NATIONAL OPEN UNIVERSITY OF NIGERIA

SCHOOL OF MANAGEMENT SCIENCES

COURSE CODE: ACC 419

COURESE TITLE: FINANCIAL ACCOUNTING

COURSE DEVELOPMENT ON

B. Sc. ACCOUNTING

ACC 419

FINANCIAL ACCOUNTING

COURSE GUIDE

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ACC 419 FINANCIAL ACCOUNTING

1.0 INTRODUCTION

ACC 419 is a 400 level first semester course. It introduces you to accounting and reporting concepts, analysis and interpretation as well as guide to presentation of financial statements of different organisations.

2.0 WHAT YOU WILL LEARN IN THIS COURSE

This course guide tells you briefly what to expect from reading this course. The study of financial accounting is to familiarize you with this subject matter which is dealt with herein and of which are expected to know much about after reading through

3.0 COURSE AIMS

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

4.0 COURSE OBJECTIVES

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

- Discuss the role of International Accounting Standards Board in providing the framework for the preparation of financial statements;
- State the objectives and elements of financial statements;
- Trace the history of Companies and Allied Matters Act (CAMA, 2004);
- Explain the purpose and objectives of cash flow statement, goodwill and disclosures required in financial statements;
- Enumerate the parties that are always interested in the interpretation of financial statements;
- Distinguish between Construction contract, Long term contract, Short term contract, Building contract and Civil contract;
- State two functions of a Stockbroker;
- Distinguish between investment purchased or sold Cum– Div and Ex – Div;

- Define the concepts investment and investment account;
- Prepare the accounts of specialised companies such as shipping as well as cooperative societies;
- Define cooperative society and enumerate the guiding principles of the society;
- Differentiate between the roles and objectives of International Accounting Standard Board, the Nigeria Accounting Standards Board;
- List and explain the generally accepted accounting principles (GAAP) governing analysis and presentation of financial statements;
- Explain the nature of investment accounting and accounting for lease and hire purchase;
- State the legal and regulatory framework of group accounts, application of such framework to preparation of consolidated profit and loss account and balance sheet.

5.0 WORKING THROUGH THIS COURSE

For you to excel in this course, you are required to carefully read each unit, and understand the contents. You are also required to attempt each unit self-assessment exercises and submit your assignment for assessment purposes. Apart from studying the course material on your own, you also need to attend tutorial sessions for exchange of ideas with your Facilitator.

You are expected to compile the questions that bug you and the grey areas in the course materials and bring these for discussion with fellow learners and the Facilitator. You are expected to carve out specific time each day, every day for your study. Try to form good study habits. Remember that you are a self-learner. In other words, you are on your own. If you study hard everyday and do your assignments, you will achieve your goal.

6.0 COURSE MATERIALS

You will be provided with the following materials:

- Course Guide
- Course Material containing Study Units
- Assignment file

7.0 STUDY UNITS

The study units in this course are as follows:

MODULE 1

Unit 1: Accounting and Reporting Concepts

Unit 2: Company Accounts and Reports

Unit 3: Preparation of a Published Financial Statement

Unit 4: Preparation of Cash Flow Statement

Unit 5: Analysis and Preparation of Financial Statements

Unit 6: Contract Accounts

MODULE TWO

Unit 1: Investment Accounting

Unit 2: Accounting for Lease and Hire Purchase

Unit 3: Accounting for Specialised Businesses

Unit 4: Generally Accepted Accounting Principles (GAAP)

Unit 5: Development, Contents and Application of Accounting

Unit 6: Regulatory Framework of Financial Accounting

MODULE THREE

Unit 1: Legal and Regulatory Framework of Group Accounts

Unit 2: Consolidated Balance Sheet

Unit 3: Consolidated Profit and Loss Account

Unit 4: Associated Companies

Unit 5: Disposal of Subsidiaries

Unit 6: Group Cash Flow

All these units are demanding. They also deal with basic principles and values, which merit your attention and thought. Tackle them in separate study periods. You may require several hours for each.

We suggest that the Modules be studied one after the other, since they are linked by a common theme. You will gain more from them if you have first carried out work on the scope of Family Law generally. You will then have a clearer picture into which to paint these topics. Subsequent courses are written on the assumption that you have completed these units.

Each study units consists of one week's work and includes specific objectives, directions for study, reading materials and self assessment exercises (SAEs). Together with tutor marked assignments (TMAs), these exercises will assist you in achieving the stated learning objectives of the individual units and of the course.

8.0 ASSESSMENTS

There are two types of assessment for this course: the Tutor Marked Assignment (TMA), the end of course examination.

In tackling the assignments, you are expected to apply information, knowledge and techniques gathered during the course. The assignments must be submitted to your tutor for formal assessment in accordance with the deadlines stated in the ***Presentation Schedule*** and the ***Assignment File***. The work you submitted to your tutor will count for 30% of your total course mark.

At the end of the course, you will need to sit for a final written examination of 'three hours' duration. This examination will also count for 50% of your total course mark.

9.0 TUTOR-MARKED ASSIGNMENT (TMAs)

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

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

10.0 FINAL EXAMINATION AND GRADING

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

11.0 COURSE SCORE DISTRIBUTION

The following table lays out how the actual course marking is broken down:

ASSESSMENT	MARKS
Assignment 1 – 4 (TMAs) (the best three of all the assignments submitted)	Four assignments. Best three marks of the four count at 30% of course marks
Final Examination	70% of overall course marks
Total	**100% of course marks**

12.0 COURSE OVERVIEW

This table brings together the units and the number of weeks you should take to complete them and the assignment that follow them.

Unit	Title of work	Weeks activity	Assessment (end of unit)
	Module 1		
1	Accounting and Reporting Concepts	1	1
2	Company Accounts and Reports	1	
3	Preparation of a Published Financial Statement	**1**	2
4	Preparation of Cash Flow Statement	1	
5	Analysis and Preparation of Financial Statements	**1**	3
6	Contract Accounts	1	
	Module 2		
1	Investment Accounting	1	4
2	Accounting for Lease and Hire Purchase	1	
3	Accounting for Specialised Businesses	1	

4	Generally Accepted Accounting Principles (GAAP)	1	5
5	Development, Contents and Application of Accounting	1	
6	Regulatory Framework of Financial Accounting	1	6
	Module 3		
1	Legal and Regulatory Framework of Group Accounts	1	7
2	Consolidated Balance Sheet	1	
3	Consolidated Profit and Loss Account	1	
4	Associated Companies	1	8
5	Disposal of Subsidiaries	1	
6	Group Cash Flow	1	9
	Revision	2	
	Total	20	

13.0 HOW TO GET THE MOST FROM THIS COURSE

In distance learning, the study units are specially developed and designed to replace the university lecturer. Hence, you can work through these materials at your own pace, and at a time and place that suits you best. Visualize it as reading the lecture instead listening to a lecturer.

Each of the study units follows a common format. The first item is an introduction to the subject matter of the unit, and how a particular unit is integrated with the other units and the course as a whole. Next is a set of learning objectives. These objectives let you know what you should be able to do by the time you have completed the unit. You should use these objectives to guide your study. When you have finished the unit, you must go back and check whether you have achieved the objectives. If you make a habit of doing this, you will significantly improve your chances of passing the course.

The main body of the unit guides you through the required reading from other sources. This will usually be either from your set books or from a ***Reading Section***. You will be directed when you need to use a computer and guided through the tasks you must do. The purpose of the computing work is two-fold. First, it will enhance your understanding of the material in the unit. Second, it will give you practical experiences of using programmes which you could well encounter in your work outside your studies. In any event, most of the techniques you will study are applicable on computers in normal working practice, so it is important you encounter them during your studies.

Activities are interspersed throughout the units, and answers are given at the end of the units. Working through these tests will help you to achieve the objectives of the units and prepare you for the assignments and the examinations. You should do each activity as you come to it in the study unit. There are also numerous examples given in the study units, work through these when you come to them, too.

The following is a practical strategy for working through the course. If you run into any trouble, telephone your facilitator or post the questions on the Web CT OLE's discussion board. Remember that your facilitator's job is to help you. When you need help, don't hesitate to call and ask your tutor to provide it. In summary,

- Read this course guide.

- Organise a study schedule. Refer to the course overview for more details. Note the time you are expected to spend on each unit and how the assignments relate to the unit. Important information e.g. details of your tutorials, and the date of the first day of the semester is available from the portal. You need to gather together all this information in one place, such as your diary or a wall calendar. Whatever method you choose to use, you should decide on and write in your own dates for working on each unit.

- Once you have created your own study schedule, do everything you can to stick to it. The major reason that students fail is that they get behind with their coursework. If you get into difficulties with your schedule, please let your facilitator know before it is too late for help.

- Turn to unit 1 and read the introduction and the objectives for the unit.

- Assemble the study materials. Information about what you need for a unit is given in the 'Overview' at the beginning of each unit. You will always need both the study unit you are working on and one of your set books, on your desk at the same time.

- Work through the unit. The content of the unit itself has been arranged to provide a sequence for you to follow. As you work through this unit, you will be instructed to read sections from your set books or other articles. Use the unit to guide your reading.

- Up-to-date course information will be continuously posted to your portal.

- Well before the relevant due dates (about 4 weeks before the dates) access the Assignment file on the portal and download your next required assignment. Keep in mind that you will learn a lot by doing the assignments carefully. They have been designed to help you meet the objectives of the course and, therefore, will help you pass the examination. Submit all assignments not later than the due dates.

- Review the objectives for each study unit confirm that you have achieved them. If you feel unsure about any of the objectives, review the study material or consult your tutor.
- When you are confident that you have achieved a unit's objectives, you can then start on the next unit. Proceed unit by unit through the course and try to pace your study so that you keep yourself on schedule.

- When you have submitted an assignment to your tutor for marking, do not wait for its return before starting on the next unit. Keep to your schedule. When the assignment is returned, pay particular attention to your facilitator's comments. Consult your tutor as soon as possible if you have any questions or problems.

- After completing the last unit, review the course and prepare yourself for the final examination. Check that you have achieved the unit objectives and the course objectives.

14.0 TUTORS AND TUTORIALS

There are 18 hours of tutorials (ten 2-hour sessions) provided in support of this course. You will be notified of the dates, times and location of these tutorials, together with the names and phone number of your tutor, as soon as you are allocated a tutorial group.

Your tutor will mark and comment on your assignments, keep a close watch on your progress and on any difficulties you might encounter as they would provide assistance to you during the course. You must mail your tutor-marked assignments to your tutor well before the due date (at least two working days are required). They will be marked by your tutor and returned to you as soon as possible. Do not hesitate to contact your tutor by telephone, e-mail, or discussion board if you need help. The following might be circumstances in which you would find help necessary: when

- you do not understand any part of the study units or the assigned readings.
- you have difficulty with the self-tests or exercises.
- you have a question or problem with an assignment with your tutor's comment on an assignment or with the grading of an assignment.

You should try your possible best to attend the tutorials. This is the only chance to have face-to-face contact with your tutor and to ask questions which are answered instantly. You can raise any problem encountered in the course of your study. To gain the maximum benefit from course tutorials, prepare a question list before attending them. You will learn a lot from participations in discussions.

15.0 SUMMARY

The course ACC 419 examines the contents of Financial Accounting. The course is designed and developed for your benefit as an accounting student.

I hope that you will find this course interesting and exciting. The course is a living course. As you go through it, you will develop more insight into family law and the family property.

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

COURSE DEVELOPMENT ON

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FINANCIAL ACCOUNTING

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MODULE ONE

UNIT ONE ACCOUNTING AND REPORTING CONCEPTS

CONTENTS

1.0 INTRODUCTION

You are welcome to this course on financial accounting. In this module, you will be introduced to six (6) units whose titles are: Accounting and Reporting Concepts; Company Accounts and Reports; Preparation of Published Financial Statements; Preparation of a Cash Flow Statement; Analysis and Interpretation of Financial Statements and Contract Accounts.

In this unit, you will be introduced to accounting and report concepts. The unit will take you through the study of financial statements, IASB framework, objectives, underlying assumptions, qualitative characteristics and the elements of financial statements.

2.0 OBJECTIVES

After studying this unit, readers should be able to:

- explain the objectives and qualitative characteristics of financial statements and information;
- identify the differences in the financial statements prepared under the accrual basis, cash basis and break-up basis;
- understand the measurement basis and recognition criteria of the elements of financial statements.

3.0 MAIN CONTENT

3.1 Financial Statements

Financial statements possess certain qualitative characteristics that enhance the usefulness of the information they convey to users. In this unit, we shall look at the elements and desirable qualities of financial statements. A number of these issues are covered in the Framework for the preparation and presentation of financial statements issued by the International Accounting Standards Boards (IASB).

3.2 The International Accounting Standards Board (IASB) Framework

In July 1989, the International Accounting Standards Committee (IASC), now replaced by the International Accounting Standards Board (IASB), produced a document titled, simply "The Framework". This document sets out the concepts that determine how financial statements are prepared and the information they contain. This is why the IASB is also called the "Conceptual Framework".

A conceptual framework is a clearly defined set of objectives and principles that can lead to the production of consistent accounting standards. The framework is therefore the "conceptual framework", the frame of reference from which the accounting standards issued by the IASB are constructed.

3.2.1 Purpose of the Framework

The framework is expected to serve the following purposes:

(a) Assist in the development of future accounting standards and in the review of existing standards.

(b) Assist in promoting harmonization of regulations, accounting standards and procedures, relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by International accounting standards.

(c) Assist national standard-setting bodies in developing national standards.

(d) Assist preparers of financial statements in applying international accounting standards and in dealing with issues not yet covered by an International Accounting Standards (IAS).

(e) Assist auditors in forming an opinion as to whether financial statements conform to IASs.

(f) Assist users of financial statements in interpreting the information contained in financial statements that comply with IASs; and

(g) Provide those who are interested in the work of the IASB with information on its approach to the formulation of accounting standards.

3.2.2 Status of the Framework

In the event of a conflict between the Framework and an International Financial Reporting Standard (IFRS), the latter will prevail.

3.2.3 Scope of the Framework

The framework deals with the following:

(a) The objectives of financial statements.
(b) Underlying assumptions.
(c) Qualitative characteristics of financial statements.
(d) Definition, recognition and measurement of the elements of financial statements; and
(e) Concepts of capital and capital maintenance.

3.3 Objectives of Financial Statements

The objectives of financial statements are to provide information about the financial position, performance and changes in financial position that will assist a wide spectrum of users in making useful economic decisions. The Framework identifies the following users of financial information: investors, employees, lenders, suppliers, customers, government and the public.
Information on the financial performance of an entity is basically provided by the income statement. Such information is useful in evaluating the returns obtained by an entity from the resources available to it.

Information about changes in financial position is contained in the cash flow statement and is useful in assessing an entity's ability to generate cash and how the cash generated is utilised.

3.4 Underlying Assumptions

The framework specifies and explains two main assumptions that underlie the preparation of financial statements. These assumptions are:

3.4.1 Accrual Basis

W hen financial statements are prepared under the accrual basis of accounting, the effects of transactions and other events are recognized when they occur and not as cash or its equivalent are received or paid. They are recorded in the accounting records and reported in the financial statements, of the periods to which they relate.

3.4.2 Going Concern Basis

Under the going concern basis, the enterprise is regarded as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity to liquidate or reduce materially the scale of its operations.

Illustration 1-1

Exotic Furniture Nig. Ltd recorded the following transactions in the first week of January 20x9:

(a) Rented an office space in Port Harcourt for N 1 million per annum and paid N 5 million, being rent for five years demanded by the landlord.

(b) Bought office equipment for N 240,000 on credit from Modern Business Machines Ltd. The expected useful life of the equipment is four years.

(c) Received cheque of N 1.3million from Rivers State Polytechnic, Bori, being final payment for sales made to the institution in 20x7.

(d) Sold furniture items on credit to a local government in Rivers State for N 4 million. The local government did not pay until the following year.

You are required to prepare extracts of the income statement and balance sheet of the company for the year ended 31 December, 20x9, on the assumption that financial statements are prepared under (a) the accrual basis and (b) the cash basis of accounting.

Suggested Solution 1-1

Exotic Furniture Nigeria Ltd
Income statement for the year ended 31 December 20x9 (extract)

	Accrual basis	cash basis
	₦' 000	₦' 000
Sales	4000	1300
Rent	1000	5000
Depreciation (240,000 x 1/4)	60	-

Exotic Furniture Nigeria Ltd
Balance sheet as at 31 December 20x9 (extract)

	Accrual Basis	Cash Basis
	₦' 000	₦' 000
Property, plant and equipment	180	nil

Under the cash basis of accounting, as can be readily seen from the suggested solution to illustration 1.1, the effects of transactions and other events are recognized when cash or its equivalent is received or paid (and not when they occur), and they are recorded in the accounting records and reported in financial statements of the periods in which cash or its equivalent is received or paid.

Illustration 1-2

The values of the following non-current assets have been presented by the accountant of Antsa Farms Ltd. The figures are in respect of the year ended 31 December 20x8

	Net book value	Market value
	₦'	₦'
Land	24	42
Plant and machinery	8	5

Equipment	4	2
Motor vehicles	6	7

This would be the carrying values of the assets in the Balance Sheet of Antsa Farms Ltd, as at 31 December, 20x8, if:

(a) Antsa Farms Ltd is expected to continue its operation in the foreseeable future?

(b) Antsa Farms Ltd will be liquidated on 31 July 20x9? Assume that the liquidating values of the company's assets are equal to the market values given above.

Suggested Solution 1-2

Antsa Farms ltd
Carrying values of assets as at 31 December, 2008.

	Where going concern principle is applicable	Where going concern principle is not applicable
	₦'	₦'
Land	24	42
Plant and machinery	8	5
Equipment	4	2
Motor vehicles	6	7

Note that if the going concern assumption is no longer applicable, the assets of an enterprise will be carried at their liquidating values.

3.5 Qualitative Characteristics of Financial Statements

This will be discussed under the following sub-topics.

3.5.1 Meaning of Qualitative characteristics

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are namely: understandability, relevance, reliability and comparability.

3.5.2 True and fair view/ fair presentation

Financial statements are usually required to give a true and fair view, or present fairly the financial position and performance of an entity.

3.6 Elements of the Financial Statements

The financial effects of transactions and events are grouped into broad classes namely assets, liabilities, equity, income and expenses. The first three elements are shown in the Balance Sheet and used in measuring the financial position of an entity, while the last two elements (income and expenses) are used to measure the performance of an entity and are shown in the income statement.

(a) An asset is a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.

(b) Liability – A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity, of resources embodying economic benefits.

(c) Equity is the residual interest in the assets of the entity after deducting all its liabilities.

(d) Income items have been defined by the framework as increases in economic benefits during the accounting period, in the form of inflows or enhancements of assets or decrease of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

(e) Expenses are decreases in economic benefits during an accounting period in the form of outflows or depletions of assets or incurring of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

Self Assessment Exercise 1.1

1. Explain what you understand by the term "conceptual framework".

2. State two scopes of the IASB framework.

3. _______________ is the principle that discourages accountants from recognising the profit of an enterprise if there's no reasonable certainty that it is realisable.

4.0 CONCLUSION

The year 1989 marked a turning point in the conceptualisation of the framework on how financial statements are prepared and the information they contain. The framework is expected to assist in the development of future accounting standards and in reviewing the existing standards; promoting harmonisation of regulations, accounting standards and procedures; developing national standards; preparers of financial statements in applying international standards and also dealing with issues not yet covered by the International Accounting Standards (IASs); auditors informing an opinion as to whether financial statements confirm to IASs; users of financial statements in interpreting the information contained in financial statements that comply with IASs; and providing information on the approach to the formulation of accounting standards.

5.0 SUMMARY

In this unit, we have examined the basic concepts that guide the production and presentation of financial statements. These concepts include the objectives, elements, and attributes of financial statements and the IASB conceptual framework.

In the next unit, you will be introduced to another interesting topic titled: company accounts and reports.

6.0 TUTOR-MARKED ASSIGNMENT

The role of International Accounting Standards Board is that of providing a framework for the preparation of financial statements. In the light of this statement, answer the following questions:

(a) List the purposes of the framework for producing financial statements.
(b) Enumerate the scope of the framework.
(c) What are the objectives of financial statements?
(d) List and briefly explain the elements of financial statements.

7.0 REFERENCES/FURTHER READINGS

Adapted from the ICAN Study Packs (2011)

UNIT TWO COMPANY ACCOUNTS AND REPORT

CONTENTS

1.0 INTRODUCTION

In the last unit, we examined the basic concepts that guide the production and presentation of financial statements. These concepts include the objectives, elements, and attributes of financial statements and the IASB conceptual framework.

In this unit, you will learn about the Companies and Allied Matters Act, its provisions in respect of the format for presentation and contents of financial statements. You will also be introduced to the basic information needs of the various users of financial information.

2.0 OBJECTIVES

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

- Enumerate the provisions of Companies and Allied Matters Act (CAMA), CAP C20 LFN 2004, in respect of the format and contents of financial statements.

- Discuss the basic information needs of the various users of financial information.

3.0 MAIN CONTENT

Iornongu (2009) traced the history of the development or evolution of company law in Nigeria and stated it is a very interesting and compelling study. According to him, before the advent of cross border trade in the territory now known as Nigeria, trading was done predominantly by barter. However with the advent of the Arab traders in the north and Portuguese and British traders in the South, trade began to expand astronomically. However, there was no regulatory mechanism to guide business transactions in any form. There then arose the need to protect the interests of the aliens whose method of trading was much more advanced and sophisticated. As the political development of Nigeria was going with the creation of colonies and protectorates so also ordinances were being introduced to regulate and formalize the formation of companies.

The principle of corporate personality had established that once a company was incorporated either by statute or through registration with the Corporate Affairs Commission (CAC) pursuant to the provisions of the Companies and Allied Matters Act, it acquires a separate and distinct legal personality.

3.1 Companies and Allied Matters Act (CAMA) 2004

This Act has made some revolutionary and landmark provisions not only for companies, but also for the registration of business names and for the incorporation of trustees. This was done in order to take care of emerging global trend in the conduct of business transactions. The Act is divided into four parts, namely, Part A deals with registration of companies, Part B deals with the registration of Business Names, Part C deals the registration of Incorporated Trustees and Part D- Citation and commencement. With reference to companies, the declared objective and the Nigerian Law Reform Commission was to evolve a comprehensive body of legal principles and rules governing companies and suitable for the circumstances of the country.

In pursuance of this objective, a broad approach was adopted. Not only the statutory provisions but also the common law principles and the doctrines of equity applicable to company law in Nigeria were examined and, wherever desirable, enacted, and often with necessary amendments. As indicated above, the Act is a product of careful consideration and extensive consultation. It represents the general views and consensus of users of company law in Nigeria. The following major innovations of the Act may be noted.

(a) Comprehensiveness of the Act: first by the enactment of some relevant principles of common law and doctrines of equity; and secondly, by incorporation in the substantive enactment many of the common and general provisions of the articles in Table A of the Companies Act. 1968;

(b) More logical arrangement of the subject matter of the Act.

(c) Establishment of a Corporate Affairs Commission to administer the Companies and Allied Matter Act.

(d) Encouraging greater seriousness and commitment in the formation and registration of companies by requiring a minimum authorized share capital and minimum subscription.

(e) Prohibition of non-voting shares and of weighted votes.

(f) Abolition of the common law rules on pre-incorporation contracts and the provision for ratification and adoption of such contracts.

(g) Provision for greater and more effective participation in and control of, the affairs of the companies through improved provision in respect of meeting.

(h) Expanded provisions for relief against illegal and oppressive acts including provision for derivative action relief against unfairly prejudicial conduct

(i) Provisions for greater accountability by directors.

(j) Provision for the appointment, qualification, duties and tenure of office of secretaries of public companies.

(k) Improvement in the forms and contents of financial statement, classification of companies into small, and others for the purpose of greater financial disclosure, incorporation of Accounting Standards and provision for greater and more relevant disclosure in the Directors' Report.

(l) More comprehensive provisions in respect of receivership.

(m) Provisions for the incorporation, authorization and control of unit trust schemes.

(n) Provisions dealing with insider trading.

(o) Provisions regulating mergers and take-over subject to the Securities and Exchange Commission Act.

Another innovation introduced by the Act is the Administration of the Act itself: The administration of the Act is divided between the Corporate Affairs Commission which administers the whole of the Act except part XVII. Part XVII which is administered by Securities and Exchange Commission makes provisions in respect of Public Offer and sale of securities, Unit Trusts, Reconstruction, Mergers and Take-overs of companies, and insider trading.

Idigbe (2007) said that the CAMA 1990 as amended provides numerous provisions for corporate accounting and auditing practices (auditing, disclosures, preparation and publication of financial statements. The Registrar of Companies at the Corporate Affairs Commission (CAC) is to monitor compliance with these requirements and specifies obsolete penalties in case of non-compliance. Please see generally sections 137, 211 (3) & (5), 343, 345, 354 CAMA),

It further provides for appointment, remuneration, rights, functions, powers, and removal of auditors and the establishment of an audit committee (please see generally sections 357, 358, 362,363 in part XI of CAMA). It should be noted that the CAMA regrettably does not provide for joint audit or rotation of auditors. By virtue of S358 CAMA only chartered accountants can be appointed as auditors of companies.

It also provide for the meetings of corporate entities. For companies, it is usually the Annual General Meeting (Section 213 CAMA). All companies are also required to file Annual returns which should contain their financial statement. It should be noted that CAMA allows for the creation of different kinds of corporate entities (e.g. private limited liability company, public limited liability company, company limited guarantee, unlimited company, incorporated trustee and business name or firm), each with its attendant distinct legal consequences associated with their incorporation and differential financial reporting requirements (creating varying degree of elaborate corporate governance structure).

3.2 Statutory Framework of CAMA

Section 331 of Companies and Allied Matters Act (CAMA), Cap C20 LFN 2004, states the procedures that apply to accounting records of a company.

Section 334 of CAM A further states that:

(a) In the case of every company, the directors shall in respect of each year of the company, prepare financial statements for the year.

(b) The financial statements required shall include:

- (i) statement of accounting policies;
- (ii) the balance sheet as at the last day of the company's financial year;
- (iii) a profit and loss account or an income and expenditure account for the year;
- (iv) notes to the accounts;
- (v) the auditors' report;
- (vi) the directors' report;
- (vii) the Audit Committee's report;
- (viii) Cash flow statement;
- (ix) a value-added statement for the year;
- (x) a five-year financial summary; and
- (xi) In the case of a holding company, the group financial statements.

The financial statements of a private company need not include the matters stated in paragraphs (i), (vii), (viii), and (ix) in sub-section (b) above.

3.3 Users of Accounting Information

Accounting information is required by a wide range of users for various reasons. These users include:

(a) Individuals, financial institutions or group of investors
(b) Managers in an enterprise
(c) Customers and employees of enterprises
(d) Government and regulatory bodies such as CBN, SEC, FIRS, NSE, SIRS etc
(e) Quasi government establishments
(f) Competitors
(g) Creditors
(h) Financial analysts

To meet the objectives of its diverse users, some of whom may not have accounting knowledge or background; financial statements are expected to be simple, clear and easy to understand.

3.4 Contents of Financial Statements

Financial Statements are expected to be drawn up in conformity with:

(a) GAAP means 'Generally Accepted Accounting Principles – The common set of accounting principles, standards and procedures that companies use to compile their financial statements. GAAP are a combination of authoritative standards (set by policy boards) and simply the commonly accepted ways of recording and reporting accounting information.

(b) SAS issued up to date by the NASB

(c) the books of accounts of the entity; and

(d) The Companies and Allied Matters Act, Cap. C 20 LFN 2004. Treatment of accounting matters not at present covered by the Nigerian Accounting Standards is to conform to the International Accounting Standards (IAS).

3.4.1 Statement of Accounting Policies

Accounting policies are those bases, rules, principles, conventions and procedures adopted in preparing and presenting financial statements.

(a) Accounting convention: There should be information as to the fact that the financial statements are prepared on the historical cost basis; that is, no adjustment for specific or general price level changes such as inflation. Revaluation of some or all assets should be so stated.

(b) Fixed assets: Directors may decide the minimum expenditure to be recognised as capital item. It should also be stated that fixed assets are stated at cost or valuation, less accumulated depreciation.

(c) Depreciation of fixed assets: The basis of depreciation of each class of fixed assets has to be stated. The methods which can be used include Straight-Line, Reducing Balance, amortisation over lives of the assets, Sum-of-the years digit. The rate of depreciation for each class of fixed assets should be stated.

(d) Debtors are stated after the deduction of specific or general provision for any debts considered doubtful of recovery.

(e) Stocks are stated at the lower of cost and net realisable value, after making provision for obsolete and damaged items. For manufactured goods, ‘cost’ may include a proportion of factory overhead.

(f) Investments are stated at cost. Diminution in value is not taken into account unless it is considered to be permanent.

(g) Turnover represents the net invoiced value of sales to external customers.

(h) Deferred taxation is provided for by the liability method which represents taxation at the current rate of company income tax, and the difference between the net book value of the assets qualifying for capital allowances and their corresponding tax written down values.

(i) Foreign currencies transactions are translated to Naira at the rates of exchange ruling on the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are translated at the official rates ruling at the balance sheet date. Exchange gains and losses are included in the profit and loss account of the period in which they arise.

(j) Employees’ retirement benefit schemes: The company makes annual provision for retirement benefits under its unfunded pension plan, using the aggregate method based upon actual valuation. Under this method, costs related to the plan are charged over the average service lives of active employees.

(k) Research and development: Expenditure on research is charged to the profit and loss account in the year it is incurred, while development expenditure can be capitalised if it meets certain criteria set out in IA S 38.

(l) Consolidation (For Group / Holding company): The group financial statements comprise the financial statements of the company and its subsidiaries. All inter-company transactions are normally eliminated.

3.4.2 Balance sheet

The balance sheet and related notes should disclose the following information:

(a) Fixed assets (property, plant and equipment): Land-freehold and leasehold, Buildings, Plant and Equipment and other categories of assets, such as motor vehicles, fixtures and fittings and Accumulated depreciation for each class of assets.

(b) Long–term investments (quoted and unquoted): investments in subsidiaries, investments in associated companies and other investments.

(c) All long term debts including their tenure.

(d) Intangible assets: goodwill, patents and trademarks, deferred charges and any write-offs during the period.

(e) Current assets: Stocks and Work-in-progress, current portion of long-term debts, trade debts, prepayments and Sundry debtors, directors debit balances, inter-company debit balances of subsidiaries and associated companies, short-term investments (including Treasury Bills, certificates of deposit and commercial notes, bills of exchange), foreign Currency Deposits for imports, deposits awaiting remittances to overseas creditors; and cash and Bank balances

(f) Capital and reserves: The variety of ownership interests such as deferred shares, ordinary shares, preference shares, cumulative and non-cumulative, participating and non-participating preference shares.

(g) Other shareholder interests indicating movements during the period by way of bonus: capital redemption reserve fund, share premium or discount, revaluation surplus, revenue and capital reserves and retained earnings.

(h) Liabilities: Disclosure of applicable rates, repayment terms, and covenants on long term liabilities such as secured and unsecured loans, loans from holding, subsidiary and associated companies.

Current liabilities disclosing separately: amounts due to holding/subsidiary and associated companies, trade creditors, other creditors, accrued expenses, dividends payable, taxation , bank loans and overdraft.

3.4.3 Profit and Loss Account/Income and Expenditure Account

The profit and loss account with related notes or Income and Expenditure Account (in the case of a company or organisation, not trading for profit), should disclose the following information:

(a) Turnover / Sales distinguishing between local and export sales.

(b) Other Operating Revenue – for example rental income or exchange gain

(c) Other Earnings – distinguishing between interest income; income from investments and other sources:

(d) Cost of sales

(e) Gross profit

(f) Selling and distribution expenses

(g) Administration expenses

(h) Interest charges

(i) Taxes on income; and

(j) Abnormal or exceptional items (income items or expenditure, which although unusually, are within the normal trading activities of the business). Examples are:
   1. abnormal charges for bad debts and "write-offs" of stocks;
   2. abnormal provision for losses on long-term contracts;
   3. most adjustments of prior year taxation provisions; and
   4. Shortfalls on actuarial valuation of gratuity scheme liabilities.

(k) Extra – ordinary items: outside the ordinary activities of the business and expected not to recur frequently or regularly. Examples of extra-ordinary items are profits or losses arising from:
   1. The discontinuance of a significant part of a business.
   2. The sale of an investment not acquired with the intention of resale.
   3. Writing off intangibles, such as goodwill, because of unusual events or development during the period; and
   4. The expropriation of assets

(l) Profit before taxation.

(m) Proposed Dividend.

(n) Profit after Taxation.

(o) Earnings per share.

(p) Dividend per share

3.4.4 Notes to the accounts

The financial statements should be accompanied by explanatory notes to the figures in the Balance Sheet, Profit and Loss Account and Cash Flow Statement.

The CAMA specifically requires the disclosure of the following information in the notes to the accounts:

(a) Directors' emoluments stating Chairman's emoluments, highest paid Director's emoluments, Directors' fees, other emoluments; and number of directors earning within a stated band of Emoluments.

(b) Auditors' Remuneration.

(c) Depreciation charged on fixed assets.

(d) Number of employees and remuneration, stating average number of employees and number of employees earning.

(e) Capital commitments stating value of capital expenditure authorised by the Board but not executed as at balance sheet date. Amount committed out of the unspent amount should also be disclosed.

(f) Contingent liabilities stating nature of the liabilities, and the Directors' opinion on the likely loss that may arise from the liability.

(g) Technical Service Agreement, stating amount payable for the period covered by the financial statements.

(h) Post Balance Sheet events, stating the material effect the events will have on the financial statements (if any).

3.4.5 Auditors' report

A set of financial statements must contain a signed and dated audit report certifying that:

(a) The company's books of accounts have been properly kept and proper returns for purpose of audit have been received from branches not visited.

(b) The financial statements:
- are in agreement with the books of accounts;
- give a true and fair view of the company's affairs;
- have been prepared in accordance w it h relevant, Statements of Accounting Standards issued by the NASB; and
- have been properly prepared in accordance with the CAMA.

3.4.6 Directors' report

Financial statements must contain a signed and dated report of the Board, highlighting the following:

(a) Directors' responsibilities in accordance with Sections 334 and 335 of CAMA.

(b) Principal activities of the company.

(c) Results of the company for the period and appropriation of the profits.

(d) Changes in the Board of Directors during the period.

(e) Directors' interest in the company's shares

(f) Directors' interest in the company's contracts.

(g) Major shareholdings disclosing shares held by individuals and organisations holding more than 10% of the company's issued share capital.

(h) Employment and employees highlighting:
- Employment of disabled persons.
- Employees' health, safety and welfare
- Employees' involvement and training

(i) Major suppliers and distributors of company's materials and products respectively.

(j) Research and Development efforts of the company; and

(k) Donations and gifts by the company, stating organisations to which the company donated and amount made available.

3.4.7 Audit committee's report

In accordance with Section 359 (6) of the CAMA, every public company is required to elect maximum of six members into the Audit Committee at every Annual General Meeting to function until the next Annual General Meeting w hen fresh election is conducted.

Three of the members are elected by the shareholders and the remaining three elected by the Board of Directors, among them.

The Audit Committee is required to:

(a) review the external auditors' scope and planning of the audit requirements;

(b) review the external auditors' memorandum of recommendations on accounting policies and internal controls, together with management responses;

(c) ascertain that the accounting and reporting policies of the company are in accordance with legal requirements and agreed ethical practices

(d) recommend to the Board with regard to the appointment, removal and remuneration of the external auditors of the company; and authorise the internal auditor to carry out investigations into any activities of the company which may be of interest or concern to the committee

The Audit Committee is required to express an opinion on the adequacy or otherwise of the matters stated above and that they are satisfied with the management responses to the external auditors' findings.

3.4.8 Cash flow statement

This provides information on the derivation and utilisation of funds during the period covered by the financial statements.

A cash flow statement should disclose the following:

(a) Cash flows from Operating Activities

Profit before taxation for the period covered by the financial statements is appropriately adjusted, for non-cash items such as:

- Depreciation and amortisation charge on fixed assets;
- Profit or loss on disposal of fixed assets; and
- Provision for unfunded pension plan.

(b) Changes In Current Assets And Liabilities

Increase or decrease in current assets and liabilities w hen compared to those in the preceding year is accounted for under this sub-head to reflect:

(i) Increase or decrease in stock;
(ii) Increase or decrease in debtors and prepayments;
(iii) Increase or decrease in creditors and accruals; and
(iv) Increase or decrease in foreign currency deposit for imports.

(c) Payments in connection with operations, such as income tax and retirement benefits paid during the period covered by the financial statements are deducted from the addition of (a) and (b) above, before arriving at net cash inflow or outflow from operating activities.

(d) Cash flow from Investing Activities

Actual cash outflows or inflows of the following, during the period covered by the financial statements, are disclosed:

(i) Purchase of fixed assets, investment or intangible assets
(ii) Proceeds from sale of assets, investment or intangible assets; and
(iii) Dividends and interests received on investments.

(e) Cash flow from Financing Activities

Actual cash inflows or outflows on the following during the period covered by the financial statements are disclosed:

(i) Dividends paid to shareholders.
(ii) Repayment of Debenture stock; and

(iii) Proceeds from issue of shares and Debenture stock.

(f) Movement in Net Liquid Funds

The net figure arrived at by pooling together all the net figures obtained in (a) – (e) above, represents net increase or decrease in cash and cash equivalents. W hen cash and cash equivalents at the beginning of the period covered by the financial statements are added to the net increase or decrease, we arrive at cash and cash equivalents at the end of the period covered by the financial statements which may consist of; Cash and bank balances, Bank overdrafts; and Investments in commercial papers and other short-term financial instruments.

3.4.9 Value Added Statement

Value-added statement reports the additional wealth created by an enterprise on its own and by its employees' efforts during the period covered by the financial statements. It usually shows how the wealth created is distributed among various interest groups (such as, employees, government, creditors, providers of capital and that retained for the future creation of more wealth).

The statement shows separately, the following:

(a) Sales to outsiders (third parties outside the group);

(b) Purchases of goods and services; distinguishing between imported and local items;

(c) (a)less (b) above represents value added; and

(d) Distribution of Value-added to various groups such as Employees, Government – company income and education taxes, Excise duties, Providers of finance, Retained for the replacement of assets and business growth to provide for depreciation of fixed assets; and augment reserves

3.4.10 Five- Year Financial Summary

The five–year financial summary enables an instant comparison of an enterprise's activities over the five-year period. Information to be disclosed is as follows:

a) Results: Turnover, Profit before tax, Taxation, Profit after taxation, Dividend, Retained earnings.

b) Assets employed: Fixed Assets, Intangible Assets, Investments, Net Current Assets, Long term liabilities and deferred charges.

c) Funds employed: issued share capital, Share premium, Revaluation Reserves and other Reserves – Revenue, Bonus issue.

d) Financial Statistics: share price at the end of the period, earnings per share, dividend per share, dividend cover, net worth per share, return on capital employed, current assets: current liabilities.

Self Assessment Exercise 2.1

1. State any major difference between Auditor's report and Audit Committee's report.

2. Highlight one piece of information usually disclosed in the form of notes to the financial statements that may not affect the figures in the accounts.

