: Debit joint venture with Green

Credit Cash Book

Goods supplied to Green: Debit joint venture with Green

Credit purchases

*In Green’s books*:

Payments by Green: Debit joint venture with White

Credit Cash Book

Cash received by Green: Debit Cash Book

Credit joint venture with White

**Stage 2**

At this stage, White and Green know only the details in their own set of books. They do not yet know what the details are in the other person’s books.

This means that they cannot yet calculate profits, or find out how much cash has to be paid or received to close the venture. To do this they must each send a copy of their joint venture accounts to the other person.

Each person will then draw up a **memorandum joint venture account**, to include all the details from each joint venture account. The memorandum joint venture account is not a double entry account. It is drawn up only (*a*) to find out the shares of net profit or loss, and (*b*) to help calculate the amounts payable and receivable to close the venture.

**4.6 Unit Activity**

**Exercise 1**

Frank entered into a joint venture with Graham for the purchase and sale of robot mowers. They agreed that profits and losses should be shared equally.

The following transactions took place:

1. Frank purchased mowers for £120,400 and paid carriage £320.
2. Graham purchased mowers for £14,860 and paid carriage £84.
3. Graham paid to Frank £70,000.
4. Frank sold mowers for £104,590 and sent a cheque for £50,000 to Graham.
5. Graham sold for £19,200 all the mowers he had purchased.
6. The unsold mowers in the possession of Frank were taken over by him at a valuation of K40,000.
7. The amount due from one venturer to the other was paid and the joint venture was dissolved.

**You are required to prepare:**

(*i*) a statement to show the net profit or loss of the joint venture, and

(*ii* ) the accounts for the joint venture in the books of Frank and Graham.

**Exercise 2**

Jean Marsh owns a small business making and selling children’s toys. The following trial balance was extracted from her books on 31 December 20X9.

*Dr Cr*

K K

Capital 15,000

Drawings 2,000

Sales 90,000

*Stocks at 1 January 20X9:*

Raw materials 3,400

Finished goods 6,100

Purchases of raw materials 18,000

Carriage inwards 800

Factory wages 18,500

Office salaries 16,900

J Marsh: salary and expenses 10,400

*General expenses:*

Factory 1,200

Office 750

Lighting 2,500

Rent 3,750

Insurance 950

Advertising 1,400

Bad debts 650

Discount received 1,600

Carriage outwards 375

Plant and machinery, at cost less depreciation 9,100

Car, at cost less depreciation 4,200

Bank 3,600

Cash in hand 325

Debtors and creditors 7,700 6,000

112,600 112,600

You are given the following additional information.

**1** Stocks at 31 December 20X9

Raw materials £2,900

Finished goods £8,200

There was no work in progress.

**2** Depreciation for the year is to be charged as follows:

Plant and machinery £1,500

Car £500

**3** At 31 December 20X9 Insurance paid in advance was £150 and Office general expenses unpaid were £75.

**4** Lighting and rent are to be apportioned: 4/5 Factory, 1/5 Office

Insurance is to be apportioned: 3/4 Factory, 1/4 Office

**5** Jean is the business’s salesperson and her salary and expenses are to be treated as a selling expense. She has sole use of the business’s car.

**Required**

For the year ended 31 December 20X9 prepare

(*a*) a manufacturing account showing prime cost and factory cost of production.

(*b*) a trading account.

summary**4.7 Unit Summary**

In this last unit of Module (2), you covered the preparation of special accounts which include incomplete records, manufacturing accounts, accounts for NFPs organisation and joint ventures. Incomplete records are using a single system as opposed to double entry system. Manufacturing accounts are prepared for internal use and may be different from retailer or wholesale businesses. Income and expenditure reports are prepared for NFPs instead of statement of profit or loss.

# References

Atrill, P, McLaney, E. J. (2013) *Accounting and Finance for Non-Specialists*

BPP(2013) FIA FFA Financial Accounting,2nd Edition. London: BPP Learning Media.

Wood, F and Sangster, A. (2005) Business Accounting 1, 10th edition, FT Prentice Hall

Wood,F. and Sangster, A.(2011) Business Accounting 1, 11th Edition. London: Pearson