4.0 CONCLUSION

It is pertinent to note that financial statements are expected to be drawn up in conformity with the Generally Accepted Accounting Principles, in accordance with the Statement of Accounting Standards issued by the NASB, and in agreement with the books of accounts of the entity.

5.0 SUMMARY

This unit explores the statutory framework guiding the contents of financial statements as stipulated in the CAMA. Objectives of the various users of financial statements were reviewed.

In the next unit, we shall study another interesting topic: preparation of published financial statements.

6.0 TUTOR-MARKED ASSIGNMENT

1. Trace the history of CAMA 2004.

2. Explain one of the following items is highlighted by the chairman's statement in a company's annual report.

   a. Projections into the future as to how to improve on the company's performance.
   b. Discussions in the last annual general meeting only.
   c. The significant development in the company in the past 6years only.

3. Which of the following items is found in a company's profit and loss account?

   a. Discontinuance of a significant part of a business
   b. Writing off goodwill
   c. Substantial loss sustained as a result of robbery attack.
   d. Sale of an investment not acquired with the intention of resale
   e. The appropriation of asset

7.0 REFERENCES/FURTHER READINGS

Adapted from the ICAN Study Packs (2011)

Iornongu, C. (2009). Company Law. MBA 704 Study Material for NOUN Post Graduate Students in the School of Management Sciences

UNIT THREE PREPARATION OF PUBLISHED FINANCIAL STATEMENTS

CONTENTS

1.0 INTRODUCTION

In the last unit, we explored the statutory framework guiding the contents of financial statements as stipulated in the CAMA. We also reviewed the objectives of the various users of financial statements.

In this unit, we shall examine the preparation of published financial statements.

2.0 OBJECTIVE

At the end of this unit, you should be able to prepare financial statements of limited liability companies.

3.0 MAIN CONTENT

3.1 Preparation of Financial Statements

Having gone through the statutory framework required in preparing financial statements, the best way to demonstrate its practical application is by working through illustrative examples.

Illustration 3-1

Samba Nigeria PLC is an Electrical Components assembly outfit with authorised and issued share capital of ₦200 million, made up of 400 million ordinary shares of 50 kobo each. The following is the company's trial balance as at 30 April 2008.

PARTICULARS	**DR** ₦'000	**CR** ₦'000
Freehold land	25,000	
Short term deposits	50,000	
Sundry debtors	60,820	
Cash and bank	50,862	
Furniture and fitting – cost	44,720	
Accumulated depreciation		11,180

Machinery and equipment-cost	164,000	
Accumulated depreciation		32,800
Stock at 1 may 2003	27,160	
Sundry creditors		39,420
Bank overdraft		25,000
Wages	97,280	
Postages and telephone	2,100	
General expenses	6,060	
Bad debts written off	560	
Auditors remuneration	2,000	
Distribution expenses	2,140	
Insurance	2,060	
Bank interest paid and received	4,100	1,000
Electricity	3,800	
Salaries (including directors remuneration N2m)	76,850	
Rates	1,580	
Purchases	306,832	
Sales		640,124
Dividends(interim)	24,000	
Profit and loss account		2,400
Share capital		200,000
	951,924	**951,924**

The following adjustments are necessary for the year ended 30/4/2008:

(a) The directors recommended that 5% of debtors should be set aside for possible bad debt.

(b) Stock w as valued at ₦28,648,000 as at 30 April, 2008.

(c) W ages outstanding at 30 April, 2008 amounted to ₦ 2,400,000 and electricity accrued w as ₦280,000.

(d) Depreciation is to be written off machinery and equipment at 10% per annum and Furniture and Fittings at 5% per annum.

(e) The Sales Manager is entitled to sales commission of 2% of gross profit. The commission is payable on 1 May, 2008.

(f) Insurance has been paid in advance amounting to ₦ 285,000.

(g) Machinery which stood in the books at 1 May, 2007 at ₦ 8million has been sold for ₦6 million in part exchange for a new machinery costing ₦ 12 million. A net invoice for ₦6 million has been posted into the Purchases account. No other entry has been made in respect of this transaction. The original cost of the old machinery was ₦ 10million. It is the company's policy to charge a full year's depreciation in the year of purchase and none in the year of sale.

(h) The Directors proposed a final dividend of 8%, making a total of 20% dividend in respect of the year to 30 April, 2008.

(i) Provision for company income tax w as ₦ 35million.

You are required to prepare the profit and loss account for the year ended 30 April, 2008 and balance sheet as at 30 April, 2008 in a form suitable for publication. Notes to the accounts are not required but you should show your workings.

Suggested Solution 3-1

SAMBA NIGERIA PLC
PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 30 APRIL 2008

	Workings	₦'000	₦'000
Turnover			640,124
Cost of sales	1		(399,024)
Gross profit			241,100
Selling and distribution expenses	2	6,962	
Administration expenses	3	118,882	(125,844)
Trading profit			115,256
Interest income			1,000
			116,256
Interest payable and similar charges			(4,100)
Profit before taxation			112,156
Taxation			(35,000)
Profit after taxation			77,156
Interim dividend paid		24,000	
Final dividend proposed (8% x ₦200,000)		16,000	(40,000)
Retained profit for the year			37,156
Earnings per share of 50kobo	4		19kobo
Dividend per share of 50kobo			10kobo

SAMBA NIGERIA PLC
BALANCE SHEET AS AT 30 APRIL 2008

	Workings	₦'000	₦'000
Fixed assets	5		174,904
Current assets:			
Stock		28,648	
Debtors and prepayments	6	58,064	
Short term deposits		50,000	
Cash and bank balances		50,862	
		187,574	
Current liabilities (amounts falling due within one year)			
Creditors and accrual			
Bank overdrafts	7	(97,922)	
		(25,000)	
Net current assets ₦(187,574– 122,922)		(122,922)	
NET ASSETS			64,652
			239,556
Financed by:			
CAPITAL AND RESERVES			
Share capital			
400,000 ordinary shares of 50kobo each			200,000
Revenue reserve			39,556
Shareholders' fund	8		239,556

Workings

1. Cost of sales		₦'000
Opening stock		27,160
Purchases (₦306,832 – ₦ 6,000)		300,832
		327,992
Less: closing stock		28,648
		299,344
Wages ₦ (97,280 + 2,400)		99,680
		399,024
2. Selling and distribution expenses:		
Distribution expenses	2,140	
Selling expenses – sales manager's commission		
₦ (2% of gross profit of 241,100)		4,822
		6,962
3. Administration expenses		
Salaries		76,850
Bad debts ₦ (60,820 x 5%) +560		3,601
Depreciation charge – P&M		
₦ (164,000 – 10,000)+ 12,000) x 10%		16,600
Furniture and fittings ₦ (44,720 x 5%)		2,236
Insurance ₦ (2,060 -285)		1,775
Loss on disposal of machinery ₦ (8,000 – 6,000)		2,000
Electricity ₦ (3,800 +280)		4,080
Postages and telephone		2,100
General expenses		6,060
Rate		1,580
Auditor's remuneration		2,000
		118,882

4. Earnings per share = $\frac{\text{Profit after tax}}{\text{No of issued shares}} = \frac{77{,}156 \times 100}{400{,}000}$ = 19.29kobo

5. Fixed assets

		Freehold land	Furniture & Fittings	Machinery & Equipment	Total
COST		₦'000	₦'000	₦'000	₦'000
At 1 may 2007		25,000	44,720	164,000	233,720
Addition		-	-	12,000	12,000
Disposal		-	-	(10,000)	(10,000)
At 30 April 2008	(a)	25,000	44,720	166,000	235,720
Depreciation					
At 1 may 2007		-	11,180	32,800	43,980
Charge for the year		-	2,236	16,600	18,836
Loss on disposal		-	-	(2,000)	(2,000)
	(b)	-	13,304	47,400	60,816
Net book value					
At 30 April 2008	(a-b)	25,000	31,304	118,600	174,904

6. Debtors and prepayments	₦'000
Sundry debtors	60,820
Less: provision for bad debts	3,041
	57,779
Prepaid insurance	285
	58,064
7. Creditors and accruals:	
Sundry creditors	39,420
Accrued sales manager's commission	4,822
Accrued wages	2,400
Accrued electricity	280
Taxation	35,000
Proposed final dividend	16,000
	97,922
8. Revenue reserve	
Balance brought forward	2,400
Retained profit for the year	37,156
	39,556

3.2 Abridged Financial Statements

Annual reports and financial statements are the means of communicating to the shareholders and other interested parties information on the financial resources, obligations and performance of a reporting entity or enterprise.

Annual report refers to the Chairman's statement, Directors' report, Auditors' Report, Audit Committee's Report , information communicated on Accounting Policies, Balance Sheet, Profit and Loss Account (Income statement), Cash flow Statement, Value Added Statement, Notes on the accounts, Five-year Financial Summary, and Notice of Annual General Meeting. Such a report usually assists shareholders and other interested parties in assessing the financial, liquidity, profitability and viability of an enterprise.

In recent years, groups of shareholders and some companies in Nigeria aim to reduce the size of annual reports and financial statements, and curtail the cost of printing and mailing the glossy information.

Section 355 of the CAMA allows companies to publish abridged financial statements. The act does not specify any minimum disclosure requirement of such statements.

3.2.1 SAS 20 – Abridged Financial Statements

The objectives of Statement of Accounting Standard No. 20 are:

- to specify the minimum contents of abridged financial statement.
- to standardize formats for presentation of abridged financial statements; and
- to improve comparability and usefulness of abridged financial statements.

Abridged financial statements should carry a declaration that:

- they are abridged financial statements;

- the financial statements and specific disclosures included in them have been derived from the financial statements of the company

- the abridged financial statements cannot be expected to provide understanding of the financial performance, financial position, financing and investing activities of the organisation as the full financial statements; and

- copies of the full financial statements can be obtained from the Registrars of Companies.

Abridged financial statements should include the following, as in the full financial statements:

(i) Accounting policies;
(ii) Profit and Loss Account for the financial year;
(iii) Balance sheet as at end of the financial year;
(iv) Statement of cash flows for the financial year;
(v) Notes in relation to exceptional and extra-ordinary items
(vi) Five-year financial summary; and
(vii) Any other information necessary to ensure that the abridged financial statements are consistent with the full account sand reports of the year.

Other information to be included in abridged financial statements is:

(i) Notice of Annual General Meeting;
(ii) Names of Directors during the year and their shareholding;
(iii) Report of the audit committee, which should confirm that the auditors' report is unqualified
(iv) Financial Highlights (Results at a glance); and
(v) Dividends paid or proposed and date of payment
    - A company w hose auditors' report on the financial statement for a period are qualified should not publish abridged financial statements for that period.

3.2.2 Disclosure Requirements

The following information should be disclosed in abridged financial statements:

1) Material events occurring after the balance sheet date and where there is a change in accounting policies or estimates from those used in the preceding financial year or is expected to have a material effect in a subsequent financial year, the information about such change in accordance with SAS No 6, on extra ordinary items and prior year adjustments.

2) Where a company is a parent company, the statement in above applies to the consolidated financial statements of the company and the accompanying notes, and does not require that the parent company's own financial information be provided information for the preceding financial year, which corresponds to the disclosures made in accordance with this standard for the current financial year, should be disclosed.

3.3 Self Assessment Exercises

In what way are extraordinary and exceptional items different?

4.0 CONCLUSION

Companies in Nigeria are allowed to publish abridged financial statements under section 355 of CAMA 2004 cap c20 LFN 2004. Such statements should comply with the requirements of SAS 20.

5.0 SUMMARY

As a follow up to the regulatory framework in the earlier unit, practical application of the theoretical background on the preparation of financial statements on limited liability companies, including relevant notes to the financial statements in the recommended formats has been shown.

In the next unit, we shall treat the topic preparation of a cash flow statement.

6.0 TUTOR-MARKED ASSIGNMENT

List any two disclosures required in notes to the financial statements in respect of directors' emoluments.

7.0 REFERENCES/FURTHER READINGS

Adapted from the ICAN Study Packs (2011)

Iornongu, C. (2009). Company Law. MBA 704 Study Material for NOUN Post Graduate Students in the School of Management Sciences.

UNIT FOUR PREPARATION OF A CASH FLOW STATEMENT

CONTENTS

1.0 INTRODUCTION

In the last unit, we undertook practical application of the theoretical background on the preparation of financial statements on limited liability companies, including relevant notes to the financial statements in the recommended formats.

In this unit, we shall examine the steps to be taken in preparing a cash flow statement.

2.0 OBJECTIVES

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

- Understand the basic principles and formats of cash flow statements; and
- Undertake Practical application and analysis of cash flow statements of limited liability companies.

3.0 MAIN CONTENT

3.1 Basic Principles Governing the Preparation of Cash Flow Statements and the Approved Formats

Statement of Accounting Standards No. 18 (SAS) deals with the approved format for preparing statement of cash flows.

A statement of cash flows provides information about the cash receipts and payments of an enterprise over a given period. It indicates the pattern of cash generation and utilization. It also reveals how cash is generated from operations through new capital raised and how it is disbursed for capital expenditure, taxes, dividends to investors, new investments and debt repayments. It is designed to shed light on an enterprise's financial strength and illuminate the balance sheet and profit and loss account.

3.1.1 Usefulness of a Cash Flow Statement

1. Assess the impact of its transactions; that is, operating, investing and financing activities of its performance and financial position.

2. Assess the ability of an enterprise to meet its debt obligations, pay dividends and meet other claims.

3. Assess the ability of an enterprise to finance on-going operations and growth from internal sources and determine the amount of external financing required.

4. Reconcile Profit or Loss and net cash flows; and

5. Assess the ability of the enterprise to generate positive net future cash flows

3.1.2 Preparation of a cash flow statement

In line with the provisions of this Standard:

(a) The statement of cash flows should include all cash inflows and outflows of the enterprise, during a reporting period. It should, however, exclude cash inflows arising from the purchase and liquidation of cash equivalents.

(b) An enterprise should report its cash flows according to the activity which gave rise to them and they should be grouped under the broad headings of operating, investing and financing activities.

(c) An enterprise should adopt either the direct or indirect method in preparing its statement of cash flow
   - Direct method highlights cash received from customers, payments made to suppliers, employees, tax authority etc.

   - Indirect method arrives at cash inflow/outflow from operating activities by stating the profit and loss before taxation, which is adjusted for items not involving movement of funds such as depreciation charge, provision for doubtful debt, profit on sale of fixed assets, and net changes in working capital, debtors, creditors, stock between the current and the preceding years.

(d) Interest paid should be classified as cash flow from financing activities while interest received should be classified as cash flow from investing activities, under direct method. The interest element of finance lease rental payments should be shown separately by the lessees; and statement of cash flows.
   - Dividends received should be classified as cash flows from investing activities except in cases where the investor company has significant influence over the Investee Company and holds at least 20% of the equity. Here, dividend received should be classified under operating activities.

   - Dividends paid and other distributions to owners should be classified as cash flows from financing activities.

(e) Cash flows resulting from foreign currency transactions should be translated, using the rates applicable at the time they occurred. A weighted average exchange rate for a period should be used for translation, if the result is substantially the same as if the rates applicable at the dates of the cash flow were used.

(f) Taxation

- The total amount of income taxes paid should be classified as operating cash outflow

- The net amount paid or received with respect to value-added tax or other sales taxes should be shown separately as cash flows from operating activities.

- Taxes paid or refunds received in respect of capital profits such as capital gains tax should be reported in line with the underlying transaction s giving rise to them.

3.2 Formats of Cash Flow Statement

3.2.1 Format for a Limited Liability Company

XYZ NIGERIA PLC
CASH FLOW STATEMENT
For the Year Ended 31 December 2004

		2004	
		₦	₦
Cash Flows from Operating Activities			
Profits before taxation			X
Depreciation of fixed assets			X
Profit / {Loss} on disposal of fixed assets			X
Net interest Expense / (Income)			
X			
Cash flow before changes in working capital		X	X
CHANGES IN WORKING CAPITAL			
Increase / (Decrease) in stock and work in progress		X	
Increase / (Decrease) in debtors and prepayments		X	
Increase / (Decrease) in Creditors & accruals		X	X
Increase / (Decrease) in Gratuities & Retirement benefits			X
		X	X
Tax paid			(X)
Net cash flows from operating activities	X	X	X
Cash Flows from Investing Activities			
Interest received		X	
Purchase of fixed assets		(X)	
Proceeds on disposal of fixed assets		X	X
Net cash used in investing activities		X	X
Cash Flow from Financing Activities			
Proceeds from sales of shares		X	
Dividend paid		(X)	
Interest paid		(X)	X
Net cash inflow/outflow in financing activities		X	X
Net Increase / (Decrease) in cash and cash equivalent		X	X
Cash and cash equivalents at January 1			X
Cash and cash equivalents at December 31		X	X
Cash and cash equivalents comprise of:			
Cash and bank balances		X	
Bank deposit		X	

Bank overdraft	(X)	X	X

Illustration 4-1

The Balance Sheets of Chuks Plc as at 31 December 2007 and 2008 are given below:

	2008		2007	
	N'000	N'000	N'000	N'000
Fixed Assets:				
Land and buildings		3,585		3,470
Plant, equipment and vehicles		2,702		3,107
		6,287		6,577
Goodwill and patents		852		785
		7,139		7,362
Currents Assets:				
Stocks &work-in-progress	5,717		5,735	
Debtors and prepayments	4,935		4,697	
Cash and bank balances	465		115	
	(a) 11,117		(a) 10,547	
Deduct: Current Liabilities				
Creditors and accruals	2,795		2,672	
Current taxation	895		985	
Bank overdraft	272		705	
Proposed dividend	637		505	
	(b) 4,599		(b) 4,867	
Net Current Assets	(a-b)	6,518	(a-b)	5,680
Deferred taxation		(1,555)		(1,545)
		12,102		11,497
Represented by:				
Capital and reserves:		4,400		4,400
Ordinary share capital		517		517
Share premium account		1,100		1,100
Other capital reserves		6,085		5,480
Revenue reserves		12,102		11,497

Notes to the accounts show that:

(a) Depreciation has been charged for year 2008 as follows:

	N
Land & Building	87,000
Plant, Machinery & Vehicles	600,000
Goodwill and Patents	23,000

(b) Plant sold during the year 2008 realised N40, 000. It was included at cost in the balance sheet for year 2007 at N152, 000, with depreciation accumulated at N132, 000. The difference between realisation and written down value of the asset was in the pro fit and loss account.

(c) The balance of profit for year 2008 after taxation charged and dividend appropriation has been transferred to Revenue Reserve.

Further enquires revealed that during year 2008, the company made cash payment for total dividend amounting to ₦927,000 and Income and Education taxes of ₦ 1,130,000.

You are required to prepare a cash flow Statement for the year ended 31December 2008

Suggested Solution 4-1

CHUKS PLC

Cash Flow Statement for the Year ended 31 December 2008

		₦'000	₦'000	
Cash flow from operating activities:				
Profit before taxation (w1)			2,714	
Depreciation of fixed assets ₦ (87+600+23)			710	
Profit/loss on disposal of fixed assets			(20)	
Cash flow before changes in working capital			3,404	
Changes in working capital				
Decrease in stock		18		
Increase in debtor		(238)		
Increase in creditors		123	(97)	
Taxes paid (w5)			(1,130)	
Net cash from operating activities			2,177	
Cash flows from investing activities				
Purchase of fixed assets (202+212)(w2,3)		(417)		
Purchase of goodwill and patents (w4)		(90)		
Proceeds from disposal of fixed assets (w3b)	40			
Net cash flow from investing activities				(467)
Cash flows from financing activities				
Dividend paid (w6)				(927)
Net increase in cash and cash equivalents				783
Cash and cash equivalents of January 1(115-705)				(590)
Cash and cash equivalents at December 31				193
Cash and cash equivalents comprise:				
Cash and bank balances				465
Bank overdraft				(272)
				193

Workings

CHUKS PLC

1. PROFIT BEFORE TAXATION

	₦ '000
Increase in revenue reserves (₦ 6,085-5,480)	605
Deferred tax charged for 2008 written back to P&L₦ (1555-1545)	10
Tax charge for the year (see w5)	1040
Dividends charged to P&L (see w 6)	1059
	2714

2. Land and Buildings

	₦ '000		₦ '000
Opening balance	3,470	depreciation change	87
Balance representing			
Assets purchased	202	closing balance	3,585
	3,672		3,672

3. (a) Plant and Machinery

	₦ '000		₦ '000
Opening balance	3,107		
(Disposal a/c).depr	132	depreciation change	600
Balance representing		disposal a/c-cost	152
Purchases	215	closing balance	2,702
	3,454		3,454

1. (b) Plant Disposal

	₦ '000		₦ '000
Plant a/c- cost	152	plant a/c depreciation	132
Profit on sale	20	sales proceeds	40
	172		172

2. Goodwill and Patents

	₦ '000		₦ '000
Opening balance	785	depreciation change	23
Balance -			
Goodwill purchased	90	closing balance	852
	875		875

3. Taxation

	₦ '000		₦ '000
Taxes paid- bank	1,130	opening balance	985
Closing Balance	895	charged to p&l	1,040
	2,025		2,025

4. Dividend

	₦ '000		₦ '000
Dividends paid-bank	927	opening balance	505
Closing balance	637	charged to p&l a/c	1,059
	1,564		1,564

Self Assessment Exercises

The purpose of cash flow statement is to _______________

(i) Provide information about cash receipts, cash payments over a given period.
(ii) Indicate the pattern of cash generation and utilization
(iii) Show the cash available at all times
(iv) Show the profit of an enterprise is related to its liquidity

(a) I only
(b) i, ii and iv only
(c) Iv only
(d) i, ii, iii only
(e) ii and iii and iv only

4.0 CONCLUSION

We have read in the unit that cash flow statements provide information about the cash receipts and cash payments of an enterprise over a given period.

5.0 SUMMARY

This unit details the usefulness and format of cash flow statements of limited liability companies in accordance with SAS 18. Preparation of cash flow statements which adopt the direct and indirect methods for companies was illustrated.

In the next unit, we shall discuss another topic, analysis and interpretation of financial statements.

6.0 TUTOR-MARKED ASSIGNMENT

1. List two objectives of preparing cash flow statements

2. State one source of cash generated from operating activities

7.0 REFERENCES/FURTHER READINGS

Adapted from the ICAN Study Packs (2011)

UNIT FIVE ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS

CONTENTS

1.0 INTRODUCTION

In the last unit, we undertook practical application of the theoretical background on the preparation of financial statements on limited liability companies, including relevant notes to the financial statements in the recommended formats.

In this unit, we shall examine the steps to be taken in preparing a cash flow statement.

2.0 OBJECTIVES

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

- Undertake detailed analysis, usefulness and limitation of significant accounting ratios;
- Interpret ratios when computed; and
- Write financial report.

3.0 MAIN CONTENT

3.1 Nature and Objectives of Accounting Ratios

An Accounting ratio is a proportion or fraction or percentage, expressing a relationship between one item in a set of financial statements and another item in the same financial statements.

For example, the relationship between gross profit and sales is expressed by the accounting ratio know n as "gross profit %" or gross margin, which is, computed as follows:

$$\text{Gross Profit \%} = \frac{\text{Gross profit}}{\text{Sales}} \times 100 = y\%$$

When preparing financial statements, the objective is to convey information to the readers and others who are interested parties with diverse interests.

The matters which are likely to concern these parties, varying according to emphasis, are:

(a) Profitability
(b) Liquidity
(c) Management efficiency
(d) Gearing
(e) Financial stability
(f) Investment appraisal.

The essence of any interpretation of financial statements is comparison. Comparison of the current figures of a company with its own past performance, and with its budget or forecast. Also, comparison with the performance of other companies in similar trades or industries. For a potential shareholder, a broader comparison between companies involved in completely different trades may be necessary.

In order to facilitate this comparison, it is customary to express figures in ratios or percentages, so that a disparity in size between two businesses does not prevent comparison of their results.

Ratio analysis is a most important device for interpreting the performances of companies from their financial statements. Other tools used in the analysis and interpretations of financial statements include:

(a) Cash flow statements (b) Value added statement.

3.2 Ratio Analysis

Each of the areas of interest highlighted in 5.1 above, will now be examined in detail, using, where possible, the following specimen set of accounts

Illustration 5-1

ABC PLC
BALANCE SHEET AS AT 31 DECEMBER 2008

	₦'000	₦'000	₦'000
FIXED ASSETS (at cost less depreciation			260,000
CURRENT ASSETS:			
Stock (opening stock ₦50 million)		60,000	
Debtors		90,000	
Cash		10,000	
		160,000	
CURRENT LIABILITIES			
Trade Creditors	40,000		
Other liabilities	40,000	80,000	
Net current assets			80,000
NET ASSETS			340,000
FINANCED BY:			
Share capital			
100million ordinary shares of ₦ 1 each			100,000
20million preference shares of ₦ 1 each			20,000

Revenue reserve LOAN CAPAITAL DEBENTURE STOCK			120,000 80,000 200,000 140,000 340,000

ABC PLC
PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31 DECEMEBER 2008

	₦'000
Turnover	600,000
Cost of sales	(450,000)
Gross profit	150,000
Admin and distribution expenses	(116,500)
Profit before interest and taxation	34,000
Debenture interest payable	(7,400)
Profit before tax	26,600
Taxation	(10,600)
Profit after tax	16,000
Preference dividend	(1,000)
	15,000
Ordinary dividend	(10,000)
Retained profit	5,000

3.2.1 Profitability

Profitability may be expressed in relation to capital employed (profit as a percentage of assets used to earn that it) or in relation to sales (gross or net profit as a percentage of sales).

(a) Return on Capital Employed (ROCE)

This is perhaps the most important ratio in assessing a company's performance. It is simply profit, expressed as a percentage of capital employed. In ratio analysis, the analyst simply obtains the profit figure from the Profit & Loss Account and the capital employed from the Balance Sheet.

(b) Return on Sales

(i) Gross Profit Percentage

The percentage of gross profit on sales can be calculated only if a trading account is available. Fluctuations in it can be very informative, especially if a fixed mark-up on cost, is used to arrive at selling prices.

$$\frac{150,000}{600,000} = 25\%$$

(ii) Net Profit Percentage

$$\frac{34,000}{600,000} = 5.7\%$$

This is a useful yardstick for comparing results of a company against its performance in previous years or those of other companies in similar trade. This ratio discloses something about the company's sales philosophy.

(c) Asset turnover

$$\frac{\text{Sales}}{\text{Capital employed}} = \frac{600{,}000}{340{,}000} = 1.8 \text{ times}$$

A low rate shows that the company is not generating sufficient volume of business for the size of the assets invested. This may be rendered by attempting to increase sales or by disposing of some assets or both.

3.2.2 Liquidity

The standard measures are:

Current ratio: $$\frac{\text{current assets}}{\text{Current liabilities}} = \frac{160{,}000}{80{,}000} = 2:1$$

Acid test or quick test: $$\frac{\text{current assets} - \text{stock}}{\text{Current liabilities}} = \frac{100{,}000}{80{,}000} = 1.25:1$$

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

1. Companies and trades vary in their working capital requirements (working capital is current assets less current liabilities). A retail company does not have to invest capital in stocks and debtors, in the way that a manufacturing company probably does.

   The current ratio might be anything from about 1.4:1 up to may be 3:1, depending on the trade. Be wary of statement that the "ideal ratio should be 2:1. The liquid ratio is, however, expected to have a value not less than 1:1, otherwise the company could have difficulty in meeting its debts as they fall due.

2. An unnecessarily high ratio may indicate that the company is not using its resources efficiently. or the company has built up its current assets at the balance sheet date for a major project, or seasonal sales, which is to begin shortly afterwards.

3. Many blue chip companies rely on bank overdraft as a permanent source of finance, although often times stated as part of their current liabilities. This may w ell give rise to very low current and liquid ratios, although no liquidity problem as such exists.

   There is need to know the terms of the overdraft and the amount of the facility, so that one could form a more reasoned conclusion.

4. Current and liquid ratios imply an immediate conversion of assets into cash and an immediate settlement of current liabilities. This may not be the real problem. Only a cash flow projection would produce an exhaustive answer to an analysis of working capital.

3.2.3 Management Efficiency

Here, the skills with which management looks after the assets, under its control, especially stock, debtors, and the use of cash to pay its creditors control, especially stock, debtors, and the use of cash to pay its creditors are analysed. The following ratios are relevant and frequently expressed in terms of days.

For example, number of days credit given = $\frac{\text{Trade debtors}}{\text{Credit sales}} * 365$

(a) Stock ratios

1. Raw materials stock holding = $\frac{\text{raw material stock}}{\text{Annual raw material consumption}} * 365$

2. Number of days work-in-progress = $\frac{\text{work in progress}}{\text{Annual cost of sales}} * 365$

3. Number of days sales covered by finished goods= $\frac{\text{finished goods stock}}{\text{Annual cost of sales}} * 365$

Information is inadequate to calculate these three ratios separately for ABC PLC, but it may still be relevant to calculate the overall stock ratio, also called stock turnover period.

Stock ratio: $\frac{\text{Stock}}{\text{Cost of sales}} * 365 = \frac{60{,}000}{450{,}000} = 49$ days

The significance of these ratios is in the detection of undesirable upward trend in stock levels and in evaluating relative management efficiency by comparing them with those in similar companies.

(b) Debtors ratio

$\frac{\text{Trade debtors}}{\text{Credit sales}} * 365 = \frac{90{,}000}{600{,}000} * 365 = 55$ days

Trade debtors should be net of provision for bad and doubtful debts, if the figure is given. There is assumption all the debtors are trade debtors and that all sales are credit sales.

Another problem which may also affect the stock and creditors ratio is that we may be dealing with a seasonal trade and those debtors are abnormally high or abnormally low at the balance sheet date. In this case, it may be more informative to take the average debtors level, or better still, compare debtors at the balance sheet date with actual sales of the months immediately, if known.

Assuming no abnormal factors, a figure of about 60 days (2 months credit) is regarded as satisfactory for debtors' ratio.

(c) Creditors ratio

Trade creditors * 365 = 40,000 *365 = 32 days
Credit purchase 460,000

Credit Purchases is arrived at thus: cost of sales+ closing stock –opening stock ₦(450+60-50) This ratio appears to indicate very prompt settlement of creditors subject to special factors discussed for debtors in 3.2.3

3.2.4 Gearing

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

For example, Ordinary Share Capital ₦ 100,000
Loan Capital ₦ 900,000

This ratio is expressed as:

Loan capital: 9/1 or 9:1
Equity capital

Loan capital * 100: 9/10 * 100 = 90%
Total capital

This is a high gearing situation in which ₦ 100, 000 worth of equity capital controls ₦ 1million of total capital.

Preference shares + debentures = 160,000 = 0.9:1
Ordinary shares + reserves 180,000

Fixed interest capital = 160,000 = 47%
Total capital 340,000

The ratio above reveals a moderate gearing situation for m any companies.

Gearing ratio is important for two reasons. First, it is one measure of risk being taken by an equity investor.

Secondly, it assists a prospective lender, who may hesitate before lending a company more than (say) twice the equity stake in it.

The borrowing powers of a company are frequently restricted by its Articles of Association.

3.2.5 Financial Stability

Tangible Net Asset value per share: that is Net Worth per share. This is calculated by dividing the net tangible assets by the number of ordinary shares in issue. Care has to be taken to exclude goodwill (an intangible asset) and to deduct the preference shares before arriving at the figure of net tangible asset s attributable to the ordinary shareholders.

Assuming no goodwill in the illustration, the net tangible assets of AB PLC are:

	₦'000	₦'000
Fixed assets		260,000
Net current assets		80,000
		340,000
Less: loan capital	140,000	
Preference capital	20,000	160,000
		180,000.
Net tangible assets		

In this case, the net tangible asset is the same as the ordinary share capital (₦ 100 million) plus the reserve (₦ 80 million): but this is a shortcut, which will not always work in a more complex set of figures. The asset value per share is, therefore:

$$\frac{180{,}000{,}000}{100{,}000{,}000} * 100 = 180\text{kobo}$$

The importance of assets per share figure is that it provides a "long step" that is, realisable value per share if the company ceases operations. It is unlikely that the assets will realise their balance sheet values exactly, a fact which partly explains the differentials between a quoted companies's net worth per share and its share market price.

3.2.6 Investment Appraisal

A prospective or an existing investor will look at the following to made decisions about buying or selling shares in a company:

a. Earnings per share price
b. Earnings ratio
c. Dividend yield, and
d. Dividend cover.

(a) Earnings Per Share (EPS)

SAS 21 underlines its importance and explains the factors involved in arriving at it. Earnings per share refer to earnings per ordinary share. It's calculated by dividing the operating profit after tax of a company for a financial year by the number of issued ordinary shares of the company.

Operating profit or loss after income tax is the figure before extra ordinary items and after applicable income tax expense.

Basic EPs: $\frac{\text{profit after tax and preference dividend}}{\text{Ordinary share capital}} = \frac{100}{100{,}000} * 15{,}000 = 15\text{k/share}$

(b) Price Earnings Ratio:

As the name implies, this ratio measures the relationship between earnings per share and the market price per share.

In ABC PLC, the market price is not given, but assumes that the market value is the same as the par value of each ordinary share.

Basic EPS = $\frac{100k}{15k}$ = 6.7 times

The significance of P/E ratio of a particular company can only be judged only in relation to the other ratios of other companies in the same kind of business.

A P/E ratio higher than that of other comparative companies, on the other hand, indicates greater demand for the company's shares presumably because a rapid growth in earnings is expected.

(c) Dividend Yield

This measures the return to a shareholder on the amount of his investments. In the case of a quoted share, the yield is calculated by reference to the current market value.

$$\text{Dividend yield} = \frac{\text{gross dividend per share}}{\text{Market value per share}} = \frac{10 * 100}{100} = 10\%$$

Since income is an important aspect of an investment for most investors, the dividend yield is key criterion.

(d) Dividend Cover

The shareholder is interested in knowing whether his investment will continue to yield his required return. For this reason, dividend cover is appropriate since it indicates the amount of profit cover for an ordinary dividend and the amount of profit retained in the business:

$$\text{Dividend cover} = \frac{\text{net profit for the year after interest and preference dividend}}{\text{Dividend on ordinary shares}}$$

$$\frac{15{,}000}{10{,}000} = 1.5 \text{ times}$$

3.3 Limitations of Ratio Analysis

In spite of the obvious benefits of ratio analysis, there are some limitations to the usefulness of ratios. They include the following:

(a) The major limitation arises from the fact that they draw historical information which is of little use in assessing future prospects of a company.

(b) Ratios are quantifiable data. They cannot provide non-quantifiable information like competence of management and staff and changes in the operating environment.

(c) Some of the ratios, for example, do not have universally accepted uniform parameters.

(d) When carrying out inter-company analysis, different accounting policies adopted by the companies could distort ratios calculated.

3.4 Computation and Interpretation of Accounting Ratios

Illustration 5-3

The balance sheet of funfair limited, a toy manufacturer, as at 31 December 2008 was as follows:

	₦'000	₦'000
FIXED ASSETS (NET)		12,000
Investments		500
Goodwill		1,900
		14,400
CURRENT ASSETS		
Stocks & work in progress	11,900	
Debtors	11,700	
Bank and cash balances	300	
	23,900	
DEDUCT: CURRENT LIABILITIES		
Creditors	8,900	
Bank overdraft	7,200	
Tax payable	400	
Dividends payable	700	
	17,200	
NET CURRENT ASSETS		6,700
NET ASSETS		21,100
FINANCED BY		
CAPITAL AND RESERVES		
Ordinary share capital- issued and fully paid		10,000
Revenue reserves		3,900
Shareholders' fund		13,900
Deferred tax		1,200
Long term loan		6,000
		21,100

Turnover during the year 2007 w as ₦ 39million, (2006 - ₦ 42million) and that in the first half of 2008 w as ₦ 12million (2007 - ₦ 13million).

Stock at December 31, 2006 was ₦ 2.1million. Stock is stated at cost (including appropriate production overheads), which is approximately 60% of selling price.

Required:

(a) Compute the current ratio of Funfair Ltd at December 31, 2007.

(b) Briefly explain the purpose of current ratios and how it may vary with the nature of the business concerned.

(c) What subsidiary ratios may usefully be computed which will enable an analyst to form a judgement as to the working capital structure? Illustrate their computation using the balance sheet and other data for Funfair Ltd.

(d) On the basis that turnover in 2007 was ₦ 39million and debtors were ₦ 11.7million, the average collection period for Funfair Ltd w as 109.5days, which is clearly excessive, comment on this analysis.

(e) Comment on the major weakness (apart from debt collection) apparent from the accounts of Funfair Ltd.

Suggested Solution 5-3

a) Current Ratio $= \frac{\text{Current assets}}{\text{Current liabilities}} = \frac{23.9}{17.2} = 1.39:1$

(i) Purpose of Current Ratio

The current ratio is an indicator of the financial soundness and stability of a business. The priority of a business is survival and it cannot survive unless it is able to meet its debts as they become due for payment.

By relating these two figures at a particular date, one can assess the company's ability to pay debts due within 12months, out of assets which are to be converted to cash in approximately within the same time scale.

Current assets include stocks and work in progress. They are perhaps the most difficult assets to convert quickly to cash. It is therefore, common to measure the company's immediate ability to pay its debt by computing the liquidity ratio or acid test ratio.

Acid test ratio: $\frac{\text{current assets less stock and work in progress}}{\text{Current liabilities}} = \frac{23.9-11.9}{17.2} = \frac{12}{17.2}$

$= 0.7:1$

Attempts are frequently made to establish a norm for these ratios. It is difficult to state an absolute figure in isolation, for example stock and debtors levels required in one industry may be quite different from those in another.

The ratios should be compared year by year within the same company and one would look for a consistent pattern. An industry average would be useful indicator for a company, as it would enable comparison to be made with other companies in the same sector.

Ratios do not usually provide final answers; they only assist in the better understanding of financial reports. It is, therefore, always necessary to relate the figures to previous performance or some external standards.

(ii) Effects of the Nature of Business

The crucial effect of the nature of the business on the current ratio can be illustrated by reference to two elements of working capital:

Stocks – Manufacturing companies hold stocks of raw materials, work-in-progress and finished goods, whereas service companies tend not to do so.

Debtors – Businesses which sell for cash (such as Supermarkets will not have material figures for trade debtors compared with businesses whose sales are principally on credit terms, for example, heavy engineering firms.

Clearly, the current ratios in these types of operation are significantly affected by the nature of the business and this clearly explains why it is essential to compare current ratios from year to year within the same company or with other companies in the same industry.

b) Working Capital Ratios

It is possible to take an overall view of the level of working capital by computing ratios which link working capital or its constituent elements to other aspects of the business. Having established normal or desired relationships, one can monitor deviations from the norm. The objective is to establish the causes and effects of these deviations (which may be justified).

(i) $\frac{\text{Working Capital}}{\text{Capital employed}} = \frac{6.7}{21.1} = 0.32:1$

Or $\frac{\text{Working Capital}}{\text{Fixed assets}} = \frac{6.7}{12} = 0.56:1$

The implication is that a high proportion of working capital to total capital employed , gives the business freedom to adapt to changing circumstances, for example, it might enable a company to boost sales by a temporary reduction of liquidity or to realise assets and invest the proceeds in the most profitable way.

	2007	2006
(ii) Stock Turnover Ratio = $\frac{\text{Sales}}{\text{Stock \& WIP}}$	$\frac{39}{11.9}$ = 3.3 times	$\frac{42}{2.1}$ = 20times

By relating sales to year-end stocks and work-in-progress, the analyst who only has access to published information, attempts to, assess the effectiveness of the company's control over its stock levels and its ability to generate sales in relation to stocks held.

Published information in this question is deficient in two principal aspects:

1. No Information is disclosed as to cost of goods sold. Such information would be useful in computing stock turnover ratio, because sales include a profit element whereas stocks are usually stated at cost. Comparisons between companies are distorted by the discrepancy between gross profit margin earned by different businesses. It would therefore be better to relate stocks to cost of goods sold.

2. No information is disclosed about the pattern of sales during the year, or about the average levels of stocks held or about cost of goods sold.

In the example, w e can re-compute the ratio using cost of goods sold as being 60% of sales.

	2007	2006
$\frac{\text{Cost of goods sold}}{\text{Stock + WIP}}$	= $\frac{23.4}{11.9}$ = 2.97 times	$\frac{25.2}{2.1}$ = 12times

(iii)Average collection period

$\frac{\text{Trade Debtors}}{\text{Sales per day}} = \frac{₦11.7m}{₦\ 106,850} = 109.5$ days

Sales per day = ₦ 106,850 (3.9m/365)

This ratio, w hen compared with those of previous years and with other similar companies, indicates the effectiveness of the company's credit control procedures and adverse movements may suggest the inclusion of bad and doubtful debts in the trade debtors figure. When calculated on the basis of published accounts, this ratio requires qualification.

c) Comment on the Average Collection Period

Funfair Ltd. has a collection period of 109.5 days based on annual turnover of ₦ 39million and year-end trade debtors of ₦ 11.7million. This appears to be excessive, but like all ratios, it must be related to other information. If other toy manufacturers have a similar collection period, funfair's 109.5days may appear very long, but that may be the norm for that industry.

This question provides information about the seasonal nature of the company's business, sales in the first half of 2007 w ere ₦ 13million and doubled in the second half to ₦ 26million (₦ 39m – ₦ 13million).

For example, if it could be established that the company's normal terms of credit were for 2months and that sales for the fourth quarter of 2007 were ₦ 18million, w e could re-compute the ratio as follows:

Sales per day over the last quarter $= \frac{₦\ 18m}{90} = ₦\ 200,000$

Collection period $= \frac{₦\ 11.7m * 365}{₦\ 200,000} = 58.5$ days

This calculation demonstrates that the collection period is almost exactly in line with the company's policy, whereas using the year-end debtor and annual turnover, the collection period extends to 109.5days. This does not mean that credit control is not weak in Funfair Ltd, but it is not possible from the published accounts of one year, to make a categorical statement about control.

d) Major Weakness apparent from the accounts of Funfair Ltd.

The company is a toy manufacturer and one would have expected its stock levels to be relatively low at its year-end, because of the seasonal nature of the business. At 31 December, 2006, stocks were valued at ₦ 2.1 million and one year later, it had risen to ₦ 11.9million.

This occurred in a year when turnover fell from ₦ 42million to ₦ 39million. One might conclude that the company had been over-producing in 2007 and the Stock /Turnover ratio based on year-end stocks and cost of goods sold, tends to give credence to that conclusion.

One possible explanation for building stocks at the year-end would be to meet expected demand in the early months of the following year, perhaps to coincide with the launch of a new product or an advertising campaign. However, it is unlikely to be the case with Funfair Ltd, because its seasonal peak of sales would fall in the last quarter of the year and not in the first quarter.

The question gives a sales figure of ₦ 12million for the first 6 months of 2008. Provided that cost represents the quoted 60% of selling price, the cost of goods sold in the period is ₦ 7.2million. This suggests that the stocks valued at ₦ 11.9million will easily last the company until the second half of 2008.

Therefore, it is likely that the company will have to reduce production drastically in 2008, to avoid holding excessive stocks, which are expensive to finance in terms of Bank overdraft interest. Redundancies would be an inevitable consequence of major cuts in production and this situation represents a serious threat to the future of the business.

3.5 Value Added Statement

Value-Added Statement represents the additional wealth which an entity has been able to create by its own and its employees' efforts. This statement shows the allocation of that wealth among employees, providers of finance, government and that retained in the business for future creation of more wealth.

Illustration 5-5
Set below is the profit and loss account of XYZ plc, a manufacturing company, for the year ended 31 December 2008, together with its comparative figures.

	2008 ₦'000	2007 ₦'000
Turnover	8,074,458	5,201,750
Cost of sales	(5,015,397)	(3,021,246)
Gross profit	3,059,061	2,180,513
Distribution costs	(520,162)	(364,475)
Administration expenses	1,366,742	(681,787)
Trading profit	1,172,157	1,134,251
Interest payable (net)	(386,079)	(235,739)
Profit before exceptional items and	786,078	898,512
taxation	113,169	-
Exceptional items	672,909	898,512
	(314,138)	(335,520)
Taxation	358,771	562,992
Profit after taxation	(351,000)	(234,000)
proposed dividend	7,771	328,992
Retained profit		

The following notes are relevant:

1. Included in cost of sales is excise duty amounting to ₦ 2,095,631,000 (2007 ₦ 1,028,900,000) charged on the manufactured goods

2. Included in Distribution and administration costs are staff salaries wages and fringe benefits totalling ₦ 495,872,000 (2007 ₦ 306,062,000) and depreciation charged on fixed assets of ₦200,264,000 (20 07- ₦ 132,397,000)

3. Taxation comprises

	2008	2007
	₦'000	₦'000
Land & Building	34,982	314,479
Plant, Machinery & Vehicles	17,117	21,041
Goodwill and Patents	262,039	0
	314,138	335,520

Required:
Prepare the statement of Value Added of the company for the year ended 31 December, 2008 as it will appear in its published financial statements.

Suggested Solution 5-5

XYZ PLC
STATEMENT OF VALUE ADDED FOR THE YEAR ENDED 31 DECEMBER 2008

	2008		2007	
	₦'000	%	₦'000	%
Turnover	8,074,458		5,201,759	
Bought in materials and services	(4,223,703)		(2,600,149)	
Value added;	3,850,755	100	2,601,610	100
Distribution of value added				
To government:				
Excise duty	2,095,631	54.4	1,028,900	39.6
Tax on company profit	52,099	1.4	335,520	12.9
To employees:				
Salaries, wages and fringe benefits	495,872	12.9	306,062	11.8
To providers of finance:	351,000	9.1	234,000	9.0
Dividends to shareholders	386,079	10.0	235,739	9.0
Interest on borrowings				
Retained in business:	200,264	5.2	132,397	5.1
To maintain and replace fixed	7,771	0.2	328,992	12.6
assets	262,039	6.8	-	0-
To augment reserves	3,850,755	100	2,601,610	100
Deferred taxation				

3.6 Report Writing

Students sometimes presume that the interpretation of financial statements merely requires the calculation of ratios; and consequently, ignore the aspect of report writing. The need to change this notion, coupled with the need to improve communication skills of would be accounting personnel in practice, industry and commerce, informs the specific inclusion of this topic at this level of the professional examinations.

3.6.1 Elements of a Report

A good report usually consists of the following:

(a) Heading

A convenient format for examination use may be in internal memo form:

To: the directors, XYZ limited
From: Mr. Ade wazobia date
Subject _______________

The heading needs to give the names of the recipient and the writer, the date and the subject been reported on.

In the absence of names, invent some, but do not use your own name.

(b) Terms of reference

Terms of reference are easily picked up by quoting from the question. Feel free to use a little constructive imagination by referring to previous letters or meetings.

(c) Main body – Facts and Recommendations

- Use of appendices: In an accounting examination, candidates will probably have to make some calculations perhaps ratios, proposals for amalgamation or absorption e.t.c. It is advisable to attach the working sheet to your report as an appendix, and refer to the appendix in the main report.

- Tabulation: In writing a report, or indeed in writing the answer to any non computational question, the problem always arises as to whether to tabulate or not to tabulate. By "tabulation", we mean the presentation of information in a tabular form.

  The advantages of tabulation are:

  - English construction is simplified.
  - It is easy to add to.
  - It is easily marked when a number of factual points have to be dealt with; and
  - It facilitates logical thought and presentation.

  The disadvantages of tabulation are:

  - If you can write good English, tabulation will limit your ability to demonstrate this to the examiner.
  - It is not suitable when an open question is to be discussed.

A reasonable compromise is probably to use tabulation for presenting facts and not opinions. You should ensure that the form of each item in t he tabulation make sense with the introduction.

- English style: a report should be written in clear, fairly formal English. Avoid pompous business jargon, but on the other hand, avoid the over- colloquial approach. Use short and simple sentences. It is probably better to report in the third person.

3.6.2 Qualities of a Good Report

A good report should have the following:

- Fullness: all aspects of the subject must be covered.

- Accuracy: information should be checked and verified.

- Literacy: grammatical correct sentences should be formed without ambiguity. Avoid split infinitives and unnecessary abbreviations and slangs.

- Level/Consciousness of users: a report is for the readers; therefore jargons should be avoided where possible.

- Interest of users: good English commands interest.

- Clarity of purpose: a report should be divided logically into parts and arrive at a conclusion.

Written information can be narrative, tabulated or diagrammatic. The diagrammatic can be further analysed into graphs, histograms, time series, bar charts, pictograms and pie charts.

Self Assessment Exercises

Price earnings ratio of a company measures______________

(a) The relationship between Profit after tax and Market Price;
(b) The market value of the shares;
(c) Its earnings over the period under review;
(d) The relationship between earnings per share and market price per share;
(e) The relationship between dividends per share and market price per share.

4.0 CONCLUSION

Accounting ratios are of tremendous benefit in analysing and interpreting financial statements. However, they have their own limitations.

5.0 SUMMARY

This unit demonstrates how accounting ratios are computed and interpreted. It is however important to note that what is termed an ideal ratio varies from industry to industry and sometimes on the size of the company.

In the next unit, you will be introduced to another topic titled contract account.

6.0 TUTOR-MARKED ASSIGNMENT

1. State two parties that are always interested in the interpretation of financial statements.
2. Mention one limitation of ratio analysis.

7.0 REFERENCES/FURTHER READINGS

Adapted from the ICAN Study Packs (2011)

UNIT SIX CONTRACT ACCOUNTS

CONTENTS

1.0 INTRODUCTION

In the last unit, we undertook practical application of the theoretical background on the preparation of financial statements on limited liability companies, including relevant notes to the financial statements in the recommended formats.

In this unit, we shall examine the steps to be taken in preparing a cash flow statement.

2.0 OBJECTIVES

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

- Explain the two methods of accounting for contracts
- Determine profit under the two methods
- Compute the value of work in progress at the end of the period.

3.0 MAIN CONTENT

3.1 Contract Account

A construction contract is a contractual agreement between two parties, whereby a party known as the contractee agrees to pay a specified consideration to the other party, known as the contractor, for the execution of a specific project based on specified terms and conditions.

A construction contract is carried out for the execution of a project, which may be Civil, Building, Engineering and so on. The period of execution may be within one year (short-term projects), or spread over a period exceeding one year (long-term projects).

In accounting for construction contracts, SAS No 5: Accounting for Construction Contracts recommends that every enterprise should use either the completed contract method or the percentage of completion method.

3.1.1 Accounting for Short-term Projects

Short-term contracts are executed within a period of 12 months which may fall within one or two accounting year-ends. Where such a contract is commenced and completed within an accounting year-end, the resultant contract profit is recognized immediately in that accounting year-end. Where the contract is commenced in one accounting year and concluded in the next, then, there is the need to determine in which accounting year to recognize such profit. There is also the need to determine the value of work-in-progress at the end of the first accounting year in which the contract w as commenced but not completed.

The provision of SAS No 5: Construction Contracts on Short-Term Contracts is summarized as follows:

(a) The Completed Contract Method should be used for short-term contracts

(b) Foreseeable Losses should be charged to the Profit and Loss account in the period in which they are identified

(c) A contract should be regarded as completed, only when all activities relating to it are accomplished. In a situation where the additional costs required to complete the contract are not significant, provision should be made for such costs and the contract treated as completed.

Illustration 6-1

Bojuboju Construction Limited undertook to build a plant for Tolu Manufacturing Limited, at a contract price of ₦100,000. Expenditure relating to the contract are as follows:

	₦'000
Materials	30,000
Direct wages	40,000
Direct expenses	5,000
Plant @ cost	35,000
Plant hire	2,000
Sundry tools	3,000

The contract w as completed by the year ended 31 March, 2008, during which, the company received ₦ 60,000 from Tolu Manufacturing Ltd. The written down values of the plant and tools were ₦ 25,000 and ₦ 500, respectively.

Required:
Prepare the contract account

Suggested Solution 6-1

BOJUBOJU CONSTRUCTION LIMITED
CONTRACT ACCOUNT FOR THE YEAR ENDED 31 MARCH 2008

	₦'000		₦'000
Materials	30,000	Contract price	100,000
Direct wages	40,000	Plant(WDV) c/d	25,000
Direct expenses	5,000	Sundry tools (WDV)	500
Plant at cost	35,000		
Plant hire	2,000		
Sundry tools	3,000		
Contract profit taken	10500		
	125,500		125,500

	TOLU MANUFACTURING CONTRACTEE ACCOUNT	LIMITED	
	₦'000		₦'000
Value of work certified	100,000	Cash received	60,000
		Contract debtor(bal c/d)	40,000
	100,000		100,000

3.1.2 Accounting for Long-term Projects

There are special problems associated with accounting for businesses which carry out long term construction contracts. These problems can be summarized as follows:

(a) These projects usually involve application of very substantial amounts of physical and financial resources

(b) The production cycle can be very long in comparison with other businesses

(c) Profit recognition for each year of operation during the period of execution of the contracts

3.1.3 Mode of operations

The following, are the methods of approach for a construction business:

(a) Resources are controlled on contract basis

(b) Each contract is given a separate identification code number and the costs of all resources supplied to that contract are charged to it

(c) At intervals, throughout the period of the contract an approximation of the degree of completion of each contract (in terms of the contract price) and a certificate to this effect is issued by a qualified professional

(d) The certificates enable estimates to be made of the profit earned or loss sustained on the contract up-to-date and also, of the value of the work-in-progress. Also the certificates are the bases for a claim for interim payments (known as progress payments).

(e) The contractor does not necessarily have to wait until the end of the contract period, or receive payments, before recognising profits

(f) It is usual for the contractee to deduct withholding tax at source, from the progress payments.

3.1.4 Accounting procedures

Separate ledger accounts are maintained, for each contract in which relevant costs are posted and other relevant entries made for proper monitoring and management of each contract

3.1.5 Profit recognition

For each contract there is the need to determine the appropriate profit to be recognized. The following are the acceptable methods of recognizing profit on construction contracts.

(a) Architect's or Engineer's certificate method.
(b) Percentage of completion method (SAS No 5)

3.1.6 Architect's /engineer's method

Under this method, each contract is debited with the costs of materials supplied, payments to sub-contractors, w ages and contract overheads.

At the end of the period, the account is credited with architectural valuation, the value of work done but not yet certified and the value of unused resources, such as materials at site, and value of fixed assets at site. A credit balance on the account indicates a potential profit on the contract, while a debit balance indicates a potential loss.

In accordance with the concept of prudence, it is recommended that any foreseeable loss should be recognized immediately while estimated profit recognized systematically as below:

$$\text{Profit recognised to date} = \text{estimated profit} * \frac{2/3 * \text{cash received}}{\text{Value of work certified}}$$

Illustration 6-2

Vulture Nigeria limited, undertakes to build another giant coal bunker for eastern coal limited, at a contract price of ₦ 150,000,000, estimating that the work will take 18 months to complete. At the financial year ended 31 March 2008, the expenditure on the contract were as follows:

	₦'000
Materials	30,000
Direct wages	40,000
Direct expenses	5,000
Plant @ cost	35,000
Plant hire	2,000
Sundry tools	3,000

The written down value of plant for the year ended 31march 2008, was 25,000,000 while the value of sundry tools was estimated to be 500,000. At the year end, the value of work certified was 100,000,000. While cash received from the customer amounted to 60,000.

Required:
Prepare the contract and contractee's accounts, for the year ended 31 March 2008.

Suggested Solution 6-2

VULTURE NIGERIA LIMITED
CONTRACT ACCOUNT FOR THE YEAR ENDED 31 MARCH 2008

	₦'000		₦'000
Materials	30,000	Plant(WDV) c/d	25,000
Direct wages	40,000	Tools (WDV) c/d	500
Direct expenses	5,000	Work in progress (c/d)	93,700
Plant hire	2,000		
Plant at cost	35,000		
Tools at cost	3,000		
Profit recognised	4,200		
	119,200		119,200
	EASTERN COAL LIMITED CONTRACTEE ACCOUNT		
	₦'000		₦'000
Value of work certified	100,000	Cash received	60,000
		Contract debtor(bal c/d)	40,000
	100,000		100,000

Workings:

1. computation of profit recognised

	₦'000	₦'000
Value of work certified		100,000
Cost of work to date:		
Material	30,000	
Direct wages	40,000	
Direct expenses	5,000	
Plant hire	2,000	
Plant @ cost	35,000	
Sundry tools	3,000	
	115,000	
Plant (WDV) c/d	(25,000)	
Tools (WDV) c/d	(500)	
		89,500
Estimated profit		10,500

$$\text{Profit to be recognised} = 2/3 * \frac{\text{cash received} * \text{estimated profit}}{\text{Value of work certified}}$$

$$= 2/3 * \frac{60{,}000{,}000 * 10{,}500{,}000}{100{,}000{,}000}$$

$$= ₦\ 4{,}200{,}000$$

Note:

- Cost of work certified, would have been used in calculating the estimated profit, if provided
- This is a prudent approach to calculating profit recognised.

Alternative approach to calculating profit taken
Another acceptable approach is as follows:

$$= \frac{\text{Cash received}}{\text{Value of work certified}} * \text{estimated profit}$$

Therefore, profit = 60% * ₦ 10,500,000

= ₦ 6,300,000

3.1.7 Percentage of Completion Method (SAS 5)

This method is in line with provisions of SAS 5: construction contracts. It is applicable where cost of completing the contract can be estimated with a degree of certainty.

Illustration 6-3

Given the details under illustration 6-2, vulture Nigeria limited, but with the following additional information:

(a) It is estimated that the plant will have a written down value of ₦ 15,000,000 at the end of the contract, while the sundry tools will be valued at ₦ 1,900,000.

(b) Estimated future cost to complete the contract are as follows:

	₦'000
Materials	13,000
Wages	25,000
Direct expenses	2,900
Sundry tools at cost	2,000

Required:

Prepare the contract account showing the profit taken.

Suggested Solution 6-3

VULTURE NIGERIA LIMITED
CONTRACT ACCOUNT FOR THE YEAR ENDED 31 MARCH 2008

	₦'000		₦'000
Materials	30,000	Plant(WDV) c/d	25,000
Direct wages	40,000	Tools (WDV) c/d	500
Direct expenses	5,000	Work in progress (c/f)	95,500
Plant hire	2,000		
Plant at cost	35,000		
Tools at cost	3,000		
Profit recognised	6,000		
	121,000		121,00

Workings:

1. computation of profit recognised

	₦'000	₦'000	₦'000
Contract price			150,000
Cost of work to date:			
Materials	30,000		
Direct wages	40,000		
Direct expenses	5,000		
Plant hire	2,000		
		(77,000)	
Estimated future cost:			
Materials	13,000		
Wages	25,000		
Direct expenses	2,900	(40,900)	
Depreciation:			
Plant ₦ (35,000- 15000)	20,000		
Tools ₦ (3000+2000-1900)	3100		
		(23,100)	
Estimated contract cost to completion			(141,000)
Estimated profit			9,000

Attributable profit:

$$\frac{\text{Value of work certified *estimated profit}}{\text{Contract price}}$$

$$= \frac{100,000,000 * 9,000,000}{150,000,000}$$

= ₦ 6,000,000

Note: Future cost must be capable of being estimated with a degree of certainty.

3.1.8 Valuation of Work-in-Progress on Long-term Contracts

Under the provisions of SAS 5, the value of work in progress for balance sheet purposes is calculated as follows:

	N
Costs incurred to date	X
Plus attributable profit–if any	X
	XX
Less foreseeable loss	X
	X
Less progress payments received	
Or receivable	X
Value of WIP for balance sheet	X

Illustration 6-4

The following details are provided in respect of four contracts:

	Sango	Abule	Pero	igbesa
	₦	₦	₦	₦
Contract price	800,000	85,000	60,000	100,000
Cash received	450,000	76,000	-	-
Value of work invoiced	500,000	80,000	-	-
Cost of work certified	400,000	60,000	50,000	12,000
Estimated future costs	120,000	2,000	20,000	70,000
Cost to dates	400,000	60,000	55,000	13,000

You are required to:

(a) Calculate profit or loss to be taken on each contract;
(b) Show how the work in progress would be disclosed in the balance sheet.

Suggested Solution 6-4

A) contracts

	Sango	Abule	Pero	)igbesa
	₦	₦	₦	₦
Contract price	800,000	85,000	60,000	100,000
Costs to date	400,000	60,000	55,000	13,000
Estimated future costs	120,000	2,000	20,000	70,000
Estimated contract costs	520,000	62,000	75,000	83,000
Estimated profit/loss	280,000	23,000	(15,000)	17,000
Profit/loss taken	157,500	20,565	(15,000)	-

B) work in progress (for balance sheet)

Cost to date:	sango		400,000
	abule		60,000
	pero		55,000
	igbesa		13,000
			528,000
Add profit taken	Sango	157,500	
	Abule	20,565	
			178,065
			706,065
Less foreseeable losses: pero			15,000
			691,065
Less progress payments:			
Received:	Sango	450,000	
	Abule	76,000	
			526,000
Receivable	Sango (500,000 -450,000)	50,000	
	Pero (80,000 -760000	4,000	
	Igbesa	15,000	
		69,000	
Construction work in progress			96,065

Workings:

1. profit or loss taken on projects:

Sango= ₦280,000* $\frac{500,000}{800,000} * \frac{450,000}{500,000}$

=157,500

Abule = ₦23,000* $\frac{80,000}{85,000} * \frac{76,000}{80,000}$

= ₦20,565

Pero = all foreseeable losses should be recognised immediately

Igbesa = ₦17,000* $\frac{15,000}{100,000} * \frac{0}{80,000}$= nil

Self Assessment Exercises

1) A contract spanning over one year is called ______
   (a) Construction contract
   (b) Long term contract
   (c) Short term contract
   (d) Building contract
   (e) Civil contract

2) Which of the following is not used in calculating work in progress at year end?
   (a) Cost up to date
   (b) Retention money
   (c) Creditors balance
   (d) Profit taken to profit and loss account
   (e) Amount received or receivables

4.0 CONCLUSION

There are two acceptable methods for accounting for construction contracts. Also, there are acceptable methods for profit determination.

5.0 SUMMARY

In the unit, the determination of work in progress for the balance sheet disclosure was examined. The criteria stated in SAS 5 were also examined.

With the discussion of this unit, we have come to the end of the first module of this course.

6.0 TUTOR-MARKED ASSIGNMENT

1. Itemise one feature of a construction contract.
2. Differentiate between long term and short term contracts.

7.0 REFERENCES/FURTHER READINGS

Adapted from the ICAN Study Packs (2011)

MODULE TWO

UNIT ONE INVESTMENT ACCOUNTING

CONTENTS

1.0 INTRODUCTION

You are welcome to model two and unit one of this course.

In this unit, you will be introduced to investment accounting. This discussion will feature investment account, accounting entries in investment account, underwriter’s account and stock brokerage’s account.

2.0 OBJECTIVES

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

- Explain the theoretical aspects of investment accounting;
- Prepare investment accounts.

3.0 MAIN CONTENT

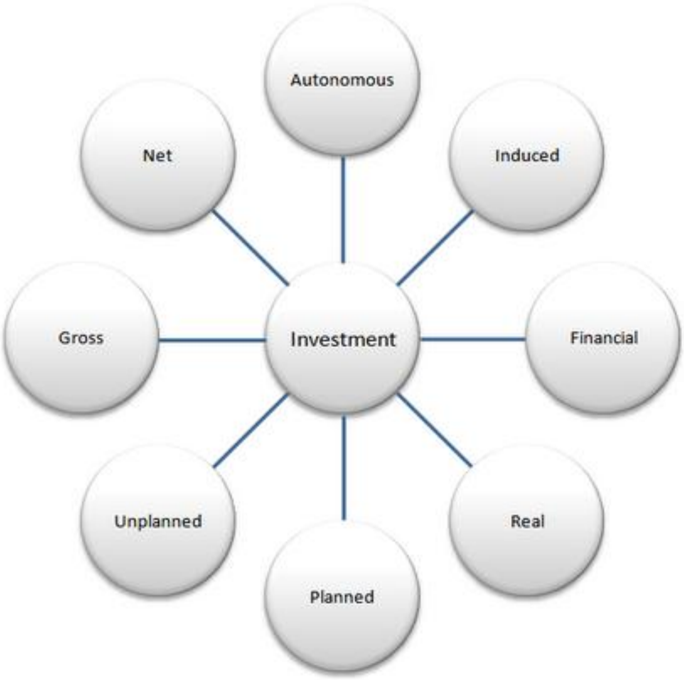
3.1 What is Investment?

In simple terms, Investment refers to purchase of financial assets. While investment goods are those goods, which are used for further production, they imply the production of new capital goods, plants and equipments.

John Keynes refers investment as real investment and not financial investment.

3.1.1 Different Types of Investment

Different types or kinds of investment are discussed in the following points.



1. Autonomous Investment

Investment which does not change with the changes in income level is called as Autonomous or **Government** Investment.

Autonomous Investment remains constant irrespective of income level. Which means even if the income is low, the autonomous, Investment remains the same. It refers to the investment made on houses, roads, public buildings and other parts of Infrastructure. The Government normally makes such a type of investment.

2. Induced Investment

Investment which changes with the changes in the income level, is called as Induced Investment.

Induced Investment is positively related to the income level. That is, at high levels of income entrepreneurs are induced to invest more and vice-versa. At a high level of income, Consumption expenditure increases this leads to an increase in investment of capital goods, in order to produce more consumer goods.

3. Financial Investment

Investment made in buying financial instruments such as new shares, bonds, securities, etc. is considered as a Financial Investment. However, the money used for purchasing existing financial instruments such as old bonds, old shares, etc., cannot be considered as financial investment. It is a mere transfer of a financial asset from one individual to another. In financial investment, money invested for buying of new shares and bonds as well as debentures have a positive impact on employment level, production and economic growth.

4. Real Investment

Investment made in new plant and equipment, construction of public utilities like schools, roads and railways, etc., is considered as Real Investment. Real investment in new machine tools, plant and equipments purchased; factory buildings, etc. increases employment, production and economic growth of the nation. Thus real investment has a direct impact on employment generation, economic growth, etc.

5. Planned Investment

Investment made with a plan in several sectors of the economy with specific objectives is called as Planned or **Intended** Investment. Planned Investment can also be called as Intended Investment because an investor while making investment makes a concrete plan of his investment.

6. Unplanned Investment

Investment done without any planning is called as an Unplanned or **Unintended** Investment. In unplanned type of investment, investors make investment randomly without making any concrete plans. Hence it can also be called as Unintended Investment. Under this type of investment, the investor may not consider the specific objectives while making an investment decision.

7. Gross Investment

Gross Investment means the total amount of money spent for creation of new capital assets like Plant and Machinery, Factory Building, etc. It is the total expenditure made on new capital assets in a period.

8. Net Investment

Net Investment is Gross Investment less (minus) Capital Consumption (Depreciation) during a period of time, usually a year. It must be noted that a part of the investment is meant for depreciation of the capital asset or for replacing a worn-out capital asset. Hence it must be deducted to arrive at net investment.

In today's complex world, investors need to make many important financial decisions, including selecting investment accounts that best fit their particular style, needs and goals.

3.2 Investment Account

Account held at a financial facility for the purpose of a long term investment for capital preservation, growth or fixed income. Financial facilities for investment accounts include banks, insurance companies, and brokerage houses.

3.2.1 Nature of Investment

- An investment could be either fixed interest securities (debentures/ loan stocks) or equities.

- The investment in fixed interest securities, attracts fixed interest, on the nominal value of the investment, which may be payable annually, semi-annually or quarterly.

- The value of the investment is the (Quoted Price x Nominal Value) plus other cost (if purchased) or less other cost (if sold)

- For the fixed interest securities, the investment can be purchased/ sold cum-div / interest (including Dividend) or ex-div / Interest (excluding dividend).

Cum – div is a situation when the price includes the right of a buyer to receive the next instalment of interest, including subsequent instalments of interest.

Ex-div is a situation when price does not include the right of a buyer to receive the next instalment of interest. He is then entitled to subsequent instalments of interest. All prices are "Cum-div" unless w hen specifically stated to be ex-div.

3.3 Accounting Entries

This topic will be discussed under the underlisted sub-topics.

3.3.1 Fixed Interest Securities

A. Purchases cum-div

(i) Compute net purchase price a:s (Quoted Price x Nominal Value) + Stamp duty, brokerage etc. - Accrued Interest.

(ii) DR Investment A/c (capital column) with the purchase price DR Accrued Interest Account (Income column) with Accrued interest. CR Bank A/c with Purchase Price; DR Bank A/c and CR Investment A/c (Income Column)} with interest including the immediate one.

B. Purchases ex-div

i) Compute purchase price as: (quoted price x nom. value) + stamp duty brokerage etc. DR Investment A/c (capital column)} with purchase price.

ii) CR Bank A /c

iii) DR Investment A/c (capital column)} with interest CR Investment A/c (income column)

iv) DR Bank A/c CR Investment A/c (income column) } with the instalments of interest excluding the Immediate next one

C. Sales cum-div

(i) Calculate NET Proceeds as: (quoted price x nom. value) - (Brokerage, Stamp duty etc. + Accrued interest).

(ii) DR Bank A/c - with Net Proceeds, CR Investment A/c (Income Column) with accrued interest; CR Investment A/c (Capital Column) with balance net proceeds.

(iii) Calculate Profit / Loss on Sales = Net Proceeds – Cost W here Cost = Nom. Value of Inv. Sold x Average Cost Nom. Value of Total Investment and Average Cost = Purchase Cum Div - Net Purchase Price; Purchase Ex Div = Purchase Price plus interest.

(iv) DR P & L A/c} with loss on sale; CR Investment A/c (capital column); DR Investment A/c (capital column)} with profit on sale; CR P & L A/c.

(v) DR Bank A/c; CR Investment A/c (income column) } with interest on Net Investment, that is Purchases – Sales as from immediate next instalment sales ex-div.

D. Sales ex- div

(i) Calculate the net proceeds (as in sales cum- div)

(ii) Calculate the interest on the securities sold from the date of sales to the date of next instalment

(iii) DR Bank A/c} CR Investment A/c (capital column)} with net proceeds

(iv) DR Investment A/c (income column; CR Investment A/c (capital column)} with interest in step 2.

(v) Calculate Profit/Loss on disposal = Net Proceeds+ Interest – Cost:

$$\text{Where Cost} = \frac{\text{Nom. Val. of Inv. Sold} \times \text{Average Cost}}{\text{Nom. Val. of Total Inv.}}$$

3.3.2 Equities

The current practice is not to make an apportionment of dividend on purchase or sales of equities, either “cum” or ‘ex’ dividend. The full cost of investment including expenses is debited to the capital column.

(a) DR Investment A/c (nominal column)} with cost of investment CR Bank A/c} including expenses.

(b) DR Investment A/c (nominal column)} with Bonus Shares (Scrip Issue) CR Bank A/c.

(c) DR Investment A/c (capital column)} with amount paid to CR Bank A/c purchase the right taken-up.

(d) DR Bank A/c} with sales proceeds on the right sold Cr investment a/c(capital column). No record will be made as regard the Nominal Value.

(e) DR Bank A/c}with dividend received CR Investment A/c (income column).

Note:

When two prices are quoted in a question e.g. 60k to 75k, the lower is the purchase price whilst the higher is the sales price. For balance sheet purposes, the mid-market price is taken.

Illustration 7-1

The following transactions of Ayo investments ltd took place during the year ended June 30, 2008.

1/7/12	Purchased ₦120,000 4% Rivers State Development Stock (Interest Payable February & August) at 60½ %
	Purchased ₦ 300,000 9% Treasury bill at 68 (Interest payable Oct & April Brokerage and other expenses amounted to ₦ 1,000.
12/7/2007	Purchased 200,000 ordinary shares each in NDC PLC for ₦ 400,000
1/8/2007	Received half-year's interest on 4% River State Dev. Stock
15/8/2007	NDC PLC made a bonus issue of 3 ordinary shares for every 2 held. 25,000 units of the bonus issue was sold for ₦ 10 each
30/8/2007	Purchased ₦ 150,000 9% Treasury bill at 70 ex – div
1/10/2007	Received interest on 9% Treasury bill – Purchased 50,000 Ordinary Shares of ₦ 1 each in OPC PLC at ₦ 7.75 each
2/01/2008	Sold ₦ 30,000 4% River State Dev. Stock at 61 ex- div
1/02/2008	Received half – year's interest on 4% River State Dev stock
1/03/2008	Received Dividend of 18% on shares in NDC PLC.
1/04/2008	Received interest on 9% Treasury bill OPC PLC made a right issue on the basis of '1 for 2' at 5 / share. Half of the right was sold on the market for ₦ 2.50 per share.

01/06/2008 Received Dividend of 12 1/2% on shares in O PC Plc.

You are required to w rite up the relevant investment accounts as they would appear in the books of Ayo Investments Limited for the year ended 30 June2008

Suggested Solution 7-1

INVESTMENT – 4% RIVER STATE DEVELOPMENT STOCK

	Nom ₦	Income ₦	Capital ₦		Nom ₦	income ₦	Capital ₦
1/7/07 bank	120,000	2,000	70,600	1/8/07		2,400	
purchase				bank			
2/1/08 adj. For		100		interest	30,000		18,300
ex-div				2/1/08			
30/1/08investme		4,200		bank sales			100
nt income				2/1/08 adj.			
30/1/08 p&l a/c			750	For ex-div			
				2/1/08		2,400	
	120,000	6,300	71,350	bank	90,000	1,500	52,950
				interest	120,000	6,300	71,350
1/7/04 bal b/d	90,000	1,500	52,950	30/6/08			
				balc/d			

NDC PLC – ordinary shares a/c

	Nom ₦	Income ₦	Capital ₦		Nom ₦	income ₦	Capital ₦
12/8/07 bank	200,000		400,000	15/8/07 bank	250,000		250,000
purchase				sales			
15/8/07 bonus	300,000			1/3/08 bank		22,500	
issue				dividend			
1/3/08 investment		22,500		30/6/08 bal c/d	250,000		200,000
income							
31/6/08 profit on							
disposal			50,000				
	500,000	22,500	450,000				
1/7/04 bal b/d					500,000	22,500	450,000
	250,000		200,000				

OPC PLC – Ordinary shares

	Nom ₦	Income ₦	Capital ₦		Nom ₦	income ₦	Capital ₦
1/10/07 bank	50,000		387,500	1/4/08 bank			
purchase				sales of right			31,256
1/4/08 bank right	12,500		62,500	1/6/08 bank		7,812.50	
30/6/08				dividend			
investment		7,812.50		30/6/08 bal	62,500		418,750

income	62,500	7812.50	450,000	c/d	62,500	7812.50	450,000
1/7/08 bal b/d	62,500	-	418,750				

Investment – 9% Treasury bill

	Nom ₦	Income ₦	Capital ₦		Nom ₦	Income ₦	Capital ₦
1/7/07 bank purchase	300,000	6,750	198,250	30/8/07 bank sales of right		1,125	
30/8/07 purchase	150,000		105,000	1/10/07 bank interest		13,500	
30/8/07 adj. For ex-div			1,125	1/4/08 bank interest		20,250	
30/6/08investment income		34,875		30/6/08 bal c/d	450,000	6,750	304,375
	450,000	41,625	304,375		450,000	41,625	304,375
1/7/48 bal b/d	450,000	6,750	304,375				

Note: Securities in fixed interest (loan Stock), are normally quoted in units of ₦ 100, unless otherwise specified

Purchase Price of 4% Rivers State Dev Stock will be:

₦ 120,000* 0.605=	₦ 72,600
Accrued interest=5/12*4%*120,000	(2,000)
	70,600

3.4 Underwriter's Account

3.4.1 Nature and terms of underwriting

An underwriter is one who undertakes to take over shares not purchased when they are being offered for sale to the public or by private placement, in return for an agreed commission.

The following terminologies are relevant:

(a) **Underwriting Commission** – This is the commission an underwriter receives on the value of shares he underwrites. This is based on the original contract, NOT on the portion actually taken up.

(b) **Sub-Underwriting Commission** – This is the commission t he principal underwriter will pay to a sub-underwriter in case he enters into a sub-underwriting agreement in order to spread the risk. This is based on the original value of the contract and NOT on the portion taken up.

(c) **Overriding Commission** – This is the additional commission paid to the principal underwriter in case of sub-underwriting agreement.

(d) **Firm Application** – This is the number of shares, which will be allotted to the principal underwriter in addition to the proportion to be underwritten, on the residue, not fully subscribed by the public.

3.4.2 Book keeping procedure

- Open a separate account for each underwriting contract
- Provide separate columns for shares and cash

Accounting entries

(a) DR: Underwriting A/c} with application and allotment proceeds, CR: Cash / Bank A/c} in respect of shares taken over.

N.B: If there is any excess payment on application due to the advance payment; the excess will be set-off against allotment monies.

(b) DR: Bank / Cash A/c CR: Underwriting A/c} with Commission Received

(c) DR: Underwriting A/c} CR: Bank / Cash A/c } with Commission paid to sub-underwriter.

Note: If shares are received for remuneration, DR the shares column only.

(d) DR: Underwriting A/c} CR: Bank / Cash A/c} with the option paid for.

(e) DR Bank / Cash A/c CR Underwriting A/c} with option money Received.

(f) DR: Underwriting A/c} with incidental expenses on CR: Bank / Cash A/c} underwriting contract.

(g) DR: Underwriting A/c} CR: P & L A/c} with profit on underwriting contract.

(h) DR P & L A/c} Underwriting A/c} with loss on underwriting contract.

(i) DR Closing stock of} with value of closing stock of unsold shares} shares CR Underwriting A /c}.

Illustration 7-2

Frontline Ltd decided to issue 1,000,000 shares of ₦ 1.00 each at par, 10kobo payable on application, 40kobo on allotment and 50kobo on first and final call. Yinkus Ltd, a finance company, agrees to underwrite the whole issue, at a commission of 2.5% and to apply firm for 200,000 shares. Yinkus Ltd arranged with Funky Ltd that they sub-underwrite 25% of the shares for a commission of 2%.

The public applies for and was allotted 400,000 shares and Yinkus Ltd w as allotted the firm's application for 200,000 shares.

Yinkus Ltd had deposited cheque designed for the application money on shares underwritten and Funky Ltd in turn, had deposited the relevant cheques and which cleared when the result of the issue became known and commission due was paid.

After allotment and before final payment, Yinkus Ltd sold 100,000 shares at 45k each, having made the final payment. Yinkus Ltd then sold 250,000 shares at 110k each.

At the end of the financial year of Yinkus Ltd, shares of Frontline Ltd were valued at 120k each.

You are required to prepare the Underwriting Account of Yinkus Ltd reflecting the above transactions.

Suggested Solution 7-2

YINKUS LTD
UNDERWRITING A/C

	₦	Shares		Shares	₦
Bank firm application	500,000	50,000	Bank		25,000
Bank-shares taken on		200,000	comm.rec'd	100,000	45,000
allot		200,000	Bank-sales	250,000	275,000
Bank-final call		5,000	Bank-sales	150,000	150,000
Bank-comm paid		40,000	Bal c/d		
P&l a/c					
	500,000	495,000		500,000	495,000
	150,000	150,000			

3.5 Stock Brokerage Account

3.5.1 Introduction

Only a Stockbroker who is a member of the Nigerian Stock Exchange is allowed to deal in quoted stocks and shares on behalf of his clients, on the capital market's trading floor.

A stockbroker buys or sells stocks and shares based on his client's instruction at a price determined daily on the floor of the Exchange by market forces. After buying or selling, the stockbroker will send to his client a contract note detailing the unit price, quotation of shares bought or sold, commissions and charges payable or receivable on the transactions.

3.5.2 Accounting Entries

On purchase of shares by a client:

	Debit	Credit	With
A	Client	Jobber commission receivable stamp account contract stamp account	Price paid for shares stockbrokers Commissions stamp duty on purchase contract stamp
B	Jobber bought stamp account	Bought ticket accounts	Make up price of shares plus stamp duty
C	Jobber or cash	Cash or jobber	Diff btw price paid for shares and make up price(plus stamp

			duty)
D	Cash	Client	Cash received from client
E	Ticket account	Cash	Cash paid to stock exchange for purchases during the account
F	Contract sold account	Cash	Monthly payment to the inland revenue
G	Commission receivable	Profit and loss account	Commission earned

On sale of shares by a client

	Debit	Credit	With
A	Jobber account	Client commission receivable contract stamp contract stamp account	Net proceeds selling Commission
B	Ticket account	Jobber's inland revenue Buyer's stamp duty	Make up price of shares sold plus
C	Jobber or cash	Cash or jobber	Diff btw gross proceed and make up price
D	Inland revenue	Cash	Stamp duty paid on behalf of the buyer
E	Contract stamp	Cash	Monthly payment to the inland revenue
F	Cash	Ticket account	Cash received from the stock exchange for sales
G	Client	Cash	Payment to client of net proceeds
H	Commission receivable a/c	Profit and loss account	Commission for accounting period

In practice, a Contract Journal will be used for the entries of purchases and Sales

Illustration 7-3

Mr Johnson a stockbroker carried out the following instructions for his clients:

From Mr. Ayodele- purchased 2000 shares of Cadbury plc at ₦ 72
From Mr. Ayodele- purchased 1000 shares of Unilever plc at ₦ 80
From Mr. Adamu- sold 2000 shares of BOC gases plc at ₦ 5
From Mr. Okoro- purchased 10,000 shares of Texaco plc at ₦ 100
From Mr. Okoro- sold 5000 shares of Nigerian breweries at ₦ 60

Stockbrokers commission is 1% and stamp duty of 1% is payable on every transaction.

Prepare contract journal of the stockbroker.

Suggested Solution

MR JOHNSON
CONTRACT JOURNAL

Date	Name of party	Des. Of securities	Price ₦	Total value ₦	Name of party	Des. Of securities & comm	Stamp duties	₦
	Ayodele	2000 Cadbury plc	72	146,880	Dealer		2,880	144,000
	Ayodele	1000 Unilever plc	80	81,600	Dealer		1,600	80,000
	Dealer		5	10,000 200	Adamu	2000BOC Gases plc	200	9,800
	Okoro	10000 Texaco plc	100	1,020,000	Dealer		20,000	1,000,000
	Dealer		60	300,000	Okoro	5000Nig breweries	6,000	294,000
				1,558,480 (1)			30,680 (2)	1,527,800 (3)

- Each item is debited to Dealer or Client Account
- Half credited to stamp duties account and half credited to commission a/c
- Each item credited to dealer or client A/c.

Self Assessment Questions

1. Details of Income and Expenditure of an Investment Trust Company is contained in its ___________________

(a) Balance Sheet
(b) Income and Expenditure
(c) Revenue and Expenditure Account
(d) Profit and Loss Account
(e) Revenue Account

2.__________ is the record maintained by a stockbroker where transactions entered into on behalf of clients are recorded.

(a) Contract Journal
(b) Stock Ledger
(c) Transaction Journal
(d) Cash book
(e) Clients Ledger

4.0 CONCLUSION

Investment accounting is a very important aspect or part of accounting and as such, thorough understanding of the theoretical aspect of it is indeed very beneficial.

5.0 SUMMARY

In this unit, details of the double entry principles and related books of accounts maintained by the operators of investment, underwriting and stock broking firms were extensively discussed and practical solutions were made to some examples.

In the next unit, we shall explore another topic 'accounting for lease and hire purchase transactions'.

6.0 TUTOR-MARKED ASSIGNMENT

1. State two functions of a Stockbroker.
2. Distinguish between investment purchased or sold Cum– Div and Ex – Div.
3. Define the concepts investment and investment account.

7.0 REFERENCES/FURTHER READINGS

Adapted from the ICAN Study Packs (2011)

UNIT TWO ACCOUNTING FOR LEASE AND HIRE PURCHASE

CONTENTS

1.0 INTRODUCTION

In the last unit, you were introduced to investment accounting. We also discussed the feature of investment account, accounting entries in investment account, underwriter's account and stock brokerage's account.

In this unit, we shall explore accounting for lease and hire purchase.

2.0 OBJECTIVES

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

- Discuss the theoretical aspects of lease accounting;
- Apply the various methods of accounting to finance charges in the books of lessor and lessee;
- Understand the accounting for hire purchase transactions.

3.0 MAIN CONTENT

3.1 Lease Accounting

Statement of Accounting Standards (SAS) No.11 stipulates detailed appropriate treatment and disclosure of lease transactions in the books of both the lessor and lessee.

A lease is a contractual agreement between an owner, the lessor, and another party, the lessee, which conveys to the latter, the right to use the leased asset for an agreed period of time in return for a consideration, usually periodic payments called 'rents'. Leasing arrangements are usually contracted as operating lease or finance / capital lease.

Operating lease is one in which the lessor, while giving the lessee the use of the leased property, retains practically all the risks, obligations and rewards of ownership (for example; early obsolescence and appreciation).

Finance or capital lease is one in which ownership risks, rewards are transferred to the lessee, who is under obligation to pay such costs as insurance, maintenance and similar charges on the property. Usually, the agreement is non cancellable and the lessee has the option to buy the property for a nominal amount upon the expiration of the lease.

Other forms of Finance or Capital leases are:

(a) Leveraged Lease is three-party lease involving a lender (often a financial institution) in addition to the usual lessor and lessee. The lender supplies, in most cases, the greater part of the purchase price of the leased asset.

(b) Sales – Typed Lease is one where the offeror or dealer (the Lessor) transfers substantially all the ownership risks and benefits of the property to the lessee and at the inception of the lease, the fair value of the leased property is greater or less than its carrying amount in the books of the lessor, resulting in a profit or loss to the lessor, w ho is often a manufacturer or dealer.

(c) Direct Finance Lease is one which transfers substantially all the ownership risks and benefits of the property to the lessee and at the inception of the lease, the fair value of the leased asset is the same as its carrying amount to the lessor (often not the manufacturer or dealer).

(d) 'Sales and Lease Back' is one in which the seller of the property leases it back from the buyer.

3.1.1 Accounting for Leases in the Books of the Lessee

The following steps are necessary:

Step 1: Calculate the total lease payments, that is:

Installmental payment x No of Instalments

Step 2: Compute cash /fair value of the leased property.

It may be given, but if not, calculate it as follows:

(a) Installments in arrears (that is, at year end)

$$= \frac{\text{instalment } (1-(1+r)^{n})}{r}$$

Where r = lease rental rate
n = duration of the lease.

(b) Installments in advance (that is, at the beginning of the year):

$$\frac{\text{Instalment } 1 - (1+r)^{t} + 1}{r}$$

Where t = n-1
n = duration of the lease

Step 3: Compute the depreciation on the cash price/ fair value of the leased asset.

Step 4: Calculate the total interest on the lease / finance charges:

Total lease payment	xx
Cash / fair value	(x)
Total lease interest / finance charges	x

3.1.2 Treatment of Finance Charges

Finance charges may be spread over the period of the lease, using:

(a) Straight line method;
(b) Sum of the years digit method; and
(c) Actuarial method

Straight Line Method

Finance charges are distributed evenly over the period of the lease and are written off to Profit and Loss Account accordingly, that is: $\frac{\text{Finance charge}}{\text{Duration of lease}}$

Sum of the Years Digit Method

The financial charges will be written off to profit and loss account on the basis of the sum of the years' digits. For a leased asset with 3years life span, the finance charges will be distributed into each year's profit and loss account as follows:

Year	digit	proportion
1	3	3/6
2	2	2/6
3	1	1/6
	6	

Actuarial Method

Interest in each period will be computed on the balance after deducting the Installmental payments and adding the interest due on the cash price.

3.1.3 Accounting Records

Interest payable method	interest suspense method
a) Leased assets a/c	leased assets a/c
b) Prov. for depreciation a/c	prov. For depreciation a/c
c) Lessors a/c	lessors a/c
d) Finance charges a/c	finance charges a/c
e) Profit and loss account	p&l a/c
	Finance charges suspense a/c

3.1.4 Accounting Entries

Interest Payable Method

1. DR leased assets account
   CR lessor's account

With cash price/fair value of leased assets

2. DR finance charge a/c
CR lessor's a/c
With interest for each of the period

3. DR lessor's a/c
CR bank a/c
With the Installmental payment

4. DR P&L a/c
CR finance charge a/c
With the interest due for each period

5. DR P&L a/c
CR prov. For depr a/c
With the depreciation for each period

Interest Suspense Method

1. DR leased assets a/c
CR lessor's a/c
With cash price/fair value of the leased assets

2. DR interest suspense a/c
CR lessor's a/c
With the total lease interest

3. DR finance charge a/c
CR interest suspense a/c
With the interest due for each of the period

4. DR P&L a/c
CR finance charge a/c
With the interest due for each of the period

5. DR lessor's a/c
CR bank a/c
With Installmental payment

6. DR P&L a/c
CR prov. For depr a/c
With depr for each period

Illustration 8-1

Bakasi Haulage Contractors Limited has two alternatives. It could either buy or lease a new truck at a cost of ₦18million. The terms of the lease are as follows:

(a) The primary period of the lease is for 4 years from January 1 2008, with a rental repayment of ₦ 6million per annum, payable on December 31 of each year

(b) The lessee has the right to continue t o lease the truck after the end of primary period for an indefinite period, subject to only a nominal rent

(c) The lessee is required to pay for repairs, maintenance and insurance cost as they arise

(d) The interest rate implicit in the lease is 15% per annum.

(e) The lessee estimated that the useful economic life of the truck is 6 years and that depreciation could be calculated on straight line basis.

Required:

a) Compute the finance charge to be recognised on the leased truck under the different methods of spreading finance charges

b) Record detailed accounting entries in respect of one of the methods identified in (a) above

Suggested Solution 8-1

BAKASI HAULAGE CONTRACTORS LIMITED

(a) Calculation of finance charge

(i)Total lease payment: 6million *4 = 24million
(ii) The fair value of the leased truck:
Instalment) 1-(1+r)n) = ₦6m*(1-(1.15)-4
R 0.15
(Installmental payment in arrears) = ₦ 6m *2.8550
= ₦ 17,130,000
(iii) Depreciation: ₦ 17,130,000
6yrs = ₦ 2,8550,000
(iv) Calculation of interest:

Total instalments -	24,000,000
Cash price/fair value	(17,130,000)
Total interest/finance charge	₦ 6,870,000

Straight line method: total interest = ₦ 6,870,000

Lease period 4
= ₦ 1,717,500

Sum of the years digit method

Year	Digit	Interest allocation	Finance charge ₦'000
1	4	4/10*6,870,000	2,748
2	3	3/10*6,870,000	2,061
3	2	2/10*6,870,000	1,374
4	1	1/10*6,870,000	687
	10		6,870

Actuarial method

		Interest
	₦'000	₦'000
Fair value/cash price	17,130	
Add: interest – 15%*17,130,000	2,570	2,570
	19,700	
Less 1st instalment	6,000	
	13,700	
Add: interest – 15% of 13,700,000	2,055	2,055
	15,755	
Less 2nd instalment	6,000	
	9,755	
Add: interest- 15% of 9,755,000	1,463	1,463
	11,218	
Less 3rd instalment	6,000	
	5,218	
Add: interest – 15% of 5,218,000	782	782
	6,000	
Less 4th instalment	6,000	
	NIL	6,870

(b) Accounting entries

Under interest payable method

Leased truck account

		₦'000		₦'000
1/1/05	lessor a/c	17,130	31/12/05 Bal c/d	17,130
1/1/06	bal b/d	17,130	31/12/06 Bal c/d	17,130
1/1/07	bal b/d	17,130	31/12/07 Bal c/d	17,130
1/1/08	bal b/d	17,130	31/12/08 Bal c/d	17,130

Provision for depreciation account

		₦'000		₦'000
31/12/06	bal c/d	2,855	31/12/06 P&L a/c	2,855
31/12/07	bal c/d	5,710	1/1/07 bal b/d	2,855
			31/12/07 P&L a/c	2,855
		5,710		5,710
31/12/08	bal c/d	8,565	1/1/08 bal b/d	5,710
			31/12/08 P&L a/c	2,855
		8,565		8,565
			1/1/09 bal b/d	8,565

Lessor's account

		₦'000		₦'000
31/12/05	instalment	6,000	1/1/05 leased truck a/c	17,130
31/12/05	bal c/d	13,700	31/12/05 finance charges	2,570
		19,700		
31/12/06	instalment	6,000	1/1/06 Bal b/d	13,700
31/12/06	bal c/d	9,755	31/12/06 finance charges	2,055

		15,755		15,755
31/12/07	instalment	6,000	1/1/07 Bal b/d	9,755
31/12/07	bal c/d	5,218	31/12/07finance charges	1,463
		11,218		11,218
31/12/08	instalment	6,000	1/1/08 Bal b/d	5,218
			31/12/08 finance charges	782
		6,000		6,000

Finance charges account

		₦'000		₦'000
31/12/05	lessor a/c	2,570	31/12/05p&l a/c	2,570
31/12/06	lessor a/c	2,055	31/12/06 p&l a/c	2,055
31/12/07	lessor a/c	1,463	31/12/07 p&l a/c	1,463
31/12/08	lessor a/c	782	31/12/08 p&l a/c	782

Under Interest Suspense Account Method

Finance charges/leased truck & depreciation provision accounts are the same as under interest payable a/c method.

Finance charges suspense account

		₦'000		₦'000
31/12/05	lessor a/c	6,870	31/12/05finance charges	2,570
			31/12/05 bal c/d	4,300
		6870		6,870
31/12/06	bal b/d	4,300	31/12/06 finance charges	2,055
			31/12/06bal c/d	2,245
		4,300		4,300
31/12/07	bal b/d	2,245	31/12/07 finance charges	1,463
			31/12/07 bal c/d	782
		2,245		2,245
31/12/08	bal b/d	782	31/12/08 finance charges	782

Lessor's account

		₦'000		₦'000
31/12/05	bank	6,000	1/1/05 leased truck	17,130
31/12/05	bal c/d	18,000	31/12/05 finance charges	6,870
		24,000		24,000
31/12/06	bank	6,000	1/1/06 bal b/d	18,000
31/12/06	bal c/d	12,000		
		18,000		18,000
31/12/07	bank	6,000	1/1/07 bal b/d	12,000
31/12/07	bal c/d	6,000		
		12,000		12,000
31/12/08		6,000	1/1/08 bal b/d	6,000

3.2 Hire Purchase

A hire purchase transaction is one in which the seller of an item parts with possession and transfers same to a buyer who in return, pays to the seller an amount known as hire purchase price by way of an initial deposit plus periodic instalments over the hire purchase period. The hire purchase price will normally be higher than the normal selling price of the item; the difference being hires purchase interest or finance charge.

It should be noted that what the hire purchaser has, while the hire period lasts, is just possession. H e does not acquire the title until he has paid the last instalment and exercised his option to acquire title by paying a further token sum, which shall be stipulated in the hire purchase agreement.

The hire purchaser, however, has the first option and the item cannot be sold to another person unless he has indicated his unwillingness to exercise the option.

3.2.1 Definition of Hire Purchase Terminologies

Hire purchase price: This is the total sum (deposit plus instalments) payable by the hire purchaser.

Cash price: This is the normal selling price of the goods to be sold

Hire purchase interest: or finance charge, is the excess of the hire purchase price over the cash price. The hire purchaser interest is the compensation to the seller for having his funds tied down with the buyer over the hire period

Deposit: This is the initial sum payable by the hire purchaser at the inception of the hire purchase transaction

Instalment: this is the sum payable by the hire purchaser buyer at specified intervals to liquidate the balance of the hire purchase price at the end of the hire period.

3.2.2 Accounting for Hire Purchase Transactions in Buyer's Books

It is in the nature of hire purchase transactions that w hat the buyer buys under this arrangement is invariably a fixed asset. To acquire trading stocks under a hire purchase arrangement is virtually not feasible for the following reasons:

(a) The hire purchase option is normally chosen where the value of the item is relatively high and payment under cash purchase transactions will involve much cash outflow. It is unlikely that trading stocks will fall under this category

(b) Goods purchased under hire purchase terms cannot be sold during the hire period

(c) To acquire trading stocks under hire purchase terms w ill require so short a hire period as to nullify the benefits of the hire purchase arrangement

The hire purchaser shall bring the asset on hire purchase into his books as a fixed asset and depreciate it normally, even though; he has not yet acquired title. This is an instance where the financial reality or substance of a transaction takes precedence over the legal form in compliance with the convention of “substance over form.

3.2.3 The Hire Purchase Interest/Finance Charge

The hire purchaser spreads the hire purchase interest on a rotational basis over the hire period. This may be achieved by using any of the following methods:

(a) Equal instalments (or straight line) method
(b) Sum of the years digit method
(c) Actuarial method

(a) Equal instalments (or straight line method)

The hire purchase interest is spread equally over the hire period. It is the simplest method.

Illustration 8-2

ABC sold a machine to XYZ on hire purchase basis. You are given the following information.

Cash price	₦ 28,000
Initial deposit	₦ 10,000

A yearly instalment of ₦ 7,500 each payable on 31december for 4years, was agreed. The company makes up accounts to 31 December.

Required: calculate the hire purchase interest attributable to each year

Suggested Solution 8-2

	₦
Initial deposit	10,000
Add: instalments (₦ 7,500 *4)	30,000
Hire purchase price	40,000
Less cash price	(28,000)
Hire purchase interest	12,000

Therefore, hire purchase interest written off each year is ₦ $\frac{12,000}{4}$ = ₦ 3,000

(b) Sum of the Years Digits Method

Under this method, H .P. interest is written off over the hire period in a reducing manner, based on digits as illustrated below:

Assuming the facts are the same as in illustration (a) above,
Calculate the H ire purchase interest attributable to each Year

Year	Digit allocated	Workings	H.P interest
			₦
1	4	4/10*₦ 12,000	4,800
2	3	3/10*₦ 12,000	3,600

3	2	2/10*₦ 12,000	2,400
4	1	1/10*₦ 12,000	1,200
			12,000

In a situation where the number of instalments is high, the determination of the sum of the digits becomes a problem. To solve the problem, you can use the formula below:

$S = n/_2(n-1)$

Where: s= sum of the digits
n= no of instalments

In the above example, sum of the digits = $4/_2(4-1)$
=10

(c) Actuarial Method

Under this method, H .P. interest is written off by charging a fixed rate of interest on the outstanding balance at the date of instalments. This method produces a constant periodic rate of return on the outstanding cash price for each period. The rate of interest may be obtained from actuarial table. Alternatively, the rate may be calculated using the annuity formula and solving for *r*, the interest rate. The annuity formula is given as follows:

$p= a(1-(1+r)^n1$

Where p = cash price less deposit

a= instalment payable at specified intervals
n = number of instalments
r= rate of interest per period covered by each instalment

Illustration 8-3

John sold equipment to Janet on hire purchase. You are given the following information:

	₦
Cash price	20,945
Initial deposit	8,000

The HP contract agreed annual instalments of ₦ 5,000 each, payable on 31 December over 4years period. HP interest is charged at 20% per annum.

Required: compute interest payable using the actuarial method.

Suggested Solution 8-3

HIRE PURCHASE INTEREST

	₦	₦
Year 0 cash price	20,945	
Less deposit	8,000	
	12,945	

Year 1 HP interest at 20%	2,589	2,589
	15,534	
1st instalment	(5,000)	
	10,534	
Year 2 HP interest at 20 %	2,106	2,106
	12,640	
2nd instalment	(5,000)	
	7,640	
Year 3 HP interest @ 20%	1,528	1,528
	9,168	
3rd instalment	(5,000)	
	4,168	
Year 4 HP Interest at 20 %	832	832
	5,000	
4th instalment	(5,000)	
	NIL	7,055

Self Assessment Exercise

Periodic payments made by the lessee to the lessor are called:

a) Rent
b) Interest
c) Cash price
d) Finance charge
e) Lease payment

4.0 CONCLUSION

Leasing and hire are like terms and as such, there is the identical problem of computing and charging to respective periods, finance charges and hire purchase interest for leasing and hire purchase respectively.

5.0 SUMMARY

This unit discussed the various methods of determining finance charges and hire purchase interest in the books of the lessor. SAS 11 stipulates detailed appropriate treatment and disclosures of lease transactions in the books of the lessor and lessee.

In the next unit, we shall examine the topic: accounting for specialised businesses.

6.0 TUTOR-MARKED ASSIGNMENT

Use the following information to answer the two questions below:

Demola sold a new motorcycle to Bola, an Okada Operator, on hire purchase basis under the following terms:

Cash price ₦280,000
Initial deposit ₦ 110,000

Yearly Instalment ₦ 75,000 (payable 31 December)
Hire period 4years.

1. Calculate the hire purchase price of the motorcycle
2. Compute the hire purchase interest to be written off each year using straight line method.
3. Write short notes on the underlisted terms:
    - Rent
    - Interest
    - Cash price
    - Finance charge
    - Lease payment

7.0 REFERENCES/FURTHER READINGS

Adapted from the ICAN Study Packs (2011)

UNIT THREE ACCOUNTING FOR SPECIALISED BUSINESSES

CONTENTS

1.0 INTRODUCTION

In the last unit, we discussed the various methods of determining finance charges and hire purchase interest in the books of the lessor. SAS 11 stipulates detailed appropriate treatment and disclosures of lease transactions in the books of the lessor and lessee.

In this unit, we shall examine the topic: accounting for specialised businesses, particularly voyage/shipping accounts as well as the account of cooperative societies.

2.0 OBJECTIVES

At the end of this unit, you should be able to prepare the accounts of shipping companies and corporative societies.

3.0 MAIN CONTENT

3.1 Voyage/Shipping Accounts

Shipping companies are expected to maintain a separate voyage account for each vessel to ascertain profit / loss from each voyage. It is like a profit and loss account of a trading concern. All expenses relating to a voyage (for example, stores, w ages, insurance, commission brokerage, fuel and repairs) are debited to the voyage account. All earnings, passage money, freight and mail money (if any) are credited to voyage account. The balance on the voyage account represents the profit or loss made on the voyage and is transferred to the general profit and loss account.

Illustration 9-1

SS Olokun was chartered on 1 March 2008, by Ocean View Shipping Agency Ltd from Awaye Lines Limited. It sets on a voyage on that date as follows:

Accra to Apapa with general cargo at ₦ 2,300 per ton. The charter stipulates for an address commission to the chatterers of 2% on freight, payable on signing the bill of lading together with a brokerage of 5% to the charters' agents, of which, one fifth is repayable to the vessel.
Conakry to Port Harcourt is at ₦ 1,700 per ton. Address commission of 2% on freight payable to chatterers and brokerage of one-third of 5% payable to charters agents on signing charter. The vessel w as insured by Cornerstone Insurance PLC on 1 January 2008, for one

year at ₦ 3 million and managing owners' Articles of Association fixed remuneration at 1.5% of gross freight charges.

The following are relevant extracts from the shipping company's account:

Freight of 15,000 tons of rice to apapa and 17,500 tons of rubber to Port Harcourt:

	₦
Wages for the year	9,600,000
Wharfage at Port Harcourt	1,750,000
Captains disbursement- port Harcourt	325,000
Wharfage at apapa	320,000
Agents' disbursements- apapa	75,000
Captain's disbursements –apapa	150,000
Stores accounts	560,000
Port charges etc. Accra	1,350,000
Captain's accounts for labour wages	750,000
Fuel	711,000
Stevedores at Conakry	420,000
Provisions at Conakry	164,000
Repair on voyage	125,000
Captain's expenses- Conakry	100,000
Agents' accounts for port charges exclusive of Address Commission and brokerage	175,000

Suggested Solution 9-1

OCEAN VIEW SHIPPING AGENCY LTD
VOYAGE ACCOUNT FOR THE PERIOD 1/3/04 to 30/11/04

	₦	₦
Outward-Accra to apapa(15000*2300)		34,500,000
Inward –conakry to port Harcourt(17,500*1,700)		29,750,000
		64,250,000
Stores	560,000	
Port charges	1,350,000	
Captain accounts	750,000	
Fuel	711,000	
Stevedores	420,000	
Provisions to Conakry	164,000	
Repairs	125,000	
Captains expenses –Conakry	100,000	
Agents accounts	175,000	
Wages (9/12* ₦ 9600,000)	7,200,000	
Wharfage-port Harcourt	1,750,000	
Captains – port Harcourt	325,000	
Wharfage –apapa	320,000	
Agents etc	75,000	
Insurance (9/12* ₦ 3,000,000)	2,250,000	
Captains- apapa	150,000	
Outward-brokerage 5%* ₦ 34,500,000* 4/5	1,380,000	
Commission 2% * ₦ 34,500,000	690,000	

Inward –brokerage 5% * ₦ 29,750,000 * 1/3	495,833	
Commission 2% * ₦ 29,750,000	595,000	
Managing owner 1.5% * ₦ 64,250,000	963,750	
		(20,549,583)
Profit on the voyage		43,700,417

3.2 Definition of a Cooperative Society

The International Labour Organisation defines cooperative society as follows:

> "*An association of persons who have voluntarily joined together to achieve a common end through the formation of democratically-controlled organisation, making equitable contribution to the capital required and accepting a fair share of the risk and benefits of the undertaking in which the members actively participate*" (Ige, 2009)

The United Nations Research on Social Development states that cooperative societies are all organisations "*legally recognized as such which is subject or organised supervision and which claim to follow cooperative principles*".

The Cooperative Societies Decree 1993 defines cooperative society to mean "*a voluntary association of individuals, united by common bond, who have come together to pursue their economic goals for their own benefit*". No matter the definition adopted, one thing that is clear is that cooperative society is a voluntary association based on democratic norms and controlled collectively by the members. There must be the will to cooperate.

3.2.1 Accounts of Co-operative Societies

Groups of individuals in employment, trade, commerce or industry come together to form a co-operative society with a view to investing their resources for the benefits of the members.

The society is guided by its constitution and by-laws and must be registered with the Director of Co-operative Societies of the State of its operations.

The Funds of a cooperative society are usually generated from the contributions from members through direct monthly contributions and agreed deductions from members' salaries, in case of employees. The fund is then lent to its members for a stated purpose at an interest rate that is usually below the market rate.

Contributions from members could be in form of subscriptions to the society's share capital, members' savings or education fund.

The society's funds are invested in shares of limited liability companies, short-term deposits, or commodities for sale to its members, to generate income for the society.

The officers of the society are obliged to prepare and lay before its members, the audited financial statements of the society at a properly convened Annual General Meeting at which issues relating to the activities of the society in the year under review and dividends payable to members are discussed.

The accounts prepared by the society must include a Balance Sheet and a Revenue account with relevant notes on the accounts.

Illustration 9-2

ONITSHA CO-OPERATIVE THRIFT AND CREDIT SOCIETY LIMITED
TRIALBALANCE AS AT 31DECEMBER 2008 IS AS FOLLOWS:

	DR	CR
	₦	₦
Fixed assets (net of depreciation)	196,770	
Stocks of recharge card	168,045	
Investments- short term deposits -quoted	4,382,510 721,145	
Members indebtedness: loans Others	19,018,339 1,618,326	
Bank and cash balances	601,962	
Accrued expenses		403,500
Share capital		657,559
Share premium		101,524
Members' savings		23,045,316
Reserve fund		1,087,710
Education fund		184,182
Interest income:		
On members' loans		1,448,402
On investment		817,719
Profit on sale of commodities		463,930
Entrance fees		3,000
Loan forms and processing fees		51,000
Sundry income		1,013
Staff salaries and expenses	259,610	
Transport expenses	35,975	
Telephone expenses	3,320	
Committee meeting expenses	79,900	
Printing and stationery	39,425	
Bank charges and commission	232,625	
General repairs and maintenance	31,290	
Audit fees	20,000	
Executive committee honoraria	103,500	
AGM Expenses	280,000	
Depreciation charge	6,583	
Transfer to reserve fund	423,209	
Transfer to education fund	42,321	
	28,264,855	28,264,855

After appropriation to reserve and education fund, the executive committee proposed to pay ₦ 1,227,000 as dividends to members and transfer the balance to general reserve.

Required: prepare the society's reserve account for the year ended 31december 2008 and a balance sheet as at that date.

Suggested Solution 9-2

ONITSHA CO-OPERATIVE THRIFT AND CREDIT SOCIETY LIMITED
REVENUE ACCOUNT FOR THE YEAR ENDED 31 DECEMBER 2008

INCOME		
	₦	₦
Interest on members' loans		1,448,402
Investment income		817,719
Profit on sale of commodities		463,930
Entrance fees		3,000
Loans forms and processing fees		51,000
Sundry income		1,013
Total income		2,785,064
CHARGES		
Staff salaries and expenses	259,610	
Transport expenses	35,975	
Telephone	3,320	
Committee meeting expenses	79,900	
Printing and stationery	39,425	
Bank charges and commissions	232,625	
General repairs and maintenance	31,290	
Audit fees	20,000	
Executive committee honoraria	103,500	
AGM expenses	280,000	
Depreciation	6,583	
TOTAL CHARGES		(1,092,228)
SURPLUS FOR THE YEAR		1,692,836
APPROPRIATIONS:		
Transfer to reserve fund	423,209	
Transfer to education fund	42,321	
Proposed dividend	1,277,000	
		1,692,530
Balance transferred to general reserve		306

ONITSHA CO-OPERATIVE THRIFT ADN CREDIT SOCIETY LIMITED
BALANCE SHEET AS AT 31 DECEMBER 2008

	₦	₦	
ASSETS			
Fixed assets		196,770	
Investments- short term deposits	4,382,510		
Quoted shares	721,145	5,103,655	
Stocks of recharge cards		168,045	
Members indebtedness- on loans	19,018,339		
Others	1,618,326	20,636,665	
Bank and cash balances		601,962	
TOTAL ASSETS			26,707,097

LIABILITIES AND FUNDS		
Current liabilities:		
Accrued expenses	403,500	
Proposed dividend	1,227,000	
Members' funds:		
Share capital	657,559	
Share premium	101,524	
Members savings	23,045,316	
Reserves fund	1,087,710	
Education fund	184,710	
General reserve	306	
TOTAL FUNDS		25,076,597
TOTAL LIABILITIES AND FUNDS		26,707,097

Self Assessment Exercises

1. Which of the following expenses is not peculiar to shipping companies?
(a) Stevedores
(b) Salaries
(c) Port charges
(d) Captain expenses
(e) Wharfage

2. Co-operative Societies' Funds are expected to be invested in the following except______
(a) Quoted Shares
(b) Treasury bills
(c) Commodities for sale to its members.
(d) Short–Term Deposits
(e) Plant and Machinery

3. State ONE guiding principle of a Co-operative Society.

4.0 CONCLUSION

This unit deals with the peculiarities associated with accounting for shipping businesses and co-operative societies.

5.0 SUMMARY

This has shown that the rules of accounting are different when it applies to the above named businesses and therefore, special consideration has to be paid to them.

In the next unit, we shall dwell extensively on the generally accepted accounting principles (GAAP).

6.0 TUTOR-MARKED ASSIGNMENT

1. What do you mean by a Cooperative Society?
2. How is cooperative society fund generated?

7.0 REFERENCES/FURTHER READINGS

Adapted from the ICAN Study Packs (2011)

Ige, Ayodeji (2009). Cooperative Law. NOUN Course Materials for Undergraduate Students in Cooperative Management.

UNIT FOUR GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

CONTENTS

1.0 INTRODUCTION

In the last unit, we discussed the rules of accounting are different as it applies to the voyage/shipping and cooperative society businesses.

In this unit, we shall dwell on the generally accepted accounting principles (GAAP).

2.0 OBJECTIVES

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

- Understand the meaning and purpose of GAAP;
- Discuss the sources of GAAP in Nigeria;
- Know what constitutes international GGAAP;
- Explain the basic accounting principles and concepts in Nigerian GAAP.

3.0 MAIN CONTENT

3.1 Generally Accepted Accounting Principles (GAAP) – Meaning of GAAP

There are many alternative postulates, assumptions, principles and methods that could be used in preparing the financial statements of a reporting entity. These alternative methods impact on the financial position and operational results of corporate entities differently. To ensure a degree of comparison of financial reports, there should be minimum uniform standards and guidelines of financial accounting that different entities have to follow in financial reporting. These standards are referred to as Generally Accepted Accounting Principles (GAAP).

Stated simply, GAAP are the conventions, rules, procedures and broad guidelines adopted in the preparation and presentation of financial statements in a given jurisdiction, e.g. Nigeria. GAAP include broad ideas of measurement and classifications, as well as detailed rules and procedures used by accountants in preparing and presenting accounting reports. The rules followed by accountants in the preparation of financial statements are contained in the accounting standards issued by the standard-setting body in a given jurisdiction. In Nigeria, such standards are issued by the Nigerian Accounting Standards Board (NASB).

3.2 Purpose of GAAP

Adherence to generally accepted accounting principles serves five important purposes. These are:

(a) It increases the ability of users of financial statements to understand the accounting reports issued by different reporting entities

(b) It provides reasonable degree of comparison between financial reports presented by entities since they adopt a standard framework of guidelines.

(c) It increases the confidence of investors, markets, and indeed the general public, that the financial statements issued by a reporting entity, faithfully represents its transactions

(d) Preparers of financial statements have a set of guidelines which can be readily referred to in accounting and reporting their financial transactions

(e) External auditors need GAAP to guide them in reporting on the truth and fairness or otherwise of the financial transactions of different entities

3.3 Sources of GAAP in Nigeria

The sources of GAAP in Nigeria include:

(a) Companies and Allied Matters Act, CA P 20, LFN 2004;

(b) Insurance Act, 2003;

(c) Banks and other Financial Institutions Act 1991;

(d) National Insurance Commission Act 2003;

(e) Prudential guidelines issued by the Central Bank of Nigeria;

(f) Security and Exchange Commission and Stock Exchange rules and regulations;

(g) Accounting Standards issued by the Nigerian Accounting Standards Board (NASB);

(h) Accounting Standards issued by the International Accounting Standards Board constitute a secondary source of GAAP in Nigeria;

(i) Pension Reforms Act, 2004.

3.4 International GAAP

In the previous sections of this chapter, we have interpreted GAAP as generally accepted accounting principles. GAAP could also be interpreted as generally accepted accounting *practice*. Some authors have argued that the term "principle" gives GAAP an unjustified measure of permanence since the concept changes in response to new developments in the business and economic environment.

The word "practice" perhaps better reflects the fact that accounting practice alters in response to changes in different social-economic environments. GAA P, therefore, goes beyond mere principles as they encompass contemporary accounting practices that are permissible within an accounting environment.

By extension, International GAAP encompasses contemporary accounting practices that are "regarded as permissible by the accounting profession and regulators internationally" (Bonham, et al 2008).

The Accounting Standards issued by the International Accounting Standards Board (IASB) constitute the source of international GAAP.

3.5 Factors that Determine the Acceptability of an Accounting Practice

The following factors, outlined by Bonham et al (2008), members of Ernst &Young Global, provide useful guide in determining whether an accounting practice should be acceptable in a country's GAAP, as w ell as international GAAP.

(a) Is the practice addressed in accounting standards or other official pronouncements?

(b) Is the practice addressed in accounting standards that deal with similar and related issues?

(c) If the practice is not addressed in accounting standards, is it dealt with in the standards of another country that could reasonably be considered to offer authoritative guidance?

(d) Is the practice consistent with the needs of users and the objectives of financial reporting?

(e) Does the practice have authoritative support in the accounting literature?

(f) Is the practice consistent with the underlying conceptual framework document?

(g) Does the practice meet basic criteria as to the quality of information required for financial statements to be useful to users

(h) Does the practice fairly reflect the economic substance of the transaction involved?

(i) Is the practice consistent with the fundamental concept of 'fair presentation'?

(j) Are other companies in similar situation generally applying the practice?

3.6 Accounting Concepts

These are generally accepted principles used in the preparation of financial statements and are rarely disclosed because of their general acceptability. They are:

(a) Entity Concept: This principle assumes that a company or corporation is a separate entity on its own; it can sue and be sued in a court of law
(b) Going Concern: The concept assumes that an organization will continue to operate for the foreseeable future. The balance sheet and profit and loss account assume no intention to liquidate or curtail its scale of operations
(c) Realization Concept: This concept recognizes revenue as soon as it is capable of objective measurement and the value of asset is reasonably certain.
(d) Matching Concept: Under this concept, revenue or income and costs in a period are matched and dealt with in the profit and loss account of the period they relate
(e) Double Entity Principle/Concept: This concept assumes that every transaction should have two entries. In other words, where there is a debit entry, there has to be a corresponding credit entry for proper accountability
(f) Consistency Concept: This means that every like item within each accounting period should be treated the same way. This allows for easy comparison of accounts of an entity over a period of time
(g) Prudence Concept: This assumes that income is actually realized, not estimated. That is, revenue and profit should not be anticipated but recognized only when realized in cash or other assets.

The methods adopted and applied by an organization in applying the

Prudence and realization concepts are basic concepts in determining profit made.
(h) Periodicity: This concept assumes that transactions should be separated into particular periods for easy matching of revenue with expenses
(i) historical Cost: This assumes that items should be stated at their original cost of purchase rather than realisable value

3.7 Accounting Methods

This is the medium through which accounting concepts are applied to financial transactions in the preparation of financial statements.

The methods adopted and applied by an organization in applying the fundamental accounting principles to its financial transactions are called the accounting bases.

There are two bases used in the preparation of financial statements. They are:

(a) The accrual basis; and
(b) The cash basis

3.8 Accounting Policy

Every organization or Corporation has a policy used in the preparation of its Accounts. Accounting policies are therefore, the basic rules, principles, conventions and procedures adopted in the preparation and presentation of financial statements.

3.9 Disclosure of Accounting Policies

Accounting policies adopted by an organization or Corporation in the preparation and presentation of financial statements are disclosed under one heading to provide an overview

3.9.1 Use of Accounting Policies

Policies adopted by an organization are based on personal judgement and the suitability of presenting a true and fair view of the result of an organization. Therefore, there is a need for management to be careful and rational in their choice of accounting policies.

There are principles that should be used as a guide. These are:

(a) ***Substance over form:*** This principle states that generally the legal form of every transaction is a basis for recording its commercial status in the books of accounts, but there are instances whereby the legal status differs from the commercial status. In such instances, the commercial status shall be recognized rather than the legal form. For example, in a finance lease agreement, the commercial status is recognized by including the assets acquired as part of the fixed assets of the lessee, despite the fact that legal title remains with the lessor.

(b) ***Objectivity:*** This principle states that an accountant should be fair and unbiased in the process of recording, collating, summarizing, analysing and interpreting financial transactions. This implies that accountants should be fair to all users of financial information and also treat transactions without emotion.

(c) ***Materiality:*** The principle holds that only items of material values are accorded strict accounting treatment; that is, items with significant values.

(d) ***Prudence:*** Revenue and profits are not to be anticipated but recognized only when realized while known losses should be adequately provided for.

(e) ***Fairness:*** This is a product of the objectivity principle. It emphasizes the need for accountants not to be influenced by any user, but to prepare accounts based on acceptable principles.

Where fundamental accounting concepts are followed in the preparation of accounts, disclosure of such concepts is not necessary unless there is a departure from the fundamental accounting concepts. However, when selecting accounting policies, rational judgement should be used; thus, the principles of substance over form, objectivity, fairness, and materiality can conveniently allow prudence to govern.

A reporting enterprise should disclose the basis used in the preparation of accounts if it is significant for the understanding and interpretation of a financial statement. The policies should also be disclosed as an integral part of the financial statements.

Accounting policies should be used consistently to facilitate comparison except where a different policy will better enhance or reflect net profit or loss of current or subsequent periods.

When there is a change in accounting policy, the nature, justification and the effect on current year's profit or loss should be disclosed. Also, cumulative effect of the change on profit and loss of prior periods should be adjusted in the retained earnings.

3.9.2 Descriptions of Accounting Policies

1. Basis of Accounting

Financial statements are prepared under the historical cost convention except for some fixed assets which are included at their professional valuation.

2. Consolidation

Group Profit and Loss account and Balance Sheet include the accounts of the company and all the subsidiaries and the company's share of profit after tax, less losses of associated companies.

3. Goodwill

Any excess of the cost of acquisition over the fair values of the net assets is recognized as an asset in the balance sheet as goodwill arising on acquisition

4. Investments

Investments in subsidiary and associated companies are stated at the lower of cost or the company's share of their net tangible asset value at the year end

5. Fixed Assets

Land and buildings are stated at their professional valuation plus additions at cost. Other fixed assets are stated at cost.

6. Depreciation

Depreciation on a fixed asset is calculated to w rite–off the cost or valuation on a straight line basis over its expected useful life.

7. Stock and Work in Progress

Stocks are stated at the lower of cost and net realizable value after making adequate provision for obsolescence and damaged items. In the case of goods manufactured by the company, cost consists of direct labour, material and appropriate proportion of factory overhead.

8. Turnover

Turnover represents the net value of goods and service invoiced or sold to third party, net of value added tax (VAT).

9. Contract in Progress

These are stated at the values of independent engineers' certificate for work done but in respect of which payments were not received at the year end, plus estimated values made by officials of the company of the realizable value of work done not yet certified.

10. Foreign Currency Conversion

Transactions in foreign currencies are converted into Naira at the prevailing rate ruling at the date the relevant invoices are received, while assets and liabilities denominated in foreign currencies are translated at the prevailing rate ruling on the Balance Sheet date

11. Deferred Taxation

Provision is made for deferred taxation by the liability method to take account of all timing differences between accounting treatment of certain items and their corresponding treatment for income tax purposes

Self Assessment Exercises

1. Which of the following is not a source of GAAP in Nigeria?

(a) Insurance Act, 2003
(b) Stock Exchange rule
(c) Investment Securities Act
(d) ICAN Act of 1965
(e) CAMA 2004

4.0 CONCLUSION

GAAP includes broad ideas of measurement and classifications as well as rules and procedures used by accountants in preparing and presenting accounting reports.

5.0 SUMMARY

This unit has explained the meaning and sources of GAAP locally and globally, and the basic accounting concepts used in Nigeria.

In the next unit, we shall discuss the development, contents and application of accounting standards.

6.0 TUTOR-MARKED ASSIGNMENT

1. Define the term accounting policies.
2. State two accounting concepts
3. What is the main advantage of historical cost concept?

7.0 REFERENCES/FURTHER READINGS

Adapted from the ICAN Study Packs (2011)

UNIT FIVE **DEVELOPMENT, CONTENTS AND APPLICATION OF ACCOUNTING STANDARDS**

CONTENTS

1.0 INTRODUCTION

In the last unit, we explained the meaning and sources of GAAP locally and globally, and the basic accounting concepts used in Nigeria.

In this unit, we shall discuss the development, contents and application of accounting standards.

2.0 OBJECTIVES

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

- Explain the process of issuing accounting standards in Nigeria
- Understand the IASB due process
- Explain the composition of Nigerian Accounting Standards Board (NASB)
- Understand NASB due process

3.0 MAIN CONTENT

3.1 Brief History of the Nigerian Accounting Standard Board (NASB)

The Nigerian Accounting Standards Board (NASB) w as established in September, 1982 with the responsibility of developing accounting standards to be observed in the preparation and presentation of financial statements in Nigeria. Its first legal authority w as the provision of Section 335(1) of the Companies and Allied Matters Act, 1990, which requires that financial statements prepared in Nigeria shall comply with the "Statement of Accounting Standards" issued by the Nigerian Accounting Standards Board. Currently, the full legal authority of the NASB is provided by the Nigeria Accounting Standards Board Act, 2003 which contains a wide range of provisions on the establishment, finances and powers of the Board.

3.2 Reasons for Establishing the NASB

The reasons for setting up the NASB, as explained by Godson Nnadi, its Chief Executive, are to:

(i) Narrow the areas of differences in practices so that financial statements that are presented to users are structurally uniform and meaningful;

(ii) Produce accounting information that reflect Nigeria's economic environment while at the same time satisfying the anticipated needs of users of the information; and

(iii) Introduce measures which will enhance the reliability and velocity of information reported in financial statements.

3.3 Composition of the Governing Council of the NASB

Under section 2 of the NASB Act 2003, the Governing Council of the NASB shall consist of the following:

(a) A Chairman who shall be a professional accountant with considerable professional experience in accounting practices.

(b) Two representatives each of the following
- (i) Institute of Chartered Accountants of Nigeria, and
- (ii) Association of National Accountants of Nigeria

(c) A representative each of the following:
- (i) Federal Ministry of Commerce
- (ii) Federal Ministry of Finance
- (iii) Central Bank of Nigeria
- (iv) Corporate Affairs Commission
- (v) Federal Inland Revenue Service
- (vi) Nigeria Deposit Insurance Corporation
- (vii) Securities and Exchange Commission
- (viii) Auditor-General for the Federation
- (ix) Accountant – General of the Federation
- (x) Chartered Institute of Taxation of Nigeria
- (xi) Nigeria Accounting Teachers Association; and
- (xii) Nigeria Association of Chambers of Commerce, Industries, Mines and Agriculture

(d) The Executive Secretary of the Board

3.4 Functions of the Board

Section 6 of the NASB Act 2003, requires the Board to perform the following functions:

(a) Develop and publish in the public interest, accounting standards to be observed in the preparation of financial statements.

(b) Promote the general acceptance and adoption of such standards by the preparers and users of financial statements.

(c) Promote and enforce compliance with the accounting standards developed or reviewed by the Board.

(d) Review from time to time, the accounting standards developed in line with the prevalent social, economic and political environment.

(e) Receive from time to time notices of non-compliance with its standards from the preparer, user or auditor of accounts.

(f) Receive copies of all qualified audit reports together with detailed explanations for such qualifications from the auditors of the accounts within a period of sixty days from the date of such qualification.

(g) Advise the supervising Minister on the making of regulations under Section 356 of CAMA, 2004.

(h) Advise the Federal Government on matters relating to accounting standards.

Perform such other duties which in the opinion of the Council are necessary or expedient to ensure the efficient performance of the functions of the Board under the Act.

3.5 Powers of the Board

Section 7 of the Act empowers the Board to:

(a) Identify accounting issues which require standardization and establish the order of priority for addressing them.

(b) Determine the scope and objectives of each standard.

(c) Prescribe the methods and procedure for the production of standards.

(d) Prescribe the time table for the production of each standard.

(e) Approve discussion papers, exposure drafts and standards.

(f) Enforce and approve enforcement of compliance with accounting standards in Nigeria.

(g) Exercise such powers as are necessary or expedient for giving effect to the provisions of the Act.

3.6 NASB Due Process

The development of a new and proposed accounting standard involves a long process which ensures that all interested parties are given the opportunity to express their views. This standard setting process is called *Due Process* and it can take more than two years in some cases. The stages involved in the production of a *Statement of Accounting Standard* (SAS) are outlined below:

a) The first stage in the development of an accounting standard is the selection of a topic for standardisation. Such topic can be suggested by any individual or organisation.

b) The next stage is the selection of a steering committee of experts, comprising mainly of leading authorities in that area. This committee usually includes an accountant in practice, representative of the affected industry, representative of the Federal Inland Revenue Service Board, and academia, and at least one person representing the business community w ho may be affected by the proposed standard" (Nnadi, 2006).

c) The Steering Committee directs the NASB secretariat in drafting or re-drafting) of the points outline, which details the aspects of the topic to be covered

d) W hen the Steering Committee is satisfied with the points outlined, it is submitted to the Council for approval

e) Upon the approval of the points outlined by the Council, the steering committee directs the Secretariat in the preparation of a draft exposure draft. After consideration of the draft exposure draft, by the steering committee, it is recommended to the Council for approval as exposure draft

f) The Council usually meets for two working days to meticulously examine the exposure draft submitted to it. If two-thirds of the members present at the Technical session vote in favour of its publication, then the document becomes an exposure draft.

g) Each Exposure Draft is exposed for about three months. During this period, recipients of the document are expected to comment in writing and the NASB may conduct a public hearing where necessary.

h) Based on comments received from the public, the Exposure Draft may be amended. If an amended exposure draft is approved by three-quarters of Council members present at its meetings, it becomes an accounting standard.

3.7 The International Accounting Standards Board (IASB)

In 1973, the International Accounting Standards Committee (IASC) was established to develop and issue accounting standards that should guide the preparation and presentation of financial statements, globally. The IASC w as in existence until 2001 by which time it had issued forty-one International Accounting Standards (IASs). Because of differences in interpreting the accounting standards issued by the IASC, a new body called *standard interpretations committee* (SIC) w as established by the IASC in 1997. As at 2001, the SIC had issued 32 interpretations, some of which are still applicable to financial statements issued today.

In 2001, there were fundamental changes in the global standard setting body which resulted in the establishment of a new body called International Accounting Standards Board (IASB), to take over the responsibilities of the IASC with effect from 1st April, 2001. The IASB now issues International Financial Reporting Standards (IFRS) in place of International Accounting Standards (IAS) issued by the IASC.

3.8 Objectives of the IASB

Article 2 of the IASB Constitution sets out the objectives of the IASC foundation, as follows:

(a) To develop, in the public interest, a single set of high quality understandable and enforceable global accounting standards that require high quality, transparent, and comparable information in financial statements and other financial reporting to help participants in world's capital markets and other users make economic decisions;

(b) To promote the use and rigorous application of those standards

(c) To fulfil the objectives associated with (a) and (b) above, to take account of, as appropriate, the special needs of small and medium-sized entities and emerging economics; and

(d) To bring about convergence of national accounting standards and international financial reporting standards to high quality resolutions

3.9 Structure of the IASB

In accordance with Article 18 of its Constitution, "The International Accounting Standards Board is an independent, privately-funded accounting standard-setter based in London, U.K. The Board members come from nine countries and have a variety of functional backgrounds".

The IASB structure has the following main features:

(a) **Trustees.** The trustees are not involved in the standard process of the IASB, but have responsibility for strategic operational issues such as budgets, operational procedures of the IASB and appointment of members of the Board, IFRIC and SAC.

(b) **The Board.** The Board consists of 12 full-time members and 2 part- time members w ho are appointed by the Trustees, based on their technical skills and other experience. These members are responsible for the standard setting activities of the IASB.

(c) **Standards Advisory Council (SAC).** The SAC provides a forum for the IASB to consult with a range of individuals and organisations affected by the IASB'S work. The SAC also advises the IASB on a wide range of issues including the IASB's agenda and IASB's project priorities and timetable.

(d) **International Financial Reporting Interpretations Committee (IFRIC).** The IFRIC assists the IASB in improving financial reporting by providing timely guidance and interpretation of international financial reporting standards

3.10 The IASB Due Process

As with SASs, the development of IFRSs follows due processes which comprise the following six stages, according to the IASB's Due Process Handbook.

Stage 1: Setting the agenda;
Stage 2: Project Planning;
Stage 3: Development and publication of a discussion paper;
Stage 4: Development and publication of an exposure draft;
Stage 5: Development and publication of an IFRS;
Stage 6: Procedures after an IFRS is issued

3.11 Arguments for and against Standards

Arguments for are:

(a) They give accountants and auditors some protection from those who may try to pressurize them into using improper methods and, therefore, ensure their independence

(b) They ensure that all stakeholders make contributions into the standard formulation and as such enriches the quality

(c) They usually conform with international accounting standards;

(d) They also conform with all existing law and regulation requirements; for example CAMA 2004, BOFIA 1991, Insurance A ct 2003;

(e) The Standards are reviewed periodically to conform with the latest economic and social developments; and

(f) The enactment of the NASB Act, 2003, gives it power to enforce compliance with standard.

Arguments against may be discussed, as follows:

(a) They inhibit initiative as decisions have already been made;

(b) They rarely take account of peculiarities of the individual businesses and

(c) Standards may be `watered – down', due to exposure to interested parties or intended users.

3.12 List of Accounting Standards Issued by the NASB

As discussed earlier, the Nigerian Accounting Standards Board is mandated by the NASB Act 2003, to issue (SAS) from time to time, to guide accounting practice in Nigeria. The accounting standards so far issued by the NASB, as stated in the Body's Handbook for 2008/2009, are listed below.

SAS NO	**TITLE**
1	Disclosure of Accounting Policies

2	Information to be disclosed in Financial Statements
3	Property, Plants and Equipment
4	Stocks
5	Construction Contracts
6	Extra-ordinary Items and Prior Year Adjustments
7	Foreign Currency Conversion and Translation
8	Accounting for Employees' Retirement Benefits
9	Accounting for Depreciation
10	Banks and Non-Bank Financial Institutions (Part 1)
11	Leases
12	Accounting for Deferred Taxes (superseded by SAS 19)
13	Accounting for Investments
14	Petroleum Industry: Upstream Activities
15	Banks and Non-Bank Financial Institutions (Part 2)
16	Accounting for Insurance Business
17	Petroleum Industry: Downstream Activities
18	Cash Flow Statements
19	Accounting for Taxes
20	Abridged Financial Statements
21	Earnings per Share
22	Research and Development Cost
23	Provisions, Contingent Liabilities and Contingent Assets
24	Segment Reporting
25	Telecommunications Activities
26	Business Combinations
27	Consolidated and Separate Financial Statements
28	Investments in Associates
29	Interests in Joint Ventures
30	Interim Financial Reporting

3.13 List of Accounting Standards Issued by International Accounting Standards Committee/Board (IASC/IASB)

International Financial Reporting Standards (IFRSs):

IFRS 1	First-time Adoption of International Financial Reporting standards
IFRS 2	Share-based Payments
IFRS 3	Business Combinations
IFRS 4	Insurance Contracts
IFRS 5	Non-current Assets Held for Sale and Discontinued operations
IFRS 6	Exploration for and Evaluation of Mineral Resources
IFRS 7	Financial Instruments: Disclosures
IFRS 8	Operating Segments

International accounting standards (IASs):

IAS 1	Presentation of Financial Statements
IAS 2	Inventories
IAS 7	Statement of Cash Flows
IAS 8	Accounting Policies, Changes in Accounting Estimates and errors
IAS 10	Events after the Reporting Period

IAS 11	Construction Contracts
IAS 12	Income Taxes
IAS 16	Property, Plant And Equipment
IAS 17	Leases
IAS 18	Revenue
IAS 19	Employee Benefits
IAS 20	Accounting for Government Grants and Disclosure of government assistance
IAS 21	The Effects of Changes in Foreign Exchange Rates
IAS 23	Borrowing Costs
IAS 24	Related Party Disclosures
IAS 26	Accounting and Reporting by Retirement Benefit Plans
IAS 27	Consolidated and Separate Financial Statements
IAS 28	Investment in Associates
IAS 29	Financial Reporting in Hyperinflationary Economies
IAS 31	Interests in Joint Venture
IAS 32	Financial Instruments: Presentation
IAS 33	Earnings per Share
IAS 34	Interim Financial Reporting
IAS 36	Impairment of Assets
IAS 37	Provisions, Contingent Liabilities and Contingent Assets
IAS 38	Intangible Assets
IAS 39	Financial Instrument: Recognition and Measurement
IAS 40	Investment Property
IAS 41	Agriculture

Currently valid interpretations issued by the IASB:

IFIC	International Financial Reporting Interpreting Committee
SIC	Standards International Committee
IFRIC 1	Changes in existing Decommissioning, Restoration and Similar Liabilities
IFRIC 2	Members' Shares in Co-operative Entities and Similar Instruments
IFRIC 4	Determining whether an Arrangement contains a Lease
IFRIC 5	Rights to Interests Arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
IFRIC 6	Liabilities arising from Participating in a Specific Market-Waste Electrical and Electronic Equipment
IFRIC 7	Applying the Restatement Approach under IAS 29 Financial Reporting in hyperinflationary Economies
IFRIC 8	Scope of IFRS 2
IFRIC 9	Reassessment of Embedded Derivatives
IFRIC 10	Interim Financial Reporting and Impairment
IFRIC 11	IFRS 2 - Group and Treasury Share Transactions
IFRIC 12	Service Concession Arrangements
IFRIC 13	Customer Loyalty Programmes
IFRIC 14	IAS 19 - The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interactions
IFRIC 15	Agreements for the Construction of Real Estate
IFRIC 16	Hedges of a Net Investment in a Foreign Operation
IFRIC 17	Distributions of Non-Cash Assets to Owners.
SIC-7	Introduction of the Euro
SIC-10	Government Assistance - No specific Relation to Operating activities

SIC-12 Consolidation - Special Purpose Entities
SIC-13 Jointly Controlled Entities - Non Monetary Contributions by venturers
SIC-15 Operating Leases - Incentives
SIC-21 Income Taxes - Recovery of re-valued Non Depreciable Assets
SIC-25 Income Taxes - Changes in the Tax Status of an Entity or its shareholders
SIC-27 Evaluating the Substance of Transactions involving the Legal Form of a lease
SIC-29 Service Concession Arrangements: Disclosures
SIC-31 Revenue - Barter Transactions involving Advertising Services
SIC-32 Intangible Assets - Web Site Costs

3.14 IFRSs AND SASs Presented Simultaneously

International Financial Reporting Standards (IFRSs)		Relating statement of Accounting stds (SASs)
IFRS 1	First time adoption of international financial Reporting standards	None
IFRS 2	Share based payments	None
IFRS 3	Business combinations	SAS 26
IFRS 4	Insurance contracts	SAS 16
IFRS 5	Non-current assets held for sale and Discontinued operations	None
IFRS 6	Exploration for and evaluation of mineral	SAS 14
	Resources	
IFRS 7	Financial instruments: disclosures	SAS 10 and15
IFRS 8	Operating segments	
		SAS 24
International Accounting Standards (IASs)		
IAS 1	Presentation of financial statements	SAS 1 &2
IAS 2	Inventories	SAS 4
IAS 7	Statement of cash flows	SAS 18
IAS 8	Accounting policies, changes in Accounting Estimates and errors	SAS 6
IAS 10	Events after the reporting period	None
IAS 11	Construction contracts	SAS 5
IAS 12	Income taxes	SAS 19
IAS 16	Property, plant and equipment	SAS 3
IAS 17	Leases	SAS 11
IAS 18	Revenue	None
IAS 19	Employee benefits	SAS 8
IAS 20	Accounting for government grants and disclosure of government assistance	None
IAS 21	The effects of change in foreign exchange rates	SAS 7
IAS 23	Borrowing costs	None
IAS 24	Related party disclosures	None
IAS 26	Accounting and reporting by retirement benefit plans	SAS 8
IAS 27	Consolidated and separate financial statements	SAS 27
IAS 28	Investment in associates	SAS 28
IAS 29	Financial reporting in hyper inflationary economies	None yet

IAS 31	Interests in joint venture	SAS 29
IAS 32	Financial instruments: presentation	SAS 10 & 15
IAS 33	Earnings per share	SAS 21
IAS 34	Interim financial reporting	SAS 30
IAS 36	Impairment of assets	SAS 9
IAS 37	Provisions, contingent liabilities and contingent assets	SAS 23
IAS 38	Intangible assets	
IAS 39	Financial instruments: recognition and measurement	SAS 10 & 15
IAS 40	Investment property	SAS 13
IAS 41	Agriculture	SAS 4

Self Assessment Exercises

1. One argument in favour of statement of accounting standards is they conform with existing ____ and ______ requirements.

2. Operating segments are disclosed under IFRS ______ and SAS _____

3. ______ is the maximum period for receiving comments on an exposure draft
   a) 12months
   b) 3months
   c) 6months
   d) 5months
   e) 2months

4.0 CONCLUSION

The full legal authority of the NASB is provided by the Nigerian Accounting Standards Board Act, 2003. This contains a wide range of provisions on the establishment, and powers of the board. The unit goes on to outline the International Accounting Standards (global) and their sister Statements of Accounting Standards (local).

5.0 SUMMARY

This unit has discussed the composition, function and powers of the NASB and IASB as well as its due process, objectives, structure and the standard setting processes.

In the next unit, we shall be examining the regulatory framework of financial accounting.

6.0 TUTOR-MARKED ASSIGNMENT

1. List the due processes of IASB and compare this with that of NASB.
2. Why NASB established and what are the functions of the Board?
3. What are the arguments for and against Standards? List some of them that you know.
4. Briefly list and explain the structure of IASB.
5. What are the objectives of IASB? List some of them.

7.0 REFERENCES/FURTHER READINGS

Adapted from the ICAN Study Packs (2011)

UNIT SIX REGULATORY FRAMEWORK OF FINANCIAL ACCOUNTING

CONTENTS

1.0 INTRODUCTION

In the last unit, we discussed extensively the development, contents and application of accounting standards.

In this unit, we shall discuss the regulatory framework of financial accounting.

2.0 OBJECTIVES

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

- Discuss the accounting requirements of the Insurance act 2003, BOFIA 1991, and Investment and Securities act 1999, Securities and Exchange Commission and Nigerian Stock Exchange.

- List and explain the accounting methods recommended by Pension Reform act 2004.

3.0 MAIN CONTENT

3.1 Banks and Other Financial Institutions Act, 1991 (BOFIA)

The statutory backing for the establishment and regulation of Banks and Other Non-Bank Financial Institutions (Discount Houses, Finance Houses, e.t.c except Insurance Companies) in Nigeria is the Banks and Other Financial Institutions A ct, 1991 (as amended). Some of the accounting requirements of the Act are stated below.

Minimum Capital

The President shall on the advice of the Central Bank of Nigeria (CBN) determine, from time to time, the appropriate minimum paid up share capital of each category of banks subject to subsection (1) of this Section. The minimum shareholders’ fund of banking institutions shall in respect of:

(a) Universal Banks be ₦25 billion
(b) Bureau de Change be ₦500 million
(c) Micro finance banks be ₦ 20 million
(d) Mortgage Institutions be ₦2 billion

Cash Reserves, Special Deposits and Specified Liquid Assets

The BOFIA requires every bank to maintain with the CBN, cash reserves and special deposit and hold specified liquid assets or stabilization securities, as the case may be, as prescribed by the Central Bank by virtue of Section 39 of Central Bank of Nigeria Act, 1991 (as amended) where both assets and /liabilities are due.

For the purpose of this section, specified liquid assets are:

(a) Currency notes and coins which are legal tender in Nigeria;

(b) Balances at the bank;

(c) Net balances at any licensed bank and money at call in Nigeria;

(d) Treasury bills and treasury certificates issued by the Federal Government

(e) Inland bills of exchange and promissory notes re - discountable at the Central Bank

(f) Stock issued by the Federal Government with such dates of maturity as may be approved by the Central Bank; and

(g) Negotiable Certificate of deposit approved by the Central Bank.

(h) Such other negotiable instruments as may from time to time be approved by the Central Bank.

Statutory Reserve Fund

The Act also requires every bank to maintain a reserve fund. Each year, a bank must transfer an amount to the reserve fund, equal to and not less than 30% of the profit after tax, if the amount in the reserve is less than the paid – up share capital, and 15% of the profit after tax, if the amount in the reserve fund is equal or greater than the paid – up share capital.

Conditions for payment of Dividends

No bank shall pay dividend until:

(a) All its preliminary expenses, organizational expenses, share selling expenses, brokerage, losses incurred and other capitalized expenses not represented by tangible assets have been written–off

(b) Adequate provision has been made for contingent losses on risk assets liabilities, off balance sheet commitment; and

(c) It has complied with capital ratio requirement specified by Section 13(1) of the act

3.1.1 Reserve for Small Scale Industries

CBN Monetary and Credit Policies require each Bank to set aside 10 percent of its profits for the financing and promotion of Small Scale Industries in Nigeria

3.1.2 Analysis of non-performing loans and advances

Prudential guidelines issued by the CBN require banks to classify non-performing loans and advances, and to provide for loan impairment as follows:

Interest and principal outstanding for over	Classification	Provision
90 days but less than 180 days	substandard	10%
180 days but less than 360 days	doubtful	50%
360 days and over	lost	100%

3.2 Insurance Act, 2003

The regulatory body for the Insurance Industry is the National Insurance Commission (NAICOM), while the regulatory statute is the Insurance Act, 2003 (as amended). Relevant sections of the statute are summarised below:

Minimum paid up capital (section 9(1))

The Act mandates every insurance business in Nigeria to maintain specified minimum paid up capital which has been reviewed by NAICOM as follows:

(a) Life Insurance not less than ₦ 2 billion;
(b) General Insurance not less than ₦3 billion;
(c) Composite Insurance Business not less than ₦ 5 billion
(d) Reinsurance business not less than ₦ 10 billion

Statutory deposit (section 10)

This Section requires that:

(a) An insurer intending to commence insurance business in Nigeria, after the commencement of the Act, shall deposit the equivalent of 50 percent of the Paid-Up Share Capital, referred to above, with the Central Bank of Nigeria. This deposit is called Statutory Deposit.

(b) Upon registration as an insurer, 80 per cent of the statutory deposit shall be returned with interest not later than 60 days after registration.

(c) In the case of existing companies, an equivalent of 10 per cent of the minimum paid-up share capital stipulated in Section 9, shall deposited with the CBN

(d) Statutory Deposit shall attract interest at the minimum lending rate by the CBN on every 1 January of each year

(e) Any short fall in the statutory deposit must be replenished within 30 days

Statutory books and records (section 17 and 18)

Section 17(1), requires an insurer to keep and maintain at its principal office, the following records:

(a) The Memorandum and Articles of Association or other evidence of the Constitution of the insurer.

(b) A record containing the names and addresses of the owners of the insurance business, whether known as, or called shareholders or otherwise.

(c) The minutes of any meeting of the owners and of the policy making executives (whether known as or called the Board of Directors).

(d) A register of all policies, in which shall be entered, in respect of every policy issued, the names and addresses of the policy-holders, the date when policy was effected and a record on any transfer, assignment or nomination of which the insurer has notice.

(e) A register of claims, in which shall be entered, every claim made together with the date of claim, the names and addresses of the claimant and the date on which the claim was settled, or in the case of claim which is repudiated, the grounds for the rejection or in the case of litigation, the particulars of the litigants and the court in this matter.

(f) A register of investments, showing those which are attributable to the insurance funds and those which are not, and also any alteration in their values, from time to time.

(g) A register of its assets.

(h) A register of re-insurance ceded, showing separately those ceded in Nigeria and those ceded outside Nigeria.

(i) A cash book.

(j) A current account book.

(k) A register of open policies, in respect of marine insurance transactions and management report by external auditors.

Section 17(2), requires a life insurance business, to maintain and keep the following additional records:

(a) A register of assured, under group policies;
(b) A register of loans on policies;
(c) A register of cash surrendered values; and
(d) A register of lapsed and expired policies.

Section 18(1), mandates a re-insurance business, to keep and maintain at its principal office, the following records:

(a) The Memorandum and Articles of Association or other evidence of the Constitution of the reinsurer

(b) Records containing the names and addresses of the owners of the reinsurer (whether known as or called shareholders or otherwise);

(c) Minutes of any meeting of the owners and of the policy making executives (whether known as the board of directors or otherwise);

(d) A register of all treaties, in which shall be entered, in respect of every treaty issued, the name of the cedant, and the date when the treaty was effected;

(e) A register of all claims, in which shall be entered, every claim made together with the date of claim, the name of the cedant or insured, their proportionate share and the date the claim is settled;

(f) A register of events, showing those which are attributable to the insurance funds and those which are not and also any alteration in value from time to time;

(g) A register of Assets;

(h) A register of business or retrocession, showing separately those ceded within and outside Nigeria;

(i) A register of new and existing clients;

(j) A cashbook; and

(k) Domestic or management report prepared by the external auditors.

A life reinsurance business, shall keep the following additional records:

(a) A register of assured, under group policies;
(b) A register of cancelled, leased and expired policies, and
(c) A register of claims, showing the names of the deceased and when the claim is settled.

Separation of Accounts and Insurance Funds (section 19)

Section 19(1), requires every insurer, who carries on the two classes of insurance business, to enter all receipts of each of those classes of insurance business, in a separate and distinct account. Separate insurance funds are also required for each class of insurance business and, in the case of life insurance business, there should be:

(a) the individual life insurance business fund;
(b) the group life insurance business and pension fund; and
(c) health insurance business.

Section 19(2), contains the following additional requirements:

(a) In the case of life insurance business, the life business funds, shall be a sum not less than the mathematical reserve; and

(b) In the case of general insurance business, the insurer is required to maintain provisions for unexpired risk and provisions for outstanding claims, including in the case of the latter, provisions estimated to provide for the expenses of adjustment or settlement of such claims.

The insurance fund of each particular class, shall:

(a) be absolutely the security of the policy holders of that class, as though it belongs to an insurer carrying on other business than insurance business of that class

(b) not be liable for any contract of the insurer for which it would not have been liable, had the business of the insurer been only that of particular insurance class; and

(c) not be applied directly or indirectly, for a purpose other than those of the class of business, to which the fund is applicable.

Technical reserves (sections 20-23)

Section 20(1), requires an insurer, in respect of its general business, to establish and maintain the following provisions applicable in respect of each class of insurance business:

(a) Provisions for unexpired risks which shall be calculated on a time appointment basis of the risks accepted in the year.

(b) Provisions for outstanding claims which shall be credited with an amount equal to the total estimated amount of all outstanding claims with a further amount representing 10 per cent of the estimated figure for outstanding claims in respect of claims incurred but not reported at the end of the year under review and
Under section 21

    (a) An insurer shall establish and maintain contingency reserves to cover fluctuations in securities and variations in statistical estimates.

    (b) The contingency reserves shall be credited with an amount not less than 3 per cent of the total premium or 20 per cent of the net profit (whichever is greater) and the amount shall accumulate until it reaches the amount of the minimum paid up capital or 50 percent of the of the net premium (whichever is greater).

Section 22(1), requires an insurer maintain the following reserves in respect of its life insurance business.

(a) A *general reserve* fund which shall be credited with an amount equal to the net liabilities on policies in force at the time of the actuarial valuation and an additional 25 per cent of net premium for every year between valuation date; and

(b) A *contingency reserve fund* which shall be credited with an amount which shall be credited with an amount equal to 1 per cent of the gross premium or 10 per cent of the profit (whichever is greater) and accumulated until it reaches the amount of the minimum paid up capital

A reinsurer shall establish a general reserve fund which shall be credited with an amount:

(a) Not less than 50 per cent of the reinsurer's gross profit for the year, where the fund is less than the authorised capital of the insurer; and

(b) Not less than 25 per cent of the reinsurer's gross profit for the year, where the fund is equal to or exceeds the authorised capital of the reinsurer.

Margin of safety (section 24(1))

The Act further requires an insurer to maintain at all times, in respect of its general business, a margin of solvency, being the excess of the value of its admissible assets in Nigeria over its liabilities in Nigeria, consisting of:

(a) Provision for unexpired risks;
(b) Provisions for outstanding claims;
(c) Provision for claims incurred but not yet reported; and
(d) Funds to meet other liabilities.

The margin of solvency shall not be less than 15 per cent of the gross premium income less reinsurance premium paid out during the year under review or the minimum paid up capital, whichever is greater.

The Act defines "admissible assets" as those designated as admissible assets, consisting of the following:

(a) cash and bank balances;
(b) quoted investment at market value;
(c) unquoted stock at cost;
(d) land and buildings;
(e) furniture and fittings;
(f) office equipment;
(g) motor vehicles;
(h) prepared expenses made to members of staff;
(i) amount due from retrocession;
(j) staff loans and advances; and
(k) claims receivable.

Assets and investments (section 25)

An insurer, shall at all times, in respect of the insurance transacted by it in Nigeria, invest and hold in Nigeria assets equivalent to not less than the amount of policy holders' funds in such insurance business, as shown in the balance sheet and the revenue account of the insurer.

Subject to the provisions of this Section, the policy holders' funds shall not be invested in property and securities except:

(a) shares of limited liability companies;
(b) shares in other securities of a co-operative society
(c) registered under a law of relating to cooperative societies
(d) loans to building societies approved by the Commission;
(e) loans on real property, machinery and plant in Nigeria;
(f) loans on life policies within their surrender values;

(g) cash deposit in bills of exchange accepted by license banks; and
(h) such investments as may be prescribed by the Commission.

No insurer, shall:

(a) in respect of its general insurance business, invest more than 25 per centum of its assets in real property; or

(b) in respect of its life insurance business, invest more than 35 per centum of its assets as defined in subsection (1), in real property.

3.3 Securities and Exchange Commission (SEC) and the Nigerian Stock Exchange (NSE) Regulations

In most jurisdictions, the Securities and Exchange Commission (SEC) exists as the apex capital market institution, providing the right regulatory framework for orderly development of the market, ensuring the integrity of securities business and protection of all participants, particularly the investors. The extent of powers and scope of regulatory responsibilities conferred on the Commission depends on enabling laws. In Nigeria, the Commission came into full existence following the enactment of Securities and Exchange Commission Act 1979, re-enacted as Act 29 of 1988. Historically, it grew out of the Capital Issues Committee, housed under the Central Bank of Nigeria in the sixties.

This Committee led to the establishment of Capital Issues Commission and subsequently Nigerian Securities Exchange Commission (NSEC), which played key role in the indigenization era of 1973–1977 periods. Roles assigned to the Commission can be broadly classified into developmental and surveillance roles.

3.3.1 Developmental Roles

These relate to efforts aimed at increasing the depth and breadth of securities business and include facilitating the establishment of important capital market institutions such as Stock and Commodity Exchanges, Capital Trade Points, Rating Agencies. These roles which are largely by SEC in developing markets also include development of innovative instruments such as derivatives and facilitating knowledge and awareness of securities.

The traditional role of surveillance includes oversight responsibilities in ensuring that existing institutions and participants conform to rules and regulations. Originally, the following specific functions were taken up by the Commission.

- Pricing of new issues- Following deregulations of the market, this function has been transferred to the Issuing House

- Timing of issues- This is to ensure that the market is not glutted with shares at any point in time

- Registering and licensing- of market operators including the stock exchanges

- Approval of allotment of shares to members of the public

- Registering of instruments issued with the possibility of transfer to persons other than those initially offered.

- The Companies and Allied Matters A ct, Cap. C20 LFN 2004 also empowers the Commission to regulate mergers and acquisitions including unit trust and similar schemes.

The enabling Act for the activities of the Securities and Exchange Commission is the Investment and Securities Act, 1999.

3.4 Investments and Securities Act, 1999

The Securities and Exchange Commission is empowered by the Investment and Securities Act (ISA) 1999, to administer securities laws and regulate investment and securities business in Nigeria. The Act requires comprehensive set of accounting records and accounting reports in a number of circumstances, including business combinations, content of prospectus, and records of security dealers. A few of these requirements are stated below.

Books of Accounts of Security Dealers (s.37)

Section 37 (1) requires a security dealer to keep or cause to be kept such accounting and other records:

(a) as shall sufficiently explain the transactions and financial position of its business accounts and balance sheets to be prepared, from time to time; and

(b) in such a manner as to enable them to be conveniently and properly audited.

A security dealer shall be deemed not to have complied with subsection (1) of this Section in relation to records unless the accounting and other records:

(a) are kept in sufficient details to show particulars of:

(1) all money received or paid by the security dealer including money paid to or deducted from a trust account;

(2) all purchases and sales of securities made by the security dealer, the charges and credits arising from them, and the names of each of these securities;

(3) all income received from commissions, interest and other sources and all expenses, commissions and interest paid for by the security dealer;

(4) all the assets and liabilities (including contingent liabilities) of the security dealer;

(5) All securities which are the priority of the security dealer, showing by whom the securities or documents of the title to the security are held and, where they are held by another person, whether or not they are held as security against loans or advances;

(6) All securities that are not the property of the security dealer and for which the dealer or any nominee controlled by the security dealer is accountable, showing

by whom, and for whom, the securities are held and the extent to which they are either held for safe custody or deposited with a third party as security for loans or advances made to the security dealer;

(7) All purchases and sales of options made by the security dealer and all fees (being options money) arising from them; and

(8) All underwriting transactions entered into by the security dealer.

(b) are kept in sufficient details to show separately particulars of all transactions by the security dealer.

(c) specify the day on which or the period during which each transaction by the security dealer took place; and

(d) contain copies of acknowledgements of the receipt of securities or of documents of title to securities received by the security dealer from clients for sale or safe custody, clearly showing the name or names in which the particular securities are registered.

Accounts for investor protection fund

Section 152 of ISA 1999, requires a Security Exchange or Capital Trade Point to establish and keep proper books of accounts in relation to its Investors Protection Fund and prepare income and expenditure account and balance sheet not later than 30th April following each 31st December.

Accountants' report to be set out in a prospectus

Section 17 of the 3rd Schedule, requires the report of accountants to be contained in the prospectus of a company wishing to issue shares or debentures. The report should cover (a) the profits and losses of the business for the five years preceding the issue of the prospectus and (b) the assets and liabilities of the business at the last date to which the accounts of the business were made.

Part 2 of Schedule 4, also requires accountants' report w here there is a proposal to acquire a business or a subsidiary.

3.5 Pensions Reform Act, 2004

Section 1 of the Pension Reform Act 2004 mandates the establishment of a Contributory Pension Scheme for the payment of retirement benefits of workers in Nigeria. Section 2 of the Act insists that the requirement is applicable to employees in both private and public sectors, thereby setting aside the use of defined benefit plan permitted by SAS 8, *Accounting for employee retirement benefits.*

Self Assessment Exercises

1. Mention at least two major roles of security and exchange commission

2. One of the following is not allowed as a liquid asset for banks in Nigeria:
   a) Treasury bills

b) Shares issued the federal government
c) Coins and notes on legal tender
d) Bonds by state governments
e) Balances with discount houses

4.0 CONCLUSION

There are statutory documents that govern financial accounting in Nigeria and these in turn form the regulatory framework of financial accounting.

5.0 SUMMARY

This unit highlights the important provisions of CAMA, insurance at 2003, BOFIA 1991 and investment securities act 1999, as they govern financial accounting in Nigeria.

With the end of discussion in this unit, we have come to the end of module two of this course.

6.0 TUTOR-MARKED ASSIGNMENT

Write short notes on the following:

- Banks and Other Financial Institutions Act, 1991 (BOFIA)
- Insurance Act, 2003
- SEC and NSE Regulations
- Investment and Securities Act, 1999
- Pensions Reform Act, 2004

7.0 REFERENCES/FURTHER READINGS

Adapted from the ICAN Study Packs (2011)

MODULE THREE

UNIT ONE LEGAL AND REGULATORY FRAMEWORK OF GROUP ACCOUNTS

CONTENTS

1.0 INTRODUCTION

You are welcome to module three and the first unit of the module in this course.

In this unit, we shall discuss the legal and regulatory framework of group accounts.

2.0 OBJECTIVES

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

- Explain the theoretical background and regulatory documents for the preparation and presentation consolidation of financial statements.

- Describe the conditions required for an enterprise to be a subsidiary, an associate of a group or a joint entity.
- Enumerate the forms of group accounts.

3.0 MAIN CONTENT

3.1 Group of Companies

Combinations based on the purchase of controlling shares by one company in another company, directly or indirectly, give rise to a group of companies within which the company that purchased the controlling shares is called the parent or `holding company' and the company whose shares are acquired is referred to as the 'subsidiary company'.

Combinations of this nature do not affect the existence of the combined companies, as separate legal entities. However, this transfer of control from one group of owners to another affects the economic substance of members of the group. To this effect, the operations of group companies and the preparation of consolidated financial statements are regulated by an Act and International Accounting Standards.

3.2 Regulatory Documents

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

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

(b) Statement of Accounting Standards (SAS) 26- on Business combination;

(c) Statement of Accounting Standards (SAS) 27 – On Consolidated and Separate Financial Statements;

(d) Statement of Accounting Standards (SAS) 28 – On Investment in Associates;

(e) International Accounting Standard (IAS) 31 - On Interests in Joint ventures.

3.3 The Need for Group Accounts

In Nigeria, the main reporting obligations of directors of parent companies are contained in the Companies and Allied Matters Act 2004. Section 336 of the Act, requires the directors of a company that has subsidiaries, at the end of the year, to prepare its individual accounts for that year and the group financial statements. These statements report on the state of affairs, the profit and loss of the company and its subsidiaries.

The objective is to provide the shareholders of the parent company with full information concerning the activities of the entire economic unit in which they have invested. This is achieved by combining all the assets and liabilities of the parent company and its subsidiaries into a single balance sheet so as to disclose the overall financial position of the group.

3.4 Group Financial Statements

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

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

(a) Consolidated balance sheet dealing with the state of affairs of the company and all the subsidiaries of the company;

(b) Consolidated profit and loss account of the company and its subsidiaries; and

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

It is not necessary to publish the parent company's profit and loss account, provided the company's consolidated profit and loss accounts contains a note stating how much of the parent company's profit and loss is dealt with in the accounts (CAMA 2004).

3.5 Parent/Holding Company and Subsidiaries

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

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

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

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

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

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

Generally control is presumed to exist when the parent owns, directly or indirectly, through subsidiaries more than one half of the voting power of an enterprise.

SAS 27 defines control as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Under the standard, control is also presumed to exist when the parent has:

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

2. Power to govern the financial and operating polices of the enterprise under a statute or agreement.

3. Power to appoint or remove the majority of the members of the board of directors.

4. Power to cast the majority of votes at a meeting of board of directors or equivalent governing body and control of the entity is by that board or body.

Illustration 13-1

Company X is said to be a subsidiary of company Y when:

(1) Company Y is a member of company X and controls the composition of the Board of directors (BOD). This means that company Y has the power to appoint or remove all or the majority of members of the BOD and power to cast majority of votes at the meeting of the BOD.

(2) Company Y owns more than half of the nominal value of the equity share capital. This is the power to govern the financial and operating policies of the enterprise under a statute or an agreement.

(3) Company X is a subsidiary of another company Z, which is itself a subsidiary of company Y. In this case, Company Y would exercise control over company X indirectly.

3.6 Uniform Accounting Policies (SAS 27)

As much as possible, uniform accounting policies should be employed by the members of a group when preparing the accounts of their individual companies.

SAS 27 specifically requires an entity to use uniform accounting policies for reporting such transactions and other events in similar circumstances. Where a subsidiary has not adopted a uniform policy, appropriate adjustments should be made to its financial statements in preparing the consolidated financial statements (see para. 38 and 11).

3.7 Co-Terminus Accounting Dates

A subsidiary is required to prepare its own financial statements at or to the same date as the group.

If a subsidiary does not prepare its own financial statements at the same date as that of the group, adjustments should be made for the effects of significant transactions or events that occur between that date and the date adopted by the parent. The difference between the reporting date of the subsidiary and that of the parent shall not be more than three months.

When it is not possible to obtain such special financial statements, appropriate adjustments should be made to the consolidated financial statements for any abnormal transactions in the intervening period. The consolidated accounts should disclose:

(i) The name of the subsidiary;
(ii) Its accounting date; and

(iii) The reason for using different dates

3.8 Methods of Preparing Consolidated Accounts

SAS 27 prescribes that all business combinations shall be accounted for by applying the purchase method. The method has the following features:

(i) Assets and liabilities of the subsidiaries are measured at fair market value at the date of acquisition;

(ii) Shares purchased and issued in settlement of the purchase are valued by the parent company at fair value.

(iii) The profits of the subsidiary are divided into pre-acquisition and post-acquisition periods. Only the post-acquisition profits are consolidated.

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

3.9 Application of Purchase Method

Application of the purchase method involves the following steps:

(a) Identifying an acquirer. The acquirer is the combining entity that obtains control of the other combining entities.

(b) Measuring the cost of the business combination.

(c) Allocating the cost of the business combination to the assets acquired and liabilities and contingent liabilities assumed at the acquisition date.

3.10 Forms of Group Accounts

Section 336(5) of the Act states that a parent company should prepare group accounts in the form of a single set of financial statements. It however allows for alternative forms of group accounts where in the opinion of the directors, the other form would present the same or better view of the group's performance and financial position.

Other forms of accounting for group interests available are:

(a) more than one set of consolidated financial statements dealing respectively with the company and one group of subsidiaries and with other groups of subsidiaries; or

(b) separate financial statements dealing with each of the subsidiaries; or

(c) statements expanding the information about subsidiaries in individual financial statements of the company or in any other form.

3.11 Exemption of Subsidiaries from Consolidation

Under the act:

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

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

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

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

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

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

Under SAS 27 of the Act, a parent need not present consolidated financial statements if, and only if, all the following conditions apply:

(a) The parent is itself a wholly-owned subsidiary, or the parent is a partially-owned subsidiary of another entity and its other owners have been informed about and do not object to the parent not preparing consolidated financial statements.

(b) The parent's debt or equity instruments are not traded in a public market.

(c) The parent did not file nor is in the process of filing its financial statements with the Securities and Exchange Commission or other regulatory organizations for the purpose of issuing any class of instrument in a public market.

(d) The ultimate or any intermediate parent of the parent, produces financial statements when the parents elect or are required by local regulations to present separate financial statements.

(e) The subsidiary is acquired with the intention to dispose of the company within 12 months and management is actively seeking a buyer.

(f) When the parent company loses control. The loss of control can occur with or without a change in absolute or relative ownership levels. For example, where a subsidiary becomes subject to the control of a government, court, administrator or regulator.

A subsidiary is not excluded from consolidation because its activities are dissimilar from those of other entities within the group. Relevant information is provided by consolidating such subsidiaries and disclosing additional information in the consolidated financial statements about the different activities of the subsidiaries.

Similarly, an entity is not permitted to exclude from consolidation a subsidiary it continues to control simply because that entity is operating under severe long term restrictions that significantly impair its ability to transfer funds to the parent. Control must be lost for exclusion to occur (SAS 27 para. 21).

3.12 Treatment of an Enterprise that ceases to be a Subsidiary

When an enterprise ceases to be a subsidiary, the investment in the enterprise shall be accounted for in accordance with other SASs from the date when control is lost.

3.13 Disclosure Requirements for Subsidiary Excluded from Consolidation

Under the Act

When a company is not a wholly owned subsidiary of another company incorporated in Nigeria, the directors of the company should state the reason for the exclusion of the subsidiary from consolidation. Schedule II paragraph 68 of the Act states that the notes to the accounts should include:

(a) the reasons why the subsidiaries are not dealt with in group accounts;

(b) any qualifications by the auditors of the subsidiaries' accounts not covered by the company's own accounts;

(c) the aggregate amount of the total investment of the parent company in the shares of the subsidiaries, for:

    (i) the financial year under consideration; and
    (ii) previous years since acquisition.

(d) such investments should be accounted for using the equity method of valuation;

(e) where any of the information in (a) to (d) above are not obtainable, a statement to that effect shall be given.

Under SAS 27, a parent that is exempted from presenting consolidated financial statements in accordance with the standard shall present separate financial statements as its only statements.

3.14 Explanation of Terms under Group Accounts

(a) Equity share capital

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

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

(b) Equity method of accounting

This is a method of accounting where the investment in a company is shown in the consolidated balance sheet at:

(i) the cost of the investment; plus

(ii) the investing company or group's share of the post-acquisition retained profits and reserves of the company; less

(iii) any amount written off in respect of (i) and (ii) above. The investing company should account separately in the profit and loss account for its share of the profit before tax, taxation and extraordinary items of the acquired company.

This method is usually applied to associated companies under the provisions of SAS28.

(c) Related company

The Act defines a related company as any body corporate (other than that which is a group company in relation to that company) in which that company holds on a long-term basis, a qualifying capital interest for the purpose of securing a contribution to that company's own activities by exercising control or influence arising from that interest. Related companies are described by SAS 28 as associated companies.

(d) Associated companies

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

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

(e) Fellow subsidiaries

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

(f) Cost of control account

It is described as an account opened to record the purchase of a business so as to determine whether the business is being purchased at a 'profit or at a loss'. In other words, it is a goodwill account. A debit balance on the Cost of Control account is regarded as a loss on purchase because the cost of shares acquired is greater than the net assets acquired while a Credit balance on the Cost of Control is regarded as a gain (i.e. Negative Goodwill). In the cost of control account, the cost of investment is cancelled against the net assets acquired to determine goodwill.

(g) Goodwill on consolidation

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

(h) Fair value of net assets

In order to calculate a realistic figure for goodwill, it is necessary to determine the fair values of the assets and liabilities of the subsidiary company when preparing consolidated accounts. Fair values need not be accounted for in the books of the subsidiary company and used for the purpose of its legal entity based accounts, but they should be used for consolidation purposes.

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

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

The 2008 amendments to IAS 27 changed the term minority interest to a new phrase called non-controlling interest. According to the Official Pronouncements of the IASB as issued at 1 January 2009, "the change in terminology reflects the fact that the owner of a minority interest in an entity might control that entity and, conversely, that the owners of majority interest might not control the entity." It is the view of the IASB that "non-controlling interest" is a better description than "minority interest" of the "interests of those owners who do not have a controlling interest in an entity."

SAS 27 uses the new phrase instead of the outdated minority interest, and defines non controlling interest as "the equity in a subsidiary not attributable, directly or indirectly, to a parent."

When the parent company owns less than 100% equity shares in the subsidiary, say 70%, the remaining 30% is attributable to the non-controlling interest (NCI). Non-controlling interest shall be presented in the consolidated balance sheet within equity; separately from the parent shareholders' fund. Minority interest in the profit and loss account of the group shall also be separately disclosed below the profit after tax.

(j) Attribution of profit or loss to non-controlling interest

SAS 27 requires an entity to attribute their share of comprehensive income to non-controlling interest (NCI) even if this will result in the NCI having a deficit balance.

(k) Pre-acquisition and post-acquisition profits

The profits of a subsidiary company are distinguished between pre-acquisition and post-acquisition for the purpose of preparing consolidated accounts.

Pre-acquisition reserves are the accumulated reserves earned by the subsidiary prior to its acquisition by the parent company. They are credited to cost of control account as part of the process required to arrive at goodwill arising on consolidation.

Post-acquisition reserves are the accumulated retained profits since the date of acquisition. The proportion of these reserves earned by the parent company is credited to the consolidated accounts. To the extent that post-acquisition profits earned by the subsidiary are transferred to the parent company by w ay of dividends, the amount to be aggregated when consolidation takes place will be reduced correspondingly.

(l) Other reserves of a subsidiary

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

3.15 Consolidation Procedures under SAS 27

In its explanatory note, SAS 27 outlines the following consolidation procedures:

(a) Financial statements of the parent and its subsidiaries are combined on a line by line basis by adding together like items of assets, liabilities, equity, income and expenses.

(b) The carrying amount of the parent’s investment in each subsidiary and the parent’s portion of equity of each subsidiary are eliminated.

(c) Non-controlling interests in the profit or loss of the consolidated subsidiaries for the reporting period are identified.

(d) Non-controlling interests in the net assets of consolidated entities are identified and presented in the consolidated balance within equity, separately from the shareholders’ fund.

3.16 Disclosure Requirements of SAS 27

The disclosure requirements relating to group accounts include the following:

(a) The nature of the relationship between the parent and a subsidiary when the parent does not own directly or indirectly through subsidiaries more than half of the voting power.

(b) The reasons why more than half of the voting power in the investee does not constitute control.

(c) When there is a significant restriction on the ability of the subsidiaries to transfer funds to the parent, the nature and significance of such restrictions must be disclosed.

(d) A list of investments in subsidiaries, jointly controlled entities and associates, including the name and country of incorporation.

(e) Where separate financial statements are prepared by a jointly controlled entity or an investor in an associate, the reason for preparing separate financial statements, the list of significant investment and country of incorporation of the investee must be disclosed.

Self Assessment Exercises

1. Mama plc owns 80% of the equity of Broda plc. Sista plc owns 20% of Broda plc. In relation to Mama plc, sista plc is considered as a/an _______

   a) An associate
   b) A fellow subsidiary
   c) A parent company
   d) A subsidiary not consolidated
   e) A minority interest

.

2. Mama plc owns 80% of the equity of Broda plc. Sista plc owns 20% of Broda plc. In relation to Mama plc, sista plc is considered as a/an _______

4.0 CONCLUSION

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

5.0 SUMMARY

This unit explained the legal and regulatory framework in the presentation of group accounts with particular reference to the detailed provisions of CAMA 2004 and SAS 27.

In the next unit, we shall discuss consolidated balance sheet.

6.0 TUTOR-MARKED ASSIGNMENT

1. State one main problem with group accounting.

2. List one of the grounds on which a subsidiary may be exempted from consolidation.

3. Enumerate the disclosure requirements of SAS 27.

4. Define a group of companies and state the regulatory documents for group accounts.

7.0 REFERENCES/FURTHER READINGS

Adapted from the ICAN Study Packs (2011)

UNIT TWO CONSOLIDATED BALANCE SHEET

CONTENTS

1.0 INTRODUCTION

In the last unit, we explained the legal and regulatory framework in the presentation of group accounts with particular reference to the detailed provisions of CAMA 2004 and SAS 27.

In this unit, we shall discuss consolidated balance sheet.

2.0 OBJECTIVES

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

- Apply the basic principles and procedures involved in balance sheet consolidation;
- Calculate goodwill, unrealized profit, fixed assets;
- Account for inter company items and revaluation reserves on fixed assets of subsidiaries.

3.0 MAIN CONTENT

3.1 Consolidation Procedures

The essence of consolidation procedures is the elimination of inter-company balances and the aggregation of the remaining balances.

Illustration 14.1

The summarised balance sheet of Nwakanobi plc ad it subsidiary Ogbuefi plc as at 31december 2008 are as follows:

	Nwakanobi plc	Ogbuefi plc
	₦'000	₦'000
Fixed assets	63,000	58,000
Investment in Ogbuefi plc	120,000	-
Current assets: stock	26,000	22,000
Debtors	22,000	20,000
Bank balance	35,000	30,000
	266,000	130,000
Ordinary shares of ₦1.00 each		
(Fully paid)	215,000	100,000
Retained profits	40,000	20,000
	255,000	120,000
Current liability	11,000	10,000
	266,000	130,000

Nwakanobi plc purchased the entire share capital of Ogbuefi plc for ₦120 million cash, at the balance sheet date (31/12/08.

Prepare the Consolidated balance sheet schedule of plc and subsidiary at 31 December 2008.

Suggested Solution 14.1

STEP 1: Preparation of the Consolidation Schedule

Consolidated balance sheet schedule of Plc and Subsidiary

	Nwakanobi	Ogbuefi	Consolidated
	₦'000	₦'000	₦'000
Fixed assets at book value	63,000+	58,000=	121,000
Investments in ogbuefi plc	120,000	-	-
Current assets: stock	26,000+	22,000=	48,000
Debtors	22,000+	20,000=	42,000
Bank balance	35,000+	30,000=	65,000
	266,000	130,000=	276,000
Ordinary share capital	215,000	100,000	215,000
Retained profits	40,000	20,000	40,000
	255,000	-	255,000
Current liability	11,000+	10,000=	21,000
	266,000	130,000	276,000

STEP 2:

NWAKANOBI PLC
Consolidated Balance Sheet as at 31dec 2008

	₦'000	₦'000
Fixed assets at book value		121,000
Current assets:		

Stock	48,000	
Debtors	42,000	
Bank balance	65,000	
	155,000	
Less current liabilities	21,000	
Net current assets		134,000
		255,000
Capital and reserves		
Ordinary share capital at ₦1 each		215,000
Retained profits		40,000
		255,000

Tutorial
The inter company balances are crossed out because they cancel on consolidation

3.2 Goodwill

Goodwill arises on consolidation when the price paid to acquire the subsidiary is greater than the fair value of net assets acquired

Illustration 14.2

Bada plc acquired the entire share capital of Santos plc for ₦40million cash on 31 December 2008. The balance sheets of the two companies at that date were as follows:

	Bada plc	Santos plc
	₦'000	₦'000
Fixed assets	160,000	16,000
Investment in santos plc	40,000	-
Current assets:	390,000	48,000
	590,000	64,000
Share capital of N1.00 per share	200,000	20,000
Profit and loss a/c	60,000	10,000
Current liability	330,000	34,000
	590,000	64,000

There is no significant difference between the book value and the fair value of santos plc's assets.

(a)Calculate goodwill
(b)Prepare the consolidated balance sheet of Bada plc at 31december 2008.

Suggested Solution 14.2
Step 1

		₦'000		₦'000
(a)	Goodwill on consolidation			
	Cost of investment			40,000
	Share capital	20,000		
	Retained profits	10,000		

		30,000	x100%	30,000
	Goodwill on consolidation			10,000
(b)	Consolidated balance sheet as at 31dec.2003			
	Fixed assets			
	Tangible ₦(160+16)			176,000
	Intangible assets - goodwill			10,000
				186,000
	Current assets ₦(390+48)	438,000		
	Less current liabilities ₦(330+34)	364,000		
	Net current assets			74000
				260,000
	Capital and reserves			
	Share capital			200,000
	Retained profits			60,000
				260,000

3.3 Pre-and Post-Acquisition Profits

3.3.1 Pre-Acquisition Profit

These are the profits which accrued to the former shareholders of the subsidiary company. They are not available for distribution to the shareholders of the parent company; rather, they are treated as part of the capitalized value of the business at acquisition.

The pre-acquisition profits could include retained profits, share premium and other capital reserves at acquisition. Others are revaluation surplus; recovery of bad debts written off before acquisition and income receivable from crystallization of contingent asset that relates to pre-acquisition period.

3.3.2 Post-Acquisition Profit

The increase in the reserves of the subsidiary which arose after acquisition by the parent company is post-acquisition reserves. This should be aggregated with the reserves of the parent company to obtain the consolidated reserves.

Illustration 14.3

The balance sheet of Peter plc and Sifau plc as at 31dec 2008 were as follows:

	Peter plc	Sifau plc
	₦'000	₦'000
Fixed assets	40,000	32,000
Investment at cost	76,000	-
Current assets:	60,000	48,000
	176,000	60,000
Share capital		
Ordinary shares of ₦1.00 per share	120,000	40,000
Accumulated reserves	32,000	16,000
	152,000	56,000

Current liability	<u>24,000</u>	<u>24,000</u>
	<u>176,000</u>	<u>80,000</u>

The entire share capital of Sifau plc was acquired when the accumulated reserves was ₦12million.

You are required to prepare the consolidated balance sheet of peter group at 31dec 2008

Suggested Solution 14.3

STEP 1 prepare the consolidated schedule and compute goodwill and reserves

Equity of sifau plc	Total	Pre-acquisition 100%	Post-acquisition
	₦'000	₦'000	₦'000
Ordinary share capital	40,000	40,000	
Accumulated reserves	<u>16,000</u>	<u>12,000</u>	<u>4,000</u>
	56,000	52,000	4,000
Cost of investment		<u>(76,000)</u>	
Goodwill		<u>24,000</u>	
Accumulated reserves of peter			<u>32,000</u>
Consolidated reserves			<u>36,000</u>

STEP 2 Prepare the consolidated balance sheet by adding the figures of assets and liabilities of the companies, except for the figures that have been calculated in the consolidation schedule above.

PETER PLC **Consolidated balance sheet as at 31dec.2008**		
	₦'000	₦'000
Fixed assets		
Tangible		72,000
Intangible assets – goodwill(w1)		<u>24,000</u>
		96,000
Current assets	108,000	
Less current liabilities	<u>48,000</u>	
Net current assets		<u>60,000</u>
		<u>156,000</u>
Capital and reserves		
Share capital of ₦1 each fully paid		120,000
Accumulated reserves(w1)		<u>36,000</u>
		<u>156,000</u>

3.4 Non-Controlling Interest

We shall now proceed to a situation where the parent company does not acquire the entire share capital of the subsidiary.

The non-controlling interest in the share capital and reserves of the subsidiary will be shown distinct from the shareholders' fund and other liabilities in the consolidated accounts.

Illustration 14.4

The facts are as in illustration 14.3 except that Peter plc acquired only 30million of the share capital of Sifau plc.

Suggested Solution 14.4

STEP 1
Determine the percentage acquired through the group structure

Peter plc acquired $\frac{30,000}{40,000} * \frac{100\%}{1} = 75\%$
In sifau plc

STEP 2

Consolidation schedule

Equity of Sifau plc				
	Total	Pre-acquisition	Post-acquisition	Non controlling interest
	₦'000	₦'000	₦'000	₦'000
share capital	40,000	30,000		10,000
Accumulated reserves	16,000	9,000 (1)	3,000 (2)	4,000 (3)
	56,000	39,000		
Cost of investment		(76,000)		
Goodwill		37,000		
Peter's reserves			32,000	
Consolidated reserves			35,000	
NCI				14,000

STEP 3
Prepare the consolidated Balance Sheet

PETER PLC Consolidated balance sheet as at 31dec.2008		
	₦'000	₦'000
Fixed assets		
Tangible		72,000
Intangible assets – goodwill		37,000
		109,000
Current assets	108,000	
Less current liabilities	48,000	
Net current assets		60,000
		169,000
Capital and reserves		
120million ordinary shares of ₦1 fully paid		120,000
Accumulated reserves		35,000
		155,000
Minority interest		14,000

		169,000
(a)pre-acquisition profit = ₦12,000(as given)x75%=		9,000
(b)post-acquisition profit= ₦ (16,000-12,000)x75%		3,000
(c)non controlling interest = ₦16,000x25%=		4,000
Total		16,000

3.5 Fair Value Adjustment

In calculating goodwill, fair values of the fixed assets are used rather than the book values. The revaluation difference is entirely a pre-acquisition reserve; if it is a surplus, the fixed assets account should be debited and the pre-acquisition reserve credited with the difference. On the other hand, if it is a deficit, the pre-acquisition reserve would be debited and fixed assets account credited.

The treatment recommended by SAS 26 is that both the group and non-controlling interest (NCI) share of revaluation difference should be accounted for.

Illustration 14.5

The facts are same as above (14.4) except that Peter acquired the share capital of Sifau plc on 1 Jan 2004. Freehold property, which was not depreciated, with a book value of ₦18million was estimated to have a fair value of ₦28million on 1january 2008. No adjustment has been made in the books of sifau plc.

Prepare the consolidated balance sheet of peter group.

Suggested Solution 14.5

STEP 1: shareholding (as in 14.4 step 1)
STEP 2: prepare the consolidation schedule taking into consideration the effect of revaluation reserves of sifau on goodwill.

Equity of sifau plc	Total	Pre-acquisition	Post-acquisition	NCI
	₦'000	₦'000	₦'000	₦'000
share capital	40,000	30,000		10,000
Accumulated reserves	16,000	9,000	3,000	4,000
Revaluation reserves	10,000	7,500		2,500
	66,000	46,500		
Cost of investment		76,000		
Goodwill		29,500		
Peter's reserves			32,000	
Consolidated reserves			35,000	
Non –controlling interest				16,500

STEP 3 – prepare the consolidated balance sheet:

PETER GROUP
CONSOLIDATED BALANCE SHEET AS AT 31 DECEMBER 2008

	₦'000	₦'000
Fixed assets–₦(40,000+32,000+10,000)		82,000
Goodwill		29,500
		11,500
Current assets	108,000	
Less: current liabilities	48,000	
Net current assets		60,000
		171,500
Capital and reserves		
Ordinary shares of ₦1 each fully paid		120,000
Accumulated reserves		35,000
		155,000
Non controlling interest		16,500
		171,500

3.5.1 Fair Value Adjustment and Depreciation

The enhanced depreciation on asset revaluation reserve is calculated from the date of acquisition to the accounting date. The value obtained is debited to the profit and loss account and credited to depreciation account.

Illustration 14.6

The facts are as in (14.5) except that the property is depreciated at 2% per annum. Calculate the accumulated reserve and the fixed assets to be included in the consolidated balance sheet.

Suggested Solution 14.6

	₦'000
Accumulated reserves	
Share of Sifau plc post- acquisition reserves (see 14.5)	3,000
Enhanced depreciation now written off 2/100 x ₦10,000	(200)
Add peter plc reserve	32,000
	34,800
Fixed assets	
As per	82,000
Less: enhanced depreciation on revaluation reserve	200
Consolidated amount	81,800

3.6 Inter-Company Items

3.6.1 Current Accounts

Inter-company transactions within a group are usually dealt with in current accounts maintained by the parent company and its subsidiaries.

At the year-end, the balances in these accounts may not agree owing to the existence of goods in transit and cash in transit.

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

(a) If the goods or cash are in transit between the parent company and the subsidiary, the adjusting entry should be made in the balance sheet of the parent company, no matter the direction of the transfer.
(b) If the items are in transit between fellow subsidiaries, the adjusting entry should be made in the books of the company to which the items are in transit; that is, recipient company.

Illustration 14.7

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

Book of hoo plc- account with sho plc	₦68,000
Book of sho plc- account with hoo plc	₦59,000

The difference is due to goods in transit from sho plc to hoo plc.

Explain the accounting treatment of the goods in transit.

Suggested Solution 14.7

Step 1: Adjustment for items in transit	₦	₦
Dr Stock in transit	9,000	
Cr Sho current account (in hoo balance sheet)		9,000

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

Step 3: include the stock in transit as part of the current assets in the consolidated balance sheet.

3.6.2 Inter-Company Debtors and Creditors

If current accounts are not maintained, inter-company indebtedness in the form of debtors and creditors must be cancelled for the purpose of consolidated balance sheet.

3.6.3 Bank Balances

Bank overdraft in any of the group companies should not be offset against favourable bank balances in the other group companies unless the banks have been given written authority to make such offset.

3.6.4 Unrealized Profit on Stock

Companies within the group normally supply goods and services to other members of the group at a profit to the supplying company in order not to prejudice the rights of the outside shareholders of those companies.

To the extent to which such goods are unsold at the end of the year, there will be some element of unrealized profit on the unsold stock, from the view point of the group as a whole.

Treatment: the element of the unrealized profits must be eliminated because a company cannot make a profit by trading with itself. The following treatments are recommended:

(a) For a wholly owned subsidiary company, the unrealized profit can be adjusted in the individual balance sheet of the parent company by

D r: Accumulated profits
Cr: Closing stock
In parent's company balance sheet

OR

D r: Consolidated reserves
Cr: Consolidated closing stock

(b) For partly owned subsidiary, SAS 27 recommends that the whole of the unrealized profit should be eliminated from the group's profit and stock, respectively.

In practice, this is interpreted as follows:

(1) That the sales from the parent company to the subsidiary will produce profit in the parent company's book. Consequently, the related unrealized profit should be eliminated in full from the group accounts as in (a) above.

(2) Sales from the subsidiary to the parent company will produce profit for the subsidiary. The unrealized profit on it should be shared between the group and minority in the proportion of their holdings.

Note:
(a) The unrealized profit may be given as a mark-up on cost or gross profit margin
(b) The statement of accounting policy on the treatment of unrealized profit on stock should be stated in the consolidated account.

Illustration 14.8

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

Calculate the unrealised profit on stock.

Suggested Solution 14.8

Price structure:

Cost	100%
Mark up	25%
Invoiced price	125%

Unrealised profit =25x ₦24,000
125
= ₦4,800

Illustration 14.9

The facts are as in 14.8 above except that the goods were invoiced at a gross profit margin of 25% to the subsidiary.

Suggested Solution 14.9

Invoiced price	100
Gross profit margin	25
	75

Unrealised profit = 25 * 24,000
100 = 6,000

Illustration 14.10

Given below are the balance sheets of panama plc and silo plc.

Balance sheet as at 31december 2008

	Panama plc	silo plc
	₦'000	₦'000
Net assets (other than stock)	88,000	64,000
Investment in silo plc	79,000	
Stock	20,000	16,000
	187,000	80,000
Ordinary share capital of ₦1 each	110,000	50,000
Revenue reserves	77,000	30,000
	187,000	80,000

Panama plc acquired 40million ordinary shares in silo plc when the revenue reserve of silo was ₦10million. During the year, silo made standard mark up of 50% on cost. At 31 December 2008, ₦12million of these goods remained in the stock of panama plc.

Prepare the consolidated balance sheet as at 31 dec 2008. It is the group policy to make allowance for the group's share and non controlling interest's share in unrealised profit.

Suggested Solution 14.10

Step I: group structure
Panama in silo 40 = 80%
50
NCI = 20%
100%

Step II: (a) adjustment for unrealised profit on stock
Cost = 100
Mark-up= 50
Invoiced price=150

Unrealised profit = $\frac{50}{150}$ X $\frac{₦12,000,000}{1}$ = ₦4,000,000

	₦'000	₦'000
(b) Dr. consolidated reserves (4000 X 80%)	3,200	
Non- controlling interest (4000 X 20%)	800	
Cr stock		4,000

Step III: prepare the consolidation schedule to calculate goodwill, consolidated revenue reserves and minority interest.

Equity in silo plc	Total	Pre-acquisition	Post-acquisition	NCI
	₦'000	₦'000	₦'000	₦'000
Ordinary shares	50,000	40,000		10,000
Revenue reserve	30,000	8,000	16,000	6,000
		48,000		
Cost of shares acquired		79,000		
Goodwill		31,000		
Panama's reserve			77,000	
Unrealised profit on stock			(3,200)	(800)
Consolidated revenue reserve			89,800	
Non controlling interest				15,200

Step IV: prepare the consolidated balance sheet.

Panama group
Consolidated balance sheet at 31december 2008

	₦'000
Goodwill	31,000
Net assets (other than stock)	152,000
Stock ₦(20,000+16,000-4,000)	32,000
	215,000
Ordinary shares of ₦1	110,000
Revenue shares	89,800
	199,800
Non controlling interest	15,200
	215,000

Statement of Accounting Policy

Stock: Allowance has been made for the whole of the unrealized profit on stocks of which the group and the non-controlling interest bear their own shares.

Illustration 14.11

The facts are as in (14.10) above except that the question was silent on the policy for unrealised profit on stock.

Suggested Solution 14.11

Step 1 as in (14.10) above

Step 2	(a)as in (14.10) above		
	(b)journal	₦'000	₦'000
Dr:	consolidated reserves	4,000	
Cr:	stock		4,000

Step 3 post- acquisition profit and NCI would change

	Post-acquisition	NCI
	₦'000	₦'000
Ordinary shares		10,000
Revenue reserve	16,000	6,000
Panama reserve	77,000	
Unrealised profit in stock	(4,000)	
Consolidated reserve	89,000	
Non-controlling interest		16,000

Step 4 in the consolidated balance sheet; replace revenue reserve and non- controlling interest with the amount obtained in step III.

Statement of Accounting Policy

Stock: allowance has been made by the group for the whole of the unrealised profit on stock

3.6.5 Inter-Company Sales of Fixed Assets

As with stock, adjustment should be made for unrealized profits. That is, the consolidated reserve must be debited and the fixed asset account credited with the unrealized profit on the assets transferred. The over-charge of depreciation arising from the unrealized profit must be removed by applying the rate of depreciation on the unrealized profit.

Illustration 14.12

Olu plc, sold a plant with a net book value of ₦60,000 to Ayo plc for ₦90,000. The policy of the group is to charge depreciation on plant at 10% on cost per annum.

Required: Calculate the amount to be included in the fixed asset account and depreciation account and show the journal entries.

Suggested Solution 14.12 ₦

Unrealised profit ₦(90,000 – 60,000)	30,000
Less: over –charged depreciation (10%)	3,000
	27,000

Journal

	Dr	Cr
	₦	₦
Depreciation account	3,000	

Reserves accounts	27,000	
Plant account		30,000

Being unrealised profit on sales of plants written off.

3.6.6 Preference Shares in Subsidiaries

The percentage of preference shares held by the parent company in the subsidiary does not determine the holding company/subsidiary relationship because they are not voting shares. The preference shares should be allocated between (that is, credited in) the cost of control account and the non-controlling interests. Any difference between the cost and nominal value of shares acquired will be reflected as goodwill on consolidation.

3.6.7 Loan Capital in Subsidiaries

Loan capital and debentures are irrelevant for the purpose of determining a parent company/subsidiary relationship. Where the parent company holds debenture or loan stock in the subsidiary, the nominal value held by it, shall be cancelled against the cost. Any differences between the cost of loan and its nominal value will be reflected as goodwill on consolidation. Discount is negative goodwill and premium is a positive goodwill.

The loan stock/debentures of subsidiaries held outside the group are disclosed in the consolidated balance sheet as part of the long term liabilities.

Loan interest of subsidiaries

In order to determine the profits available for appropriation, all interests' payable and receivable must be recorded by the companies within the group in their own books of account; before the results are allocated for the purpose of consolidation.

For consolidated balance sheet purposes, the inter company indebtedness on interest payable and receivable will be cancelled out. The interest payable to holders outside the group will be disclosed under current liabilities of the group.

In no circumstances should the nominal value of or accrued interest on loan capital held outside the group be shown as part of the non-controlling interest.

Illustration 14.13

James plc acquired 96million ₦1ordinary shares of ₦1each, 20 milllion of ₦1preference shares of ₦1each and ₦25million 10% debentures in flemming plc on 1january 2008.

Balance sheets as at 31 December 2008, were as follows:

	James plc	flemming plc
	₦'000	₦'000
Investment in flemming plc:		
96million ordinary shares at cost	130,000	
20million preference shares at cost	21,000	
₦25million debentures at cost	23,600	
Sundry net assets	385,400	360,000
	560,000	360,000

Ordinary shares ₦1each	400,000	120,000
8% preference shares	0	80,000
Retained profits	160,000	60,000
10% debenture	0	100,000
	560,000	360,000

James plc acquired its investment in flemming plc when the latter's reserves amounted to ₦24million. Provision is to be made for half-year interest on debenture. Dividends were proposed on ordinary shares as follows:

James plc – 10%
Flemming plc- 6%

Half year dividend is to be provided on preference shares.

You are required to prepare the consolidated balance sheet of James group as at 31december 2008.

Suggested Solution 14.13

Step 1 percentage holdings of James plc in flemming plc share capital and debenture:

Ordinary shares	preference shares	debenture
Group 96/120 = 80%	20/80 =25%	25/100 = 25%
NCI/liabilities 20%	75%	75%

Step 2 calculations of adjusted profits

	James plc	flemming plc
	₦'000	₦'000
As per draft balance sheet	160,000	60,000
Interest on debenture	0	(5,000)
Proposed dividend on ordinary shares	(40,000)	(7,200)
Preference dividend	0	(3,200)
Retained profit	120,000	44,600

	Total	group	current liabilities
	₦'000	₦'000	₦'000
Interest on debenture	5,000(25:75)	1,250	3,750
Dividend on ordinary shares	7,200(80:20)	5,760	1,440
Preference dividend	3,200(25:75)	800	2,400

Step 3 Consolidated Balance sheet schedule

flemming plc	Total	Pre-acquisition	Post-acquisition	NCI
	₦'000	₦'000	₦'000	₦'000
Ordinary shares	120,000	96,000		24,000
Preference shares	80,000	20,000		60,000
Retained profit (step ii)	44,600	19,200	16,480	8,920

Net assets acquired		135,200		
Cost of investments		151,000		
Goodwill		(15,800)		
Discount on debenture		1,400		
Consolidated goodwill		(14,400)		
Add James' retained profit (step ii)			127,810	
Group retained profit			144,290	______
Non controlling interest				92,920

Step 4 Cost of investments in flemming plc

	₦'000
In ordinary shares	130,000
In preference shares	21,000
	151,000
Discount on debenture ₦(25,000- 23,600)	1,400

Step 5 Consolidated Balance Sheet as at 31 December 2008

	₦'000	₦'000
Intangible assets- goodwill		14,400
Sundry net tangible assets		745,400
Less: current liabilities		
Proposed dividend on:		
Ordinary shares ₦(40,000+1,440)	41,440	
Preference dividend	2,400	
Interest payable	3,750	
		(47,590)
Tangible assets, less current liabilities		712,210
Financed by:		
Ordinary share capital of ₦1 each		400,000
Retained profit		144,290
		544,290
Non controlling interest		92,920
		637,210
10% debenture		75,000
		712,210

Treatment of intra-group dividends in the consolidated balance sheet

Where the parent company does not hold 100% of the equity share capital, only part of the dividends paid or payable by the subsidiary will be received or receivable by the parent company. These transactions in the individual accounts of the group members should be adjusted for in the consolidated balance sheet depending on the following circumstances.

(a) Dividends are paid/payable out of the post-acquisition profits of the subsidiary and
   (i) have been accounted for by the parent company
   (ii) have not been accounted for by the parent company

(b) Dividends are paid/payable out of the pre-acquisition profits of the subsidiary and
   (1) have been accounted for by the parent company

(2) have not been accounted for by the parent company

In the case of a (ii above), the parent company has credited its share of dividends received or receivable to its individual accounts. The debtors of the parent Company will contain the relevant amount receivable from the Subsidiary, if it is dividend receivable.

In this circumstance, the debtors' account of the parent company offsets the proposed dividend account of the subsidiary leaving the dividend payable to third parties. This dividend payable to third parties is shown separately as part of the current liabilities.

In the case where the dividends have been paid, no further adjustments are required in the accounts of the parent company.

Illustration 14.14

Kudi plc acquired 80% of the ordinary share capital of owo plc some years ago, when the reserves of the latter was Treatment of intra-group dividends in the consolidated balance sheet ₦60million. The balance sheets of the two companies at 31 December 2008, are given below.

	Kudi plc	owo plc
	₦m	₦m
Investments in owo plc	220	
Assets (excluding debtors)	280	320
Debtors	100	80
	600	400
Ordinary share capital	300	200
Reserves	150	90
	450	290
Current liabilities:		
Creditors	80	70
Proposed dividends	70	40
	600	400

Kudi plc has included the dividend receivable in its accounts.

Prepare the consolidated balance sheet of kudi plc and its subsidiary as at 31 December 2008

Suggested Solution 14.14

Step 1 determines the dividend receivable by kudi plc that has been included in its debtors and reserves.

	₦'m	
Dividend payable by owo plc	40	
Receivable included in debtors (80% X 40m)		(32)
Payable to outside parties	8	

Step 2 Adjustment for debtors in the balance sheet

Debtors in kudi plc	100
Debtors in owo plc	80
Dividends receivable included in debtors	(32)

Debtors consolidated	148

Step 3 consolidated balance sheet schedule.

	Subsidiary	pre-acquisition	post-acquisition	minority
	₦'m	₦'m	₦'m	₦'m
Ordinary shares	200	160		40
Reserves	90	48	24	18
		208		
Cost of investment		220		
Goodwill		12		
Add kudi plc reserves			150	
Consolidated reserves			174	
Non-controlling interest				58

Step 4 consolidated balance sheet of kudi group as at 31 December 2008

	₦'m	₦'m
Goodwill		12
Assets (exclusive of debtors)		600
Debtors (step ii)		148
		760
Current liabilities:		
Creditors	150	
Dividends payable:		
Kudi plc shareholders	70	
Minority shareholders (step 1)	8	(228)
		532
Capital and reserves		
Ordinary share capital ₦1 per share		300
Accumulated reserves		174
		474
Non controlling interest		58
		532

(ii) Where dividends are paid out of post-acquisition profits and the parent has not yet recognised its own share of dividends, the financial statements of the parent would be adjusted before proceeding with the consolidation.

The necessary adjustment in the above circumstance is to:
Dr Debtors
Cr reserves

ILLUSTRATION 14.15
The facts are as in illustration 14.14 except that kudi plc has not accounted for its share of dividend receivable in owo plc.

SUGGESTED SOLUTION 14.15
Step I: adjustment for kudi reserves

	₦'m
As per draft balance sheet	150
Add dividend receivable from owo plc	32

	182

Step II Debtors account

Kudi plc ₦ (100+32) million	132
Owo plc	80
Dividends included in debtors	(32)
	180

Step III only the post-acquisition reserves would be affected in the consolidated schedule thus ₦m (24+182-12) = ₦ 194m

Step IV consolidated balance sheet as at 31 December 2008

	₦'m
Net assets (excluding debtors)	600
Debtors	180
	780
Current liabilities	(228)
	552
Ordinary shares	300
Reserves (step 111)	194
	494
Non controlling interest	58
	552

B. Dividend received by the parent from the pre-acquisition profit of the subsidiary is a realization of part of the asset acquired in the subsidiary; hence this dividend must be deducted from the cost of investment;

(i) If the dividend received by the parent has been credited to the reserves (debited in the cash account), the following adjustment will be made.

Debit: reserves of the parent company
Credit: Cost of Investment.

Illustration 14.16

Given below are the balance sheets of P and S both public limited liability companies as at 31december 2008.

	P	S
	₦'m	₦'m
Fixed assets	800	500
Cost of investment in S	290	-
Current assets	184	125
Current liabilities:		
Trade creditors	(68)	(85)
	1,206	540
Ordinary share capital	722	250
Reserves	484	290
	1,206	540

On 1st Jan 2008, P acquired 70% of the ordinary share capital of S. The reserve of S at this date was 100 million naira. In March 2008, S paid a dividend of ₦50million from this profit. P has credited its share of dividend to profit and loss account. No dividends have been paid nor proposed on the profits for the year ended 31 December 2008.

You are required to prepare the consolidated balance sheet of P group as at 31 December 2008.

Suggested Solution 14.16

Step I adjust the cost of investment as follows

		₦'m
As per draft balance sheet		290
Less: dividends received from pre-acquisition profits		35
Adjusted cost of share	355	

Pre-acquisition profit would be ₦'m (100-50) = ₦50m

Step II post acquisition profit of P

As per draft	484
Less: dividends received from pre-acquisition profit	35
	449

Step III consolidation schedule

subsidiary	Total	Pre-acquisition	Post-acquisition	NCI
	₦'m	₦'m	₦'m	₦'m
Ordinary shares	250	175		75
Reserves	290	35	168	87
		210		
Cost of investments(step 1)		225		
Goodwill		(45)		
Add P reserves (step II)			449	
Consolidated reserves			617	
Non controlling interest				162

Step IV consolidated balance sheet as at 31 December 2008

	₦'m		₦'m
Fixed assets (P+S)			1,300
Goodwill (step III)			45
Current assets (P+S)	309		
Current liabilities (P+S)	(153)		
Net current assets			156
			1,501
Ordinary share		722	
Reserves (step III)			617

	1,339
Non controlling interest (step III)	162
	1,501

(ii) If dividends are proposed out of pre-acquisition profit of the subsidiary but the parent had not accounted for its own share, the adjustment required is to:

Debit: debtors account
Credit: cost of investment account

3.7 Acquisition of a Subsidiary during the Year

When a parent company acquires a subsidiary during the year under review, it is necessary to apportion the retained profit for the year between pre-acquisition and post-acquisition profit. In order to apportion profit between these periods, income is deemed to accrue evenly during the year.

The pre-acquisition profit so determined would be added to the accumulated profits brought forward at the beginning of the period under review.

Illustration 14.17

Insight limited acquired all the ordinary share capital of Asa ltd on 1 march 2008. The profit brought forward in the books of Asa ltd on 10 October 2007 was ₦288,000, while the loss for the year ended 30 September 2008 was ₦600,000. Calculate the pre-acquisition profit of Asa ltd for the purpose of preparing consolidated balance sheet at 30 September 2008. Enquiries indicate that profit and loss accrued evenly throughout the year.

Suggested Solution 14.17

Step 1: divide the accounting period between pre-acquisition and post acquisition periods, from 1 October 2007 to 1 march 2008, is 5months pre-acquisition and 1 march 2008 to 30 September 2008, is 7mths post-acquisition.

Step 2: determine the profit/loss for the year between pre and post acquisition period.

Pre-acquisition = $\frac{5 \times 600,000}{12}$

= ₦250,000 loss

Post acquisition = $\frac{7 * 600,000}{12}$

= ₦350,000 loss

Step 3: determine the pre-acquisition profits or loss of Asa ltd

Accumulated profits on 1/10/2007	288,000	
Pre-acquisition loss for the year	(250,000)	
Pre-acquisition loss of Asa ltd		38,000

3.8 Piecemeal Acquistion

It is possible that a parent company did not acquire the whole of the equity shares in a subsidiary on the same date but that the shares are acquired in bits (piecemeal) at different dates. The investing company may not become a parent company until the second or third series of acquisition.

Approach:

(a) The intention of the parent company will be taken into account right at the first acquisition, whether it intends to gain control later. The investing company does not gain control until it has acquired 50% equity, as earlier stated.

(b) If each purchase is substantial, and it is the intention of the parent company to gain ultimate control, the pre-acquisition reserves should be calculated by reference to the proportion of shares purchased related to the balance on the reserve account at the date of each purchase.

Acquisition of 20% of the equity capital of the company is regarded as substantial and it is therefore presumed that the acquiring company w ill gain control.

(c) If the parent company does not intend to gain control, the pre-acquisition profit is calculated where control is eventually gained. No post-acquisition profits would be attributed to the group until control has been gained.

(d) Dividends received before control is gained would be credited to the investing company's profit and loss account as normal income.

Illustration 14.18

Balance sheet of Harold ltd and Sule ltd at 31 December 2008

	Harold ltd	sule ltd
	₦	₦
Net assets	645,000	500,000
Ordinary share capital of ₦1 per share	420,000	400,000
Retained profits	225,000	100,000
	645,000	500,000

Note: the shares in Sule ltd were acquired in two stages by Harold ltd, 100,000 ordinary shares at ₦1.25 per share were acquired on 1 Jan 2005, when the retained profits of sule ltd totalled ₦25,000 and 200,000 ordinary shares at ₦1.75 per share were acquired on 15 February 2007 when the retained profits of Sule ltd totalled ₦75,000.

You are required to determine the:
(i) Non controlling interest
(ii) Goodwill on consolidation
(iii) Profit and loss account balances to be included in consolidated balance sheet

Assume (a) that the parent company intends to gain control from the first acquisition
(b) That the parent company did not intend to gain control initially

Suggested Solution 14.18

Assumption (a) consolidation schedule:

	Total	Pre-acquisition		Post-acquisition	NCI
	₦	₦	₦	₦	₦
Sule ltd		2005	2007		
		25%	50%		0
Ordinary shares	400,000	100,000	200,000		100,000
Retained profit	100,000	6,250	37,500	31,250	25,000
Net assets acquired		106,250	237,500		
Cost of investment		125,000	350,000		
Goodwill		(18,750)	(112,500)	-	
Transfer		18,750	(18,750)	-	
Consolidated goodwill			131,250		_______
Non-controlling interest					125,000
Add: Harold retained profit				225,000	
Consolidated retained profits				256,250	

Step 1: since Harold did not intend to gain control initially, pre-acquisition profit for the purpose of determining goodwill would not be computed until Harold plc acquired more than 50% holding.

I.e. 25%+50% = 75%

Step 2 prepare the consolidation schedule:

	Sule ltd	Pre-acquisition 75%	Post-acquisition	NCI
	₦	₦	₦	₦
Ordinary shares	400,000	300,000		100,000
Retained profit	100,000	56,250	18,750	25,000
Net assets acquired		356,250		
Less: cost of investment		475,000		
Goodwill		118,750		_______
Non controlling interests				125,000
Add: Harold retained profit			225,000	
Consolidated retained profit			243,750	

Note: the goodwill and retained profits under the two alternative methods differ.

3.9 Fellow Subsidiaries

A company may acquire majority equity share capital in more than one company such that those other companies are its subsidiaries but are not one another's subsidiaries.

The goodwill acquired from each subsidiary would be aggregated to a single figure for consolidation.

Illustration 14.19

P ltd acquired 70% of the ordinary shares of S ltd two years ago for ₦250,000 when the reserves of S ltd were ₦100,000. On the same day, P ltd acquired 80% of the ordinary shares and 20% of the preference shares of S ltd and paid ₦380,000 for ordinary shares and ₦56,000 for preference shares. On this date, the balance on the reserve account of R ltd was ₦150,000. The balance sheet of the three companies as at 31 December 2007 is given below:

	P ltd	S ltd	R ltd
	₦ '000	₦ '000	₦ '000
Net assets	246	350	800
Investment in S ltd at cost	250		
Investment in R ltd at cost	436	____	____
	932	350	800
Preference share capital	200	100	200
Ordinary share capital	380	120	400
Profit and loss account	352	130	200
	932	350	800

You are required to prepare the consolidated balance sheet of P group as at 31 December 2007.

Suggested Solution 14.19

Step 1: prepare separate columns in the schedule for S ltd and R ltd.

Consolidation schedule

Subsidiaries		Pre-acquisition		Post-acquisition	NCI
	Total	S ltd	R ltd	-	-
S Ltd	₦ '000	₦ '000	₦ '000	₦ '000	₦ '000
Preference shares	100				100
Ordinary shares	120	84			36
Profit and loss	130	70		21	39
Net assets acquired		154			
Cost of investment		(250)			
Goodwill		(96)			
R Ltd					
Preference shares	200		40		160
Ordinary shares	400		320		80
Profit and loss account	200		120	40	40
Net assets acquired			480		
Cost of investment			(436)		
Negative goodwill			44		
Transfer S Ltd goodwill			(96)		
Consolidated goodwill			(52)		____

Non-controlling interest					455
Add: P profit				352	
Consolidated profit & loss				413	

Step 2: consolidated balance sheet of P group as at 31 December, 2007

	₦ '000
Net assets	1,396
Goodwill	52
	1,448
Financed by	
Ordinary share capital	380
Preference share capital	200
Profit and loss account	413
	993
Non controlling interest	455
	1,448

3.10 Vertical Group

A parent company may exercise indirect control over a subsidiary through a subsidiary on which it exercises direct control. The subsidiary on which it exercises the indirect control is called a sub-subsidiary.

Illustration 14.20

Cacao plc acquired 80% ordinary shares in Pod plc few years ago and Pod plc acquired 60% of the ordinary shares of Cook plc the same year. Show the group structure:

Group structure
Cacao plc
80%
Pod plc
60%
Cook plc

Conclusion
Cacao plc exercises control over Pod plc
Pod plc exercises control over Cook plc
Therefore, Cacao exercises indirect control over Cook plc

Consolidation procedure
Any of these two methods can be adopted to consolidate the result of the group members
Two stages/indirect method
One stage/direct method

TWO STAGE/INDIRECT METHOD

(a) Under this, the sub-subsidiary will first be consolidated with the subsidiary. The goodwill acquired by subsidiary in the sub-subsidiary will be calculated. The reserves of the subsidiary will be added to the share of post-acquisition reserves of sub-subsidiary. This amount would be cancelled through the pre-acquisition period, post-acquisition period and non-controlling interest in stage 'b'.

(b) The subsidiary and the parent company will then be consolidated. The goodwill acquired by the parent in the subsidiary would be obtained. The goodwill calculated for sub-subsidiary in 'a' above will be shared between pre-acquisition and non-controlling interest in the ratio of ordinary shares held by the parent in the subsidiary.

THE ONE-STAGE METHOD

(a) Under this method, the effective percentage of the shares held by the parent company and non-controlling interest in the sub-subsidiary will be calculated.

  (i) To obtain the goodwill, post-acquisition reserve and non-controlling interest, (these percentages will be applied into the share capital and reserves of the sub-subsidiary).

  (ii) To obtain the goodwill, the cost of shares acquired by the subsidiary in the sub-subsidiary will be shared between the pre-acquisition and non-controlling interest in the ratio of the shares held in the subsidiary by the parent company.

(b) The subsidiary will be consolidated in the group in the usual manner. The application of the methods is now demonstrated with an illustration.

Illustration 14.21

The balance sheets of P, S, and R at 31/12/2007

	P	S	R		P	S	R
	₦ '000	₦ '000	₦ '000		₦ '000	₦ '000	₦ '000
₦1 ordinary shares	1,500	600	300	Net assets	1,400	714	420
Profit and loss a/c	600	390	120	Investment at cost	660	276	____
	2,100	990	420		2,100	990	420

P acquired 80% of the ordinary share capital of S in year 2004, for ₦ 660,000, when the profit and loss account balance was ₦ 120,000 and S acquired 60% of the ordinary share capital of R in the year 2005, for ₦ 186,000, when the profit and loss account balance was ₦60,000.

You are required to prepare the consolidated balance sheet of P group as at 31 December 2007.

Suggested Solution 14.21

1st method

Step 1: group structure

		Group	NCI
80%	P in S	80%	20%
60%	S in R	60%	40%

Step 2: consolidate subsidiary with sub-subsidiary

Consolidation schedule

subsidiaries	Pre-acquisition		Post -acquisition	NCI
R ₦ '000	R 60%	S 80%	₦ '000	₦ '000
Ordinary shares 300	180			120
Profit and loss 120	36		36	48
	216			
Cost of shares	(186)			
Negative goodwill	30			
Add S reserves			390	___
			426	168

Step 3: consolidate S with P

Consolidation schedule

	Pre-acquisition		Post -acquisition	NCI
Subsidiaries ₦ '000	R	S		
S = 80%	₦ '000	₦ '000	₦ '000	₦ '000
Ordinary shares 600		480		120.0
Profit and loss (see step III) 426		96	244.8	85.2
		576		
Cost of shares acquired		(660)		
Goodwill		(84)		
Share of negative goodwill	80%:20%	24		6.0
Consolidated goodwill		60.0		
Add P reserve			600.0	
Consolidated reserve			844.8	
Add minority interest in R				168.0
Non- controlling interest				379.2

2nd method

Step 1: group structure

		Group	MI
P			
	80% P IN S	80%	20%
S			
	60% 9 IN S (indirect)	48%	52%
R			

Note: even though the indirect holding of P in R is less than 51%, R remains a subsidiary of P because S is a subsidiary of P and R is a subsidiary of S and P exercises indirect control over R.

Step 2: prepare the consolidation schedule

consolidation schedule				
Subsidiaries ₦ '000	Pre-acquisition		Post -acquisition	NCI
R =48%	₦ '000	₦ '000	₦ '000	₦ '000
Ordinary shares 300	144.0		156.0	
Profit and loss 200	28.8	28.8	62.4	
A = 80%				
Ordinary shares 600	480.0		120.0	
Profit loss 90	96.0	216.0	78.0	
	748.8			
Cost of investment (step 3)	(808.8)		(37.2)	
Goodwill	60.0			
Add P reserve			600	
Consolidated profit			844.8	
Non-controlling interest				379.2

Step 3:
(a) Cost of investment

		Group	MI
	₦ '000	₦ '000	₦ '000
P IN S direct		660.0	
Profit and loss a/c (80%:20%)	186	148.8	37.2
total		808.8	37.2

(b) Reconcile the cost of investment in the draft balance sheet to the one in the note

	₦ '000	₦ '000
As per draft		660
P cost of investment		276
S cost of investment		936
As per note:	₦ (660+186)	846
The difference is ordinary investment		90

Step 4: prepare the consolidated balance sheet

P Group
Consolidated balance sheet as at 31 December 2008

	₦ '000
Net assets	2,574
Investment (step 3b)	90
Goodwill	60
	2,724

Financed by:	
Ordinary shares	1,500
Profit and loss account	844.8
	2,344.8
Non controlling interest	379.2
	2,724.0

3.11 Mixed Group

Direct and indirect shareholdings in sub-subsidiary.

We shall use the two methods to consolidate a group balance sheet where the parent company owns shares directly by itself and indirectly through the subsidiary in the sub-subsidiaries.

Illustration 14.22

The balance sheets of P, S and R at 31 December 2008

	P	S	R		P	S	R
	₦ ‘000	₦ ‘000	₦ ‘000		₦ ‘000	₦ ‘000	₦ ‘000
₦1 ordinary shares	1,500	600	300	Net assets	1,400	714	420
Profit and loss a/c	600	300	120	Investment at cost	660	186	___
	2,100	900	420		2,100	990	420

Notes:

1. P acquired 80% of the ordinary share capital of S for ₦570,000 and 20% of the ordinary share capital of R for ₦90,000, when the profit and loss account balances of S and R were ₦120,000 and ₦60,000 respectively in year 2008.

2. S acquired 60% of the ordinary shares of R for ₦186,000 in 2006 when the profit and loss account balance of R was ₦60,000.

You are required to prepare the consolidated balance sheet of P group as at 31 Dec 2008.

Suggested Solution 14.22

Step 1:

		Group	NCI
	P in S direct	80%	20%
80%	P in R direct	20%	20%
60%	S in R	60%	
	Total	80%	20%

Step 2: determine R pre-acquisition profits to be off-set against cost of control account.

P in S	year	2007
S in R	year	2006

S had acquired shares in R before P acquired shares in S. P will not start to consolidate the sub-subsidiary until year 2007. Therefore, the relevant pre-acquisition reserve of R in P group is ₦60,000.

Step 3: prepare the consolidated schedule of group
First method

Consolidated schedule

			Pre-acquisition		Post-acquisition		NCI
Subsidiary R	₦ '000	S in R 60% ₦ '000	P in R 20% ₦ '000	P in S 80% ₦ '000	P ₦ '000	S ₦ '000	₦ '000
Ordinary shares	300	180	60				60.0
Profit and loss account	120	36	12		12	36	24.0
S							
Ordinary shares	600			480			120.0
Profit and loss account	300			96	144		60.0
Transfer S post-acq.	_____	_____	_____	_____	28.8	(36)	7.2
		216	72	576	184.8		271.2
Cost of acquisition		186	90	570			
Goodwill		30	18	6			
Share of S in R							
Negative goodwill (30)			24				6
Transfer H in S goodwill				(18)			
Consolidated negative goodwill			12				
Transfer of negative goodwill			(12)	12			_____
Non controlling interest							277.2
Add P's profits				600.0			
Consolidated profits				796.8			

Tutorial notes

(a) The share capital of R was shared between P,S and non controlling interest in ration 20%:60% and 20% respectively.

(b) The profit and loss of R was shared as follows:

Pre-acquisition:
S in R = ₦60,000 x 60% = 36,000
P in S = ₦60,000 x 20% = 12,000

Post-acquisition:
P = ₦(120,000- 60,000) x 20% = 12,000
S = ₦(120,000 – 60,000) x 60% = 36,000

Non controlling interest
₦120,000 x 20% = 24,000

(c) Since we are consolidating P group, S post-acquisition profits should be shared between P and non-controlling interest in ratio 80% and 20%.

i.e. P= ₦36,000 x 80% = 28,800
S= ₦36,000 x 20% = 7,200
36,000

4. The negative goodwill of S in R must be shared between the group and non-controlling interest in ratio 80% and 20%.

That is: to group= 80% x ₦30,000= 24,000
Non controlling interest= 20% x ₦30,000= 6,000
30,000

Method two
Using this direct method could be less complicated than the first indirect method.
Step 1: group structure

	Group	NCI
P IN S (direct)	80%	20%
P IN R (direct)	20%	
P IN R(indirect)80% x 60%	48%	
Total	68%	32%

Step 2:

consolidation schedule				
Subsidiaries	₦ '000	Pre-acquisition	Post -acquisition	NCI
R =68%		₦ '000	₦ '000	₦ '000
Ordinary shares	300	204.0		96.0
Profit and loss	120	40.8	40.8	38.4
S = 80%				
Ordinary shares	600	480.0		120.0
Profit loss	300	96.0	144.0	60.0
		820.8		
Cost of investment (step 3)		(808.8)		(37.2)
Negative Goodwill			12.0	
Add P's reserve			600.0	
Consolidated profit			796.8	
Non-controlling interest				277.2

Step 3: cost of investment

		Group	Non controlling interest
	₦ '000	₦ '000	₦ '000
P IN S direct		570.0	-

P IN R-direct		90.0	
P IN R-indirect (80%:20%)	186.0	148.8	37.2
Total		808.8	37.2

Step 4: reconcile the cost of investment in the note with the draft balance

Sheet figures	₦ '000	₦ '000
P cost of investment		660
R cost of investment		186
Total		846
P cost of investment in S	570	
P cost of investment in R	90	
S cost of investment in R	186	(846)
P cost of investment in R		NIL

Step 5:

P group
Consolidated balance sheet as at 31 December 2008

	₦ '000
Net assets	2,574
Financed by:	
Ordinary share capital	1,500.0
Profit and loss account	769.8
	2,296.8
Non controlling interest	2,77.2
	2,574.0

Tutorial notes:

(1) Steps 4 and 5 are common to both methods.

(2) The direct method appears to be easier for consolidating mixed groups and that is the method usually adopted in solving examination questions.

3.12 Rights Issues by a Subsidiary Company

The parent company will take up its share of rights in its subsidiary company. The number of shares will change but the percentage held by the parent company in relation to the total will not change. The rights issue might be made at a premium. This share premium is regarded as pre-acquisition from the parent's point of view since the value has existed before the date of the rights.

3.13 Bonus Issues by a Subsidiary Company

The treatment accorded to the issue of bonus shares by a subsidiary depends on whether it is made from pre-acquisition profits or post-acquisition reserves.

(a) Bonus issues made out of pre-acquisition reserves

Where the necessary adjustments have not been made in the books, the necessary adjustments should be as follows:

- Debit the subsidiary's reserves and
- Credit the subsidiary's share capital with the amount of scrip issue

The goodwill and consolidation reserves will be the same before and after the bonus shares were made from pre-acquisition reserves.

(b) Bonus paid out of post-acquisition reserves

Where the bonus is paid from capital reserves, no adjustment is needed for group account purpose. However, if the bonus is paid out of revenue reserves, group distributable reserves will be affected. The post-acquisition reserves would reduce by the amount of bonus issue while the ordinary share capital will increase by corresponding amount.

Self Assessment Exercises

1. P owns 60% of S and 25% of R. S owns 35% of R. R is a subsidiary of **______**
2. What do you understand by the term consolidated balance sheet.

4.0 CONCLUSION

There are a lot of intricacies associated with balance sheet consolidation and as such, it is necessary that we know to apply the basic principles and procedures involved in balance sheet consolidation.

5.0 SUMMARY

This unit treated in-depth the mechanics of consolidating balance sheets in business combinations, highlighting items that should not appear in the consolidated balance sheet and explaining the adjustments required to eliminate them.

In this next unit, we shall discuss consolidated profit and loss account.

6.0 TUTOR-MARKED ASSIGNMENT

1. A subsidiary's fixed assets were re-valued at a surplus on the date it was acquired by the parent company. What will be the effect of this surplus on pre-acquisition profits and post-acquisition profits of the subsidiary?

2. Judith plc acquired 85% of the six million ₦1 ordinary shares of Tolu plc on 30th June 2008 for ₦7.2million. Tolu plc paid a dividend of 10% from a profit of ₦3million for the year ended 30 September 2008.

7.0 REFERENCES/FURTHER READINGS

Adapted from the ICAN Study Packs (2011)

UNIT THREE CONSOLIDATED PROFIT AND LOSS ACCOUNT

CONTENTS

1.0 INTRODUCTION

In the last unit, we treated in-depth the mechanics of consolidating balance sheets in business combinations, highlighting items that should not appear in the consolidated balance sheet and explaining the adjustments required to eliminate them.

In this unit, we shall discuss consolidated profit and loss account.

2.0 OBJECTIVES

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

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

3.0 MAIN CONTENT

3.1 Consolidation Procedures

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

The law exempts the parent company from presenting its own profit and loss account together with the group profit and loss account provided the consolidated profit and loss account contains a note stating how much of the consolidated profit is dealt with in the accounts of the parent company.

3.2 Format of the Consolidated Profit and Loss Account

In general, the format of the consolidated profit and loss account is the same as the individual company accounts.

The consolidated profit and loss account for the year is divided into the following parts:

(1) Turnover less cost of sales of companies in the group after excluding inter-company sales and purchases.

(2) The operating expenses of the companies in the group. Unrealized profit on group sales still held in stock and fixed assets should be eliminated.

(3) Profit (or loss) on ordinary activities before tax for the year by companies in the group.

(4) Taxation on ordinary activities for the year by companies in the group.

(5) Non-controlling interest, where the parent company did not acquire 100% equity interest in the subsidiary.

(6) Extra-ordinary items, only the group share less the related tax should be consolidated.

(7) Appropriation of profits: This includes dividends of the parent company only and transfer to reserves.

(8) Retained profit brought forward: only the post-acquisition profits of the subsidiary should be consolidated with the profit of the parent company.

(9) Retained profit carried forward: This is the addition of the retained profit for the year and the retained profits brought forward.

3.2.1 Format

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

Turnover		X
Cost of sales	(X)	
Gross profit	X	
Distribution cost	(X)	
Administration costs /and any impairment loss	(X)	
Profit from main business		X
Other operating income	X	
Other interest receivable and similar income	X	
Interest payable and similar charges	(X)	
Profit on ordinary activities before tax		X

Taxation	(X)	
Profit on ordinary activities after tax		X
Non-controlling interest	(X)	
Profit before extra ordinary items attributable to group members	X	
Extra ordinary profit / (loss)	X	
Profit/(Loss) for the year	X	
Appropriations:	(X)	
Retained profits for the year	X	
Retained profits brought forward	X	
Retained profits carried forward		X

Notes:

i. Of the group profit for the financial year, ₦x has been dealt with in the accounts of the parent company.

ii. Profit on ordinary activities before taxation is stated after charging the following:

	₦
Depreciation on fixed assets	x
Auditors' remuneration and fees	x
Directors' emoluments	x

iii. The figures for extra-ordinary items and tax thereon are made up of all the parent company's extra-ordinary items and the group share of the subsidiaries extra-ordinary amounts.

iv. Movement on Reserves

	The group	the parent company
	₦	₦
Retained profit b/f	x	x
Retained profit for the year	x	x
Retained profit c/f	x	x

Illustration 15.1

The draft profit and loss accounts of Joe plc and Abe plc for the year ended 31 December 2008 were as follows:

	Joe plc	Abe plc
	₦ '000	₦ '000
Sales revenue	12,000	8,000
Cost of sales	(5,000)	(3,000)
Gross profit	7,000	5,000
Operating expenses	(2,250)	(1,450)
Profit before tax	4,750	3,550
Taxation	(1,000)	(800)
Profit after tax	3,750	2,750
Retained profit b/f	7,000	3,750
Retained profit c/f	10,750	6,500

Joe plc acquired the entire ordinary share capital of Abe plc when Abe plc was incorporated. Prepare the consolidated profit and loss a/c for the year ended 31 December 2008.

Suggested Solution 15.1

Since it is a 100% acquisition, there is no inter-company transactions, simply add similar items in the profit and loss of parent and subsidiary company.

Consolidated Profit and Loss Account
for the year ended 31 December 2008

	₦ '000
Turnover	20,000
Cost of sales	(8,000)
Gross profit	12,000
Operating expenses	(3,700)
Profit before tax	8,300
Taxation	(1,800)
Profit after tax	6,500
Retained profit b/f	10,750
Retained profit c/f	17,250

Movement of reserves

	The group	the parent company
	₦ '000	₦ '000
Retained profit 1 Jan 2008	10,750	7,000
Retained profit for the year	6,500	3,750
Retained profit c/f	17,250	10,750

3.3 Cancellation of Intra-Group Transaction and Non-Controlling Interest

3.3.1 Inter-company dividends

Investment income receivable by the parent company would be cancelled against dividend payable by the subsidiary.

Illustration 15.2

The facts are the same as in illustration 15.1 above, except both companies proposed dividends

	Joe plc	Abe plc
	₦ '000	₦ '000
Profit after tax (as in 15.1)	3,750	2,750
Proposed dividends	(1,200)	(1,000)
Retained profit for the year	2,550	1,750
Retained profit b/f	7,000	3,750
Retained profit c/f	9,550	5,500

Suggested Solution 15.2

Step 1: Investment income receivable by Joe

	₦ '000	₦ '000
Journal entry		
Dr. Inv. Income receivable		
Account (100% x 1,000):	1,000	

Cr. Profit and loss a/c of Joe 1,000

Step 2: Consolidation schedule

	Joe plc	Abe plc	consolidation
	₦ '000	₦ '000	₦ '000
Turnover	12,000	8,000	20,000
Cost of sales	(5,000)	(3,000)	(8,000)
Gross profit	7,000	5,000	12,000
Operating expenses	(2,250)	(1,450)	(3,700)
Profit before tax	4,750	3,550	8,300
Taxation	(1,000)	(800)	(1,800)
Profit after tax	3,750	2,750	6,500
Adjustment for Inter-company dividends	1,000	(1,000)	
Profit attributable to Group members	4,750	1,750	6,500
Proposed dividend	(1,200)	-	(1,200)
Retained profit for the year	5,950	1,750	8,700
Retained profit b/f	7,000	3,750	10,750
Retained profit c/f	12,950	5,500	19,450

3.4 Ownership of less than 100% Equity Interest in a Subsidiary

It is necessary to consider a situation where the parent company does not own the entire ordinary share capital in the subsidiary and the profits of the subsidiary brought forward at the beginning of the period is not entirely post acquisition.

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

The following illustration will explain it better.

Illustration 15.3

Tolu plc and Ife plc
Profit and loss Account
for the year ended 31 December 2007

	Tolu plc	Ife plc
	₦ '000	₦ '000
Turnover	50,000	14,500
Cost of sales	20,000	5,000
Gross profit	30,000	9,500
Admin expenses	(8,000)	(1,200)
	22,000	8,300
Income from shares in group company	3,600	
Profit before tax	25,600	8,300
Taxation	(3,400)	(600)
Profit after tax	22,000	7,700

Dividends	(8,000)	(4,500)
Retained profit for the year	14,200	3,200
Retained profit b/f	8,000	1,000
Retained profit c/f	22,200	4,200

Tolu plc acquired 80% of the ordinary share capital of Ife plc when the reserve of Ife plc was ₦ 600,000. You are required to prepare the consolidated profit and loss account of Tolu group for the year ended 31 December 2007.

Suggested Solution 15.3

Step 1: reconcile the inter group dividend	₦ '000
Dividend receivable by Tolu group as per draft	3,600
Should agree with ₦ 4,500,000 x 80%	3,600

Step 2: Consolidation schedule

	Tolu plc	Ife plc	consolidation
	₦ '000	₦ '000	₦ '000
Turnover	50,000	14,500	64,500
Cost of sales	(20,000)	(5,000)	(25,000)
Gross profit	30,000	9,500	39,500
Admin expenses	(8,000)	(1,200)	(9,200)
Profit before tax	22,000	8,300	30,300
Taxation	(3,400)	(600)	(4,000)
Profit after tax	18,600	7,700	26,300
Non controlling interest (20%)	-	(1,540)	(1,540)
Inter-company dividend	3,600	(3,600)	
Group profit for the year	22,200	2,560	24,760
Proposed dividends	(8,000)	-	(8,000)
Retained profit for the year	14,200	2,560	16,760
Retained profit b/f	8,000	320	8,320
Retained profit c/f	22,200	2,880	25,080

Step 3: the retained profit brought forward for consolidation for Ife plc is arrived at as follows:

	₦ '000
Profit b/f as per draft	1,000
Pre-acquisition profit (on date of acquisition)	(600)
Post acquisition	400
Apply 80% to it	320

Step 4:

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

	₦ '000
Turnover	64,500
Cost of sales	(25,000)
Gross profit	39,500
Operating expenses	(9,200)

Profit before tax	30,300
Taxation	(4,000)
Profit after tax	26,300
Non-controlling interest	(1,540)
Group profit for the year	24,760
Proposed dividends	(8,000)
Retained profit for the year	16,760
Retained profit b/f	8,320
Retained profit c/f	25,080

Notes to the accounts
Movement of reserves

	The group	Tolu
	₦ '000	₦ '000
Retained profit b/f 1 Jan 2007	8,320	8,000
Retained profit for the year	16,760	14,200
Retained profit c/f 31/12/2007	25,080	22,200

3.5 Intra-Group Trading

Intra group sales should be eliminated from turnover and cost of sales because the consolidated profit and loss account figure for turnover and cost of sales should represent only sales to and purchases from, companies outside the group.

The unrealized profit in goods not yet sold should also be excluded. The procedures are as follows:

(a) Deduct the inter-company sales at selling price from both sales and cost of sales;

(b) Calculate the unrealized profit in such goods not yet sold (as explained under consolidated balance sheet).

This amount should be deducted from profit and loss account and the stock in the balance sheet.

3.5.1 Rules for removing Unrealized Profit

a. If the sales were made by the parent company, there would be no adjustment to non-controlling interest;

b. If the unrealised profit originally arose in the subsidiary (that is, the sale is from the subsidiary to the parent company) the non controlling interest should be adjusted for its share in the unrealised profits;

c. Notwithstanding this second rule, all the unrealised profit should be eliminated from cost of sales to determine the correct amount of gross profit earned by the group as if they are trading as a single entity.

Illustration 15.4

The draft trading and profit and loss account of papa ltd and Suzie ltd for the year ended 31december 2007.

	Papa ltd	Suzie ltd
	₦ '000	₦ '000
Turnover	5,000	20,000
Cost of sales	(18,000)	(8,000)
Gross profit	32,000	12,000
Operating expenses	(10,000)	(3,000)
Profit before tax	22,000	9,000
Taxation	6,000	1,500
Profit after tax	16,000	7,500

Additional information

a. Papa acquires 80% of the issued ordinary share capital of Suzie when the reserve of Suzie was ₦ 9,500,000.

b. In the year ended 31 December 2007, papa sold to Suzie goods costing ₦ 3,040,000 for ₦3,800,000.

c. At the end of the year, Suzie sold 60% of these goods.

You are required to prepare the consolidated profit and loss account of papa ltd, and its subsidiary for the year ended 31 December 2007.

Suggested Solution 15.4

Step 1: calculate the unrealised profits on intra-group trading, still in stock

	₦ '000
Sales revenue on intra-group sales	3,800
Cost of goods sold	(3,040)
Total unrealised profit	760
Proportion not yet sold 100% - 60% = 40%	
Unrealised profit ₦ 760,000 x 40%	304

Step 2: eliminate inter-company sales at selling price from sales and cost of sales.

Add ₦ 304,000 to cost of sales, (and deduct from the stock value in the balance sheet)

Step 3: Consolidation schedule

	Papa ltd	Suzie ltd	adjustment	consolidation
	₦ '000	₦ '000	₦ '000	₦ '000
Turnover	5,000	20,000	(3,800)	66,200
Cost of sales	(18,000)	(8,000)	3,800	(22,200)
Unrealised profit	(304)	-	-	(304)
Gross profit	31,696	12,000		43,696
Operating expenses	(10,000)	(3,000)	-	(13,000)

Profit before tax	21,696	9,000		30,696
Taxation	(6,000)	(1,500)	-	(7,500)
Profit after tax	15,696	7,500		23,196
Non-contr.int x 20%	-	(1,500)		(1,500)
Profit to group members	15,696	6,000	-	21,696

3.6 Transfer of Fixed Assets between Group Companies

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

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

Illustration 15.5

On 1 January 2008, parker ltd sold a plant to Saro ltd for ₦ 165,000. The asset which originally cost ₦ 132,000 had a net book value of ₦ 99,000 on the date of transfer. Both companies depreciate plant at 20% on cost per annum and parker owns 60% of Saro. Show the adjustments necessary at 31 December, 2008, the year-end of the group.

Suggested Solution 15.5

	₦ '000
Unrealised profit on sale of plant	33,000
Enhanced depreciation ₦ 33,000 x 20%	(6,600)
Consolidated profit and loss account	26,400

The double entry is	₦ '000	₦ '000
Dr. Profit on sale of plant	33,000	
Cr. Depreciation account		6,600
Cr. Plant account		26,400

Another way to calculate the enhanced depreciation is:

	₦
20% x ₦ 165,000 (transfer value)	33,000
20% x ₦ 132,000 (cost)	26,400
Enhanced depreciation	6,600

The non controlling interest will be adjusted for its share of the reduction in depreciation, because this was recorded in the subsidiary's books.

	₦ '000	₦ '000
The double entry is		
Dr. Non controlling interest		
(Profit and loss a/c) 40 % x ₦ 6,600	2,640	
Cr. Non controlling interest		2,640
(Balance sheet)		

Illustration 15.6

The facts are as in illustration above except that Saro transferred the assets to parker. What adjustments are required in the consolidated accounts?

Suggested Solution 15.6

The adjustments are as before:

That is to eliminate unrealised profit of	₦ 33,000 and
Reduce the depreciation charge by	₦ 6,600

However, the non controlling interest would be adjusted by ₦ 13,200 (40% x 33,000) since the unrealised profit is in the books of Saro.
The double entry is:

	₦	₦
Dr. Non controlling interest (balance sheet)	13,200	
Cr. Non –controlling interest (income statement)		13,200

3.7 Intra-Group Interest on Loan

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

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

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

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

Illustration 15.7

Piper ltd acquired 75% of the ordinary share capital and 45% of the preference share capital of Soso ltd many years ago.

Extract from the draft profit and loss account of Soso ltd for the year ended 31 December 2007:

	₦	₦
Profit after tax		250,000
Dividend payable		
Preference	15,000	
Ordinary	90,000	
	105,000	(105,000)
Retained profit		145,000

Compute the non controlling interest (NCI)

Suggested Solution 15.7

	Total	NCI
	₦	₦
Profit after tax (Soso ltd)	250,000	
Less preference dividend	15,000(55%)	8,250
Available to ordinary shareholders	235,000(25%)	58,750
Total		67,000

3.9 Acquisition of a Subsidiary during the Year

The profit of the subsidiary from the beginning of the accounting period to the date of acquisition is pre-acquisition profit. This profit will be excluded from consolidation.
There are two methods for accounting for acquisition during the year, to ensure that only post-acquisition profits are consolidated
The two methods are:
(a) The part year method
(b) The whole year method.

For the purpose of consolidation, turnover is assumed to accrue evenly during the year.

3.9.1 Part Year Method

The subsidiary's profit to be consolidated is the post acquisition profits only. The turnover, cost of sales and other expenses will be divided between the pre-acquisition and post-acquisition periods and only those of post-acquisition periods will be consolidated.

3.9.2 Whole Year Method

Under this method, the total profit for the year is included in the consolidation figures. However, after the non controlling interest figure had been obtained, a deduction will be made for pre-acquisition period. Similarly, the share of pre-acquisition dividends will be excluded from consolidation.

Illustration 15.8

The draft profit and loss accounts of Hammer ltd and Nail ltd for the year ended 30 sept 2008 are as follows.

	Hammer	Nail
	₦ '000	₦ '000
Turnover	5,720	2,400
Cost of sales	(3,200)	(1,200)
Gross profit	2,520	1,200
Operating expenses	(1,440)	(816)
Profit before tax	1,080	384
Tax	(540)	(192)
Profit after tax	540	192
Dividends declared	(220)	(45)
Retained profit for the year	320	147

Hammer acquired 75% of the ordinary share capital of nail on 1march 2008. Assume that profits accrued evenly during the year. Prepare the consolidated profit and loss account for the year ended 30sept 2008 using:

1) Part year method
2) Whole year method

Suggested Solution 15.8

Part year method

Step 1: the post acquisition period is from 1 march 2008 – 30 sept 2008= 7months
Step 2: consolidation schedule for profit and loss account

	Hammer	Nail (7/12)	consolidation
	₦ '000	₦ '000	₦ '000
Turnover	5,720	1,400	7,120
Cost of sales	(3,200)	(700)	(3,900)
Gross profit	2,520	700	3,220
Operating expenses	(1,440)	(476)	(1,916)
Profit before tax	1,080	224	1,304
Tax	(540)	(112)	(652)
Profit after tax	540	112	652
Non controlling int (25% of ₦ 112k)		(28)	(28)
Inter-company dividend (step 3)	49	(49)	
Profit available to group members	589	35	624
Dividends declared	(320)		(320)
Retained profit for the year	269	35	304

Step 3: inter-company dividend	₦ '000
Dividend declared by nail ltd	112
Attributable to group 75% x ₦ 112,000	84
Less pre-acquisition 5/12 x 84,000	35
Post acquisition	49

Whole Year Method

Step 1: Consolidation schedule

	Hammer	Nail	consolidation
	₦ '000	₦ '000	₦ '000
Turnover	5,720	2,400	8,100
Cost of sales	(3,200)	(1,200)	(4,400)
Gross profit	2,520	1,200	3,720
Operating expenses	(1,440)	(816)	(2,256)
Profit before tax	1,080	384	1,464
Tax	(540)	(192)	(732)
Profit after tax	540	192	732
NCI (₦ 192,000 x 25%)	-	(48)	(48)
Pre-acquisition profit for the yr (step 2)	-	(60)	(60)

Inter-company dividend	49	(49)	
Profit attributable to members	589	35	624
Dividends declared	(320)	-	(320)
Retained profit for the year	269	35	304

Step 2: Pre-acquisition profits for the year
5/12 x 75% x ₦ 192,000 = ₦ 60,000

3.10 Assets Impairment

The goodwill on acquisition should not be amortized but any impairment loss should be accounted for in the profit and loss account in the period in which the impairment occurred.

The cumulative amount of impairment loss at the beginning of the accounting period is deducted from the subsidiary's post-acquisition reserves brought forward.
The impairment loss recognized during the current accounting period is treated as operating expenses.

Illustration 15.9

The draft profit and loss account for the year ended 30june 2008 of a group are as follows:

	Henry ltd	souza ltd
	₦ '000	₦ '000
Turnover	518,200	58,560
Cost of sales	(327,045)	(36,892)
Gross profit	191,355	21,668
Operating expenses	(51,912)	(5,856)
Income from shares in souza	3,740	
Net Profit before tax	143,183	15,812
Tax	(67,485)	(7,612)
Net Profit after tax	75,698	8,200
Dividends proposed	48,000	4,675
Retained profit for the year	27,698	3,525
Retained profit at 1 July 2003	88,147	16,983
Retained profit c/f	115,845	20,508

Additional information:

a) Henry bought 80% of the ordinary shares of souza ltd, three years ago when that company's reserves amounted to ₦ 12,292,000. Goodwill of ₦ 12,000,000 arose on the acquisition.

b) Total of impairment loss of ₦ 7,200,000 had been written off goodwill since acquisition of souza of which ₦ 2,400,000 is recognised during the current year.

Prepare the consolidated profit and loss account for the year ended 30june 2008.

Suggested Solution 15.9

Step 1: reconcile the intra group dividends

	₦ '000		₦ '000
Henry received	3,740	should agree with 80%x ₦ 4,675	3,740

No adjustment is required.

Step 2: Consolidation schedule

	Henry ltd	Souza ltd	adjusted	consolidated
	₦ '000	₦ '000	₦ '000	₦ '000
Turnover	518,400	58,560		576,960
Cost of sales	(327,045)	(36,892)		(363,937)
Gross profit	191,355	21,668		213,023
Operating expenses	(51,912)	(5,856)	(2,400)	(60,168)
Net Profit before tax	139,443	15,812	(2,400)	152,855
Tax	(67,485)	(7,612)		(75,097)
Net Profit after tax	71,958	8,200	(2,400)	77,758
Non controlling interest (20%)	-	(1,640)		(1,640)
Profit available to group members	71,958	6,500		76,118

Step 3: calculate the reserves of group brought forward

	₦ '000	₦ '000
Henry ltd		88,147
Souza ₦ (16,982-12,292) x 80%		3,752
		91,899
Less: impairment loss (note 1)		4,800
		87,099

Step 4: prepare the consolidated profit and loss account

Henry ltd and its Subsidiary
Consolidated Profit and Loss Account
for the year ended 30 June 2008

	₦ '000
Turnover	576,960
Cost of sales	(363,937)
Gross profit	213,023
Operating expenses	(60,168)
Profit before tax	152,855
Taxation	(75,097)
Profit after tax	77,758
Non-controlling interest	(1,640)
Net profit after tax attributable To group members	76,118
Proposed dividends	(48,000)
Retained profit for the year	28,118
Retained profit b/f	(87,099)
Retained profit c/f	115,217

Movement of reserves

	₦ '000
At July 2007	87,099
Retained profit for the year	28,118
At 30 June 2008	115,217

Tutorial

		₦ '000
a)	Total impairment loss written off	7,200
	Charged to profit in current year	2,400
	Adjusted on reserve brought forward	4,800

b) The amount of the group profit for the year dealt with in the account of Henry ltd can be obtained as follows:

Henry's net profit before tax	139,449
Inter-company dividend receivable ₦ (4675 x 80%)	3,740
Impairment loss (current year)	(2,400)
	140,783
Taxation	(67,485)
Profit dealt with in Henry's account	73,298

3.11 Extra-Ordinary Items

The proportion of the group's share of the subsidiary's extra-ordinary item should be aggregated with that of the parent company for consolidation. The extra-ordinary loss or profit is included after the profit in ordinary activities attributable to group members, less the related tax.

3.12 Profit and Loss Account of Vertical Group

The principles for deriving the profit and loss of a vertical group can be understood as follows:

- The post-acquisition profits of the sub-subsidiary will first be consolidated with the subsidiary

- The aggregate of the post-acquisition profits of the subsidiary and sub-subsidiary will then be consolidated with the parent company's result

- All other items will be adjusted as explained before, that is, where the parent has only one subsidiary

Illustration 15.10

The following information is given on port ltd, sea ltd and tea ltd for the year ended 31 December 2007:

	Port ltd	sea ltd	tea ltd
	₦ '000	₦ '000	₦ '000
Operating profit	1,995	1,030	775
Investment income	35	20	
Profit before tax	2,030	1,050	775
Taxation	(750)	(500)	(250)
Profit after tax	1,280	550	525

Dividend paid:

Ordinary	(100)	(50)	(25)
Preference	(50)	(25)	(25)
	1,130	475	475
Retained profit 1/1/07	2,400	800	650
Retained profit 31/12/07	3,530	1,275	1,125

(a) Port ltd acquired 60% of the ordinary share capital of sea ltd on 31 Dec. 2003 when the profit and loss account balance of sea ltd was ₦ 300,000.

(b) Sea ltd acquired 80% of the ordinary share capital of tea ltd in 2006, when the profit and loss account balance of tea ltd was ₦350,000.

Required: prepare consolidated profit and loss of port ltd and its subsidiaries for the year ended 31dec 2007.

Suggested Solution 15.10

Step 1: group structure

$$\begin{array}{l} \text{Port ltd} \\ \downarrow 60\% \\ \text{Sea ltd} \\ \downarrow 80\% \\ \text{Tea ltd} \end{array}$$

Step 2: reconcile the intra-group dividends

	₦ '000	₦ '000
Investment income to port		35
Investment income to sea		20
		55
Should agree with		
Dividend received by port for sea 60% x ₦ 50	30	
Dividend received by sea for tea 80% x ₦ 25	20	50
Investment income to be consolidated		5

Step 3: calculate the post acquisition profit brought forward:

	Sea ltd ₦ '000	tea ltd ₦ '000
Balance b/f	800	650
Balance at acquisition	300	350
Post-acquisition	500	300
Add 80% of tea post acq.	240	
	740	

Therefore to be consolidated is:	₦ '000
60% x ₦ 740,000=	444
Add reserve of port plc	2,400
Consolidated reserves	2,844

Step 4: prepare the consolidation schedule

Port ltdsea ltd tea ltd consolidation NCI

	₦ '000	₦ '000	₦ '000	₦ '000	₦ '000
Operating profit	1,995	1,030	775	3,800	
Investment income	5			5	
Profit before tax	2,000	1,030	775	3,805	
Taxation	(750)	(500)	(250)	(1,500)	
Profit after tax	1,250	530	525	2,305	
Pref. dividend of Subsidiaries:					
Sea ltd		(25)			25
Tea ltd			(25)		25
Available to ord. Shares		505	500		
NCI (Tea 20%)			(100)		100
Post acq. Profit (tea)			400		
Transfer to sea		400	(400)		
Available to ord. shares		905			
Non contr. Int 40%		(362)			362
Total minority int.				(512)	512
	1,250	543		1,793	

Step 5:

Port ltd and its subsidiary
Consolidated profit and loss account
for the year ended 31 December 2007

	₦ '000	₦ '000
Operating profit		3,800
Investment income		5
Profit before tax		3,805
Taxation		(1,500)
Profit after tax		2,305
Non-contr. Interest		(512)
		1,793
Dividend paid		
Ordinary dividend	100	
Preference dividend	50	(150)
Retained profit for the year		1,643
Retained profit b/f		2,844
Retained profit c/f		4,487

Tutorial

The retained profit c/f can be reconciled with the retained profit in the draft profit and loss account as follows:

	₦ '000	
Post-acquisition profit of Sea ltd in tea ltd ₦ (1,125-350) x80%		620
Add sea ltd reserve	1,275	
	1,895	
Post-acquisition of port ltd In sea ltd (1,895-300) x60%	957	

Add port reserves	3,530
	4,487

Self Assessment Exercises

1. Intra group sales should be eliminated from ____ and ____

2. In a vertical group situation, the post-acquisition profits of the sub-subsidiary will be consolidated with that of the ____

3. Unrealised profit in goods not yet sold in intra group trading should be ____

4.0 CONCLUSION

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

5.0 SUMMARY

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

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

6.0 TUTOR-MARKED ASSIGNMENT

Try your hands again on all the ten illustrations in the Unit in order to have a good grasp of the step by step procedure of treating consolidated transactions in the profit and loss account of a parent company and its subsidiaries.

7.0 REFERENCES/FURTHER READINGS

Adapted from the ICAN Study Packs (2011)

UNIT FOUR ASSOCIATED COMPANIES

CONTENTS

1.0 INTRODUCTION

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

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

2.0 OBJECTIVES

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

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

3.0 MAIN CONTENT

3.1 Accounting for Investment in Associated Companies

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

3.1.1 Definitions

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

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

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

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

3.1.2 Investments in Associates

SAS 28 defines an associate as an entity, including unincorporated entities such as partnership, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture.

3.2 Significant Influence

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

3.2.1 Evidence of Significant Influence

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

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

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

3.3 Methods of Accounting for Associates

The accounting method prescribed by SAS 28 is the equity method.

Under the equity method

(a) The investment in the associate is initially carried in the balance sheet at the historical cost. Thereafter, it is stated at the investor’s share of the net assets of the associate.

(b) The investor’s share of the associate profits is recognized in the profit and loss account.

3.3.1 Detailed Procedure of the Equity Method

(a) Balance sheet

The group's interest in the associate is the aggregate of the:

(i) group's share of the associate goodwill, plus
(ii) premium arising on acquisition of interest in the associate profit/loss; plus
iii) the groups share of the net assets of the associate, less
(iv) any discount arising from acquisition of interest.

The investment in the associate is disclosed separately as a non-current asset.

(b) Profit and loss account

(i) The investor recognizes its share of associated company's profit before tax.

(ii) The investor discloses separately its share of associated company's tax.

(iii) The investor recognizes its share of extra-ordinary items and retained profit

(iv) There is a limit to the amount of the losses that the investor will recognize. Once the associate's net assets have been reduced to a zero value, no further losses will be recognized.

3.3.2 Other Considerations

Unrealised profits

Only the group share of the unrealized profit should be accounted for.

3.3.3 Balance Sheet date

The financial statements used to account for the associate should be drawn up to the investor's balance sheet date. The investor may not be able to effect a change in the year-end of the associate because it does not exercise control over it. Therefore, w here the accounting dates differ; the most recent accounts would have to be used, with disclosures of significant transactions since that date.

3.3.4 Uniform Accounting Policies

The accounting policies of the associate should be harmonized with that of the investor. If it is not possible, the facts should be disclosed.

3.3.5 Contingencies

The investor should disclose:

(a) Its share of the contingencies and capital commitments of an associate for which it is also contingently liable; and

(b) Those contingencies that arise because the investor is separately liable for all the liabilities of the associates.

3.4 Transactions between the Investor and the Associate

Since an associate is not consolidated, these inter-company transactions will not be cancelled out.

(a) Loan between associate and investor

The loan should be disclosed separately in the balance sheet as investment in the associate. Loans to and from the associated company should not be netted off.

(**b) Receivables and payables arising between the associate and the investor**

The receivable and payables should not be netted off. Rather they should be included under respective current asset or liabilities. Such receivables and payables should be disclosed separately, if material.

3.4.1 Other Disclosure Requirements

(a) A list and description of significant associates showing:

i. the proportion of the ownership interest; or
ii. the proportion of the voting interest.

(b) The method used to account for investment in each associate.

Illustration 16.1

Tafa plc acquired 25% of the ordinary share capital of Balo plc three years ago for ₦1,440,000. At that date, the share capital and reserves of Balo plc amounted to ₦5,184,000. On 31 dec 2008, Balo plc capital and reserves amounted to ₦8,640,000. The net tangible assets in Balo plc are stated at their fair values.

Required:

State at what amount the investment in Balo plc will be shown in the consolidated balance sheet of Tafa plc as on 31 december 2008.

Suggested Solution 16.1

Consolidated balance sheet (extracts) of Tafa plc as on 31 December 2008.

	₦
Fixed assets	xx
Investments in Tafa plc (note 1)	2,304,000

Note 1

	₦
Investments in the net assets of the associate	
(25% x ₦ 8,640,000)	2,160,000
Goodwill (note 2)	144,000

		2,304,000
Note 2	goodwill	
Cost		1,440,000
Less: share of the net assets at acquisition		
(₦ 5,184,000x25%)		1,296,000
Goodwill		144,000

Alternative method

Cost of investment	1,440,000
Share of post-acquisition profit	
25%x (₦ 8,640,000 - ₦ 5,184,000)	864,000
	2,304,000

3.5 Effect of Associate on Group Profits

The group profits will be increased by the group share of the post-acquisition profits of the associate.

Illustration 16.2

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

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

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

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

Suggested Solution 16.2

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

	₦ '000	₦ '000
Turnover		xx
Group profit before tax (P+S)	-	15,800
Group share of associate profit ₦ 4,000 x 40%		1,600
Profit before tax		17,400

Taxation: group (P+S)	5,600	-
Associate (₦ 1,400+40%)	560	(6,160)
Profit after tax	-	11,240
Non-controlling interest ₦ 4,000+40%	-	(1,600)
Net profit for the period	-	9,640
Extra ordinary loss ₦ 1,600x40%	-	(640)
Net profit for the period	-	9,000
Dividend proposed	-	(2,000)
Retained profit for the year	-	7,000
Retained profit b/f (w2)	-	3,560
Retained profit c/d	-	10,560

Movement on reserves

Retained profit b/f	3,560
Retained profit for the year	7,000
Retained profit c/f	10,560

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

	Group	Associate	
	₦ '000	₦ '000	₦ '000
Brought forward (w2)	3,240	320	3,560
Retained for the year (w3)	6,680	320	7,000
	9,920	640	10,560

Workings

(a) Goodwill in associate ₦ '000

Cost of shares acquired	1,700
Share of net assets 40% ₦ (2,000+1,200)	1,280
Goodwill	420

(b) Retained profits brought forward

Group ₦ 3,000 + 60% (₦ 2,400-2,000)	3,240
Associate 40% (₦ 2,000-1,200)	320
	3,560

(c) Profit for the year

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

Tutorial notes

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

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

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

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

The retained profit b/f for Abu plc is ₦ 3,000,000

Self Assessment Exercises

What is the entity over which the investor has significant influence and is neither a subsidiary/interest called ______

4.0 CONCLUSION

The unit highlights the difference between the equity method of accounting and proportional consolidation and their applications.

5.0 SUMMARY

This unit deals with the basic principles and accounting for associated companies.

In the next unit, we will examine procedures and principles guiding disposal of subsidiaries.

6.0 TUTOR-MARKED ASSIGNMENT

What accounting approach is prescribed by SAS 28 for associates?

7.0 REFERENCES/FURTHER READINGS

Adapted from the ICAN Study Packs (2011)

UNIT FIVE DISPOSAL OF SUBSIDIARIES

CONTENTS

1.0 INTRODUCTION

The last unit dealt extensively with the basic principles and accounting for associated companies.

In the next unit, we will examine procedures and principles guiding disposal of subsidiaries.

2.0 OBJECTIVES

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

- Explain and apply the principles relating to group companies disposal;
- Calculate the gains or losses and treatment of goodwill on disposal;
- Prepare consolidated accounts after disposals, including full and partial disposals.

3.0 MAIN CONTENT

3.1 Categories of Sales of Shares in Subsidiary

There are different categories of sales of shares in a subsidiary. The transaction may involve the selling of the total holding of the subsidiary; on the other hand, it may be partial sales. Disposal of subsidiaries will give rise to special accounting problems mainly in the accounting period in which the disposal occurs. The main objectives of accounting for the disposal of investment in a subsidiary are to:

(a) Determine the gain/loss to the parent company on one hand and to the group on the other.
(b) Determine the effect of the sales on reserve and
(c) Determine the effect of the sales on the balance sheet items.

3.2 Accounting for Disposal of Subsidiaries

Whenever there is a material disposal there is a need to calculate the gain or loss on disposal of investment. Gains or losses on sales result in capital gains or losses. However, different treatments are required in the individual accounts of the parent company and in the group accounts, as follows:

(a) In the accounts of the parent company

The carrying value of the investment will be matched with the sale proceeds of the investment sold less any capital gain tax.

(b) In the consolidated accounts

(i) The difference between the sales proceeds and the parent company's share of the net asset of the subsidiary at the date of sale plus the goodwill on consolidation to the extent that it has not been written off

(ii) The profit or loss obtained for the parent company's account (as in (a)) less the post acquisition profits no longer required.

Illustration 17.1

Sale of total shares in Subsidiary

Shu plc acquired the entire ordinary share capital of kako plc some years ago for ₦ 792,000. On that date, the net assets and reserves of kako plc were ₦ 608,000 and ₦ 1,000,000 respectively.

On 31 December 2008, the entire shares held were sold for ₦ 2,740,000 when the net assets of kako plc stood at ₦ 1,912,000. There had been no change in the share capital of kako plc since the acquisition.

(a) Compute the profit or loss on disposal to be recorded in the books of shu.

(b) Compute the profit or loss on disposal; assume that goodwill had been fully written off due to impairment.

Suggested Solution 17.1

(a) Gain on sale

	₦ '000	₦ '000
(i) Separate account of shu		
Proceeds		2,740
Cost of shares sold		(792)
Capital gain to shu		1,948
(ii) Gain to group		
Proceeds		2,740
Less: net assets at disposal (100%x ₦ 1,912)	1,912	
Goodwill not yet written off (w1)	184	2,096
Capital gain to group		644

Alternative method

Gain to group could be obtained as follows:

Gain to shu	1,948
Less: post acquisition profit to date of disposal	1,304
Capital gain to group	644

(b) Goodwill had been fully written off

()i Gain to shu		
Proceeds		2,740
Cost of shares sold		(792)
Capital gain to shu		1,948

(ii) Gain to group		
Proceeds		1,948
Less: post acquisition reserves to date of disposal	1,304	
Goodwill not yet written off (w1)	184	1,120
Gain to group		828

Alternative method

	₦ '000	₦ '000
Gain to shu		1,948
Less: post acquisition reserves to date of disposal	1,304	
Goodwill written off	(184)	1,120
Gain to group		828

Workings	₦ '000
1. Goodwill on consolidation	
Cost of shares	792
Net assets acquired	608
Goodwill	184

2. Since there is no change in the share capital of kako plc between the acquisition and disposal dates, the difference between the net assets at the two dates must be post-acquisition profit.

Post-Acquisition Profit	₦ '000
Net asset at disposal date	1,912
Less: net asset at acquisition date	608
Post acquisition	1,304

3.3 Effect of Sale on Disclosure

The subsidiary sold may constitute a discontinuing operation and may have to be disclosed separately on the face of the profit and loss accounts in accordance with IFRS 5-Non-current assets held for sale and discontinued operations.

Illustration 17.2

Ade plc acquired 75% of the 200,000 ₦1 share capital of Olu plc on 1 January, 2005 for ₦350,000 when the reserve of that company stood at ₦192,000 and sold the entire holding on 1 September 2008 for ₦1,024,000. Ade plc held the entire equity shares in another company.

Given below are the draft profit and loss account of Ade group (with its wholly owned subsidiary) and Olu plc for the year ended 31 December 2008.

	Ade group	Olu plc
	₦ '000	₦ '000
Turnover	645	400
Operating cost	(241)	(120)
Profit before tax	404	280
Taxation	(162)	(112)
Profit after tax	242	168
Dividend paid	(100)	-
Retained profit for the year	142	168
Brought forward	680	640
Carried forward	822	808

(a) Ade has not yet accounted for the disposal of Olu
(b) Dividends paid were after the disposal of shares

You are required to prepare the consolidated profit and loss account of Ade group and olu plc for the year ended 31 December 2008 in accordance with IFRS 5, incorporating the gain on disposal.

Step 1: compute the gain on sale

	₦ '000	₦ '000
Proceed		1,024
Less cost of sale		350
Gain to Ade plc		674

Gain to Group

Sale proceed		1,024
Less: net asset at date of disposal		
Ordinary shares	200	
Profit to 1/1/08	640	
From 1/1/08 – 31/12/08 (8/12 x ₦168)	112	
	952	
Group share 75% x ₦952	714	
Goodwill not yet written off (w1)	56	770
Gain to group		254

OR

Gain to Ade plc		674
Less: post acquisition profit to date of sale	-	-
At 1/1/08 ₦(640 – 192)	448	-
1/1/08 – 31/12/08 (8/12 x ₦168)	112	-
	560	
Group share 75% x ₦560		420
Gain to group		254

Workings

Goodwill on consolidation		
Cost of shares	-	350
		-
Net Assets Acquired	-	-
Ordinary shares	200	-
Reserves	192	-
Group share	392	-
Group share	75%	294
Goodwill		56

Step 2: Ade plc consolidated profit and loss account for the year ended 31 December 2008

	Continuing Operations	discontinuing operations	total
	₦ '000	₦ '000	₦ '000
Turnover (₦400 x 8/12)	645	267	912
Operating costs (₦120 x 8/12)	(241)	(80)	(321)
Operating profit	404	187	591
Profit on disposal of discontinuing operation		254	254
Profit before tax	404	441	845
Taxation ₦112 x 8/12	(162)	(75)	(237)
Profit after tax	242	366	608
Non controlling interest (25% x ₦168 x 8/12)			(28)
Profit for the year			580
Dividends	-	-	(100)
Retained profit for the year	-	-	480

Note on the Financial Statements

Movement on reserves

	Ade plc	group
	₦ '000	₦ '000
Brought forward (w1)	680	1,016
Retained for the year (w2)	816	480
Retained profit carried forward	1,496	1,496

Workings:

(a) Group retained profit b/f (₦680+ (640-192)75% =	₦1,016
(b) Ade plc retained profit for the year = as per draft P&L	142
Add profit on sale of Olu plc in Ade's book	674
Total	816

3.4 Capital Gains Tax (CGT)

Capital gain tax is obtained by applying the capital gain tax rate on the gain on disposal in the parent company's account. It should be noted however that in Nigeria, with effect from 1 January, 1996, shares of every description have been exempted from CGT. However, it is included for in some of the worked examples for illustration.

3.5 Partial Disposal of Subsidiary

A partial disposal may give rise to three types of relationship between the parent company and the subsidiary.

(1) The parent/subsidiary relationship may remain but with a reduced shareholding;

(2) The subsidiary may now become an associate;

(3) The parent may now own less than 20% of the equity share capital which is ordinary investment.

3.5.1 Partial Disposal of a Subsidiary leaving a Subsidiary

The consolidated accounts would normally be prepared for the whole year. However, the non-controlling interest share would increase by the proportion of the share sold from the date of disposal.

Illustration 17.3

The facts are as in 17.2, except that Ade plc sold only 40,000 of the ordinary shares held in Olu plc for ₦560,000. Capital gain tax is 20%.

Required:
(a) The group profit on disposal
(b) Consolidated profit and loss account for the year ended 31 December 2008.

Suggested Solution 17.3

Step 1: calculate the proportion of the shares sold and the remaining shares

Shares acquired originally	75%
Proportion of Olu plc shares sold 40/200 x 100%	(20%)
Proportion remaining	55%

Step 2: calculate the goodwill on acquisition

	₦ '000	₦ '000
Balance at 1/1/04		56.0

Part disposal: 20/75 of share owned		(14.9)
		41.1

Step 3: calculation of profit on disposal of shares in Olu plc

Sales proceeds	560.0	
Net assets of Olu at disposal (17.2 step 1)		952.0
Proportion of shares sold at 20% x ₦952,000	190.4	
Goodwill disposed	14.9	
		205.3
Group gain before capital gains tax		354.7
Capital gain tax at 20% of ₦466.7 (alt method)		(93.3)
Group gain after tax		261.4

Alternative method

Sales proceeds	560.0	
Cost of shares purchased 75%	350.0	
Cost of shares sold 20/75		(93.3)
Gain to Olu plc before tax		466.7
Capital gain tax at 20%		(93.3)
Gain to Ade plc		373.4
Less: post acquisition profit no longer required	560.0	
Proportion of shares sold 20%		112.0
Group gain		261.4

Step 4: we can now prepare the consolidated profit and loss account of Ade group incorporating the result of Olu plc. Olu plc is not a discontinuing operation.

Ade group
Consolidated profit and loss account for the Year ended 31 December 2008

	₦ '000	₦ '000	
Turnover (P+S)		1,045.0	
Operating cost (P+S+GW amortised)		(361.0)	
Profit before tax		684.0	
Profit on disposal of shares in Olu plc		261.4	
		945.4	
Taxation (P+S)			(274.0)
Profit after tax		671.4	
Non controlling interest			
8/12 x ₦168 x 25%	28.0		
4/12 x ₦168 x 45%	25.2	(53.2)	
Group profit after tax		618.2	
Dividend paid		(100.0)	
Retained profit for the year		518.2	
Retained profit b/f		1,016.2	
Retained profit c/f		1,534.2	

3.5.2 Disposal of Shares leaving an Associated Company

The following are the basic principles for accounting for disposal of shares leaving an associate company.

(a) The relevant profits of the subsidiary for part of the year before the sale, subject to deduction of any non-controlling interest must be consolidated.

(b) For the period after acquisition, w e must include the appropriate portion of the profits of the associated company using the equity method of accounting.

(c) In the consolidated balance sheet at the year end, the investment in the associated company will appear at its cost, less any goodwill written off, plus the appropriate post-acquisition profits of that associated company.

Illustration 17.4

The facts are same in 17.3 except that Ade sold 60,000 shares in Olu plc for ₦840,000.

Suggested Solution 17.4

Step 1: calculate the proportion of the shares sold and the remaining shares.

Percentage shares acquired	75%
Proportion of shares sold 60/200 x 100%	30%
Proportion remaining	45%

Step 2: calculate the balance of goodwill on disposal		₦'000
Bal at 1/1/04	56.0	
Balance on disposal	(22.4)	
Balance on disposal	33.6	

Step 3: calculate the profit or loss on disposal of investment

	₦ '000	₦ '000
Sale proceeds		840.0
Net asset at disposal	952.0	
Proportion of shares sold (30% x ₦952)	285.6	
NBV of goodwill disposed off	22.4	308.0
Group gain before tax		532.0
Tax at 20% (see alternative)		(106.4)
		425.6
Alternative method	₦ '000	₦ '000
Sales proceeds		840
Cost of shares purchased	350	
Cost of shares sold (30/75 x ₦350)		(140)
Gain to Olu before tax		700
Tax at 20%		140
Gain to Ade plc		560

Post acquisition profit no longer consolidated

Post acquisition profit	560

Proportion of shares sold (30% x ₦560)	(168)
Group gain	392

Step 4:

Ade group
Consolidated profit and loss account
For the year ended 31 December 2008

	₦ '000	₦ '000
Turnover (₦645+ (8/12 x ₦400))		912.0
Operating cost (₦241+(8/12 x 120))		(321.0)
		591.0
Share of operating profit of Olu plc step 3		42.0
		633.0
Profit on sales of shares in associates		392.0
Profit before tax		1,025
Taxation:		
Group companies (₦162+(8/12 x ₦112))	236.7	
Share of taxation associate ₦(112 x 4/12)	37.3	
		(274.0)
Profit after tax		751.0
Minority interest (25% x 8/12 x 168)		(28.0)
Group profit		723.0
Proposed dividend		(100.0)
Retained profit for the year		623.0
Retained profit b/f		1,016.0
Retained profit c/f		1,639.0

Working
Share of operating profit of associate = ₦(280x (45% x 4/12)= ₦42

3.5.3 Disposal leaving Ordinary/Trade Investment

The following principles give the disposal of subsidiaries leaving ordinary/trade investment.

(a) The consolidated profit and loss account must include the whole of the profits of the subsidiary up to date of disposal subject to any minority interest together with the profit or loss on disposal. Subsequently, credit will be taken in the investing company for the dividend receivable.

(b) In the balance sheet the investment will appear at either its historical cost unless its value had fallen permanently below cost or at a re-valued amount (SAS 13 and IAS 39).

Illustration 17.5

The facts are as in 17.3 except that Ade sold 60% of the shares held in Olu plc for ₦1,680,000.

Suggested Solution 17.5

Step 1: calculate the balance of goodwill at disposal date

₦ '000

Bal at 1/1/04	56.0
Part disposal 60/75	(44.8)
	11.2

Step 2: calculating the profit or loss on disposal of investment

	₦ '000	₦ '000
Sales proceeds	1,680.0	
Net assets at disposal (as before)	952.0	
Proportion of shares sold 60% of ₦952	571.2	
NBV of goodwill disposal	44.8	-
		(616.0)
Group gain before tax		1,064.0
Taxation 20%		(280.0)
		784.0

Alternative method

	₦ '000	₦ '000
Sales proceeds	1,680.0	
Cost of shares purchased	350.0	
Cost of shares sold 60/75 x ₦350		(280.0)
		1,400.0
Taxation 20%		(280.0)
Gain to Ade after tax		1,120.0
Post acquisition profit	560.0	
Proportion of shares sold 60%		(336.0)
Gain to group		784.0

Step 3:

Ade group
Consolidated profit and loss account
For the year ended 31 December 2008

	₦ '000
Turnover (as in 17.4)	912.0
Operating cost	(361.0)
Operating profits	551.0
Profit on sale of shares in Olu plc	784.0
Profit before tax	1,335.0
Tax- Group Company only	(236.7)
Profit after tax	1,098.3
Non controlling interest (25% x (8/12 x 168))	(28.0)
Retained profit	1,070.3
Retained profit b/f as before	1,016.0
Retained profit c/f	2,086.3

3.6 Treatment of Dividend on Disposal of a Subsidiary Company

There are two approaches to the treatment of dividends. Each approach depends on whether the dividend is paid before the date of disposal or paid/proposed after the date of disposal.

(a) If the dividend has been paid before the disposal, the full amount is deducted from the net assets at the date of disposal.

(b) If the dividend is paid after the date of the disposal, the payment will not affect the net asset at date of disposal. Therefore, the dividend should be ignored for the purpose of determining net asset disposed.

3.7 Deemed Disposal

A deemed disposal arises where the interest of a group in a subsidiary company is reduced for reasons other than direct sales of shares. Some of such instances are:

(a) Rights issue by the subsidiary company were not taken up by the parent.
(b) Scrip or bonus issue by the subsidiary is not taken up by the parent.
(c) Third parties in the subsidiary exercises option or warrants.
(d) The subsidiary issued voting shares to third parties.

The principles for the computation of the profit or loss on sale and treatment of the subsidiary in year of the disposal are applicable to deemed disposal.

However, no change is made to the goodwill when a deemed disposal occurs because none of the cost of acquisition has been realized in the form of actual sales.

Illustration 17.6

The profit and loss account of Gwuzo plc and its subsidiaries for the year ended 31 December 2007.

	Gwuzo	salim	masca
	₦ '000	₦ '000	₦ '000
Profit before tax	600,000	400,000	240,000
Taxation	(280,000)	(168,000)	(63,000)
Profit after tax	320,000	232,000	177,000
Dividend paid	120,000	-	-
Retained profit for the year	200,000	232,000	177,000

Gwuzo owned 80% of salim and 75% of masca since their incorporation. At 1 January 2007, both subsidiaries have issued share capital of ₦300 million. On 30 April 2007, masca issued ₦300 million ordinary shares to third parties for consideration of ₦300 million and its reserves amounted to ₦226 million.

Prepare the consolidated income statement for the year ended 31 December 2007.

Suggested Solution 17.6

Step 1: calculate the profit or loss on disposal. Only the profit of the group can be calculated in case of deemed disposal because the individual parent company has received no consideration for the disposal.

Share of nets at disposal		₦ '000	₦ '000
Share capital		300,000	
Reserves b/f on 1/1/07		266,000	
Reserves from 1/1/07 – 30/4/07			
(4/12 x ₦177,000)		59,000	
	75%x	625,000	468,750

Share of net assets after disposal

Share capital		600,000	
Reserves b/f 1/1/07		266,000	
Reserves from 1/1/07 – 30/4/07		59,000	
	37.5%x	925,000	346,875
Loss on disposal			121,875

Note: When the share capital of masca plc was 300 million, gwuzo held 75% or 225 million. Now that the share capital of masca has been increased to 600 million without a corresponding increase in the shares held by gwuzo , the proportion held by gwuzo reduced to:

$$\frac{225 \text{ x } 100\%}{600} = 37.5\%$$

Step 2: **Gwuzo group consolidated profit and loss account for the year ended 31/12/07**

	₦ '000	₦ '000
Profit before tax (w+s+4/12 x 240)		1,080,000
Share of associates (8/12 x 37.5% x 240)		60,000
Loss on disposal of masca		(121,875)
		1,018,125
Tax (w+s+4/12 x 63)	469,000	
Share of associates (8/12 x 37.5% x 63)	14,750	(484,750)
		533,375
Non controlling interest:		
Salim (20% x 232)	46,400	
Masca (25% x 177 x 4/12)	14,750	(61,150)
Profit attributable to group members		472,225
Dividend paid		(120,000)
Retained profit		352,225

3.8 Loss of Control

A parent loses control of a subsidiary when it no longer has the power to govern the financial and operating policies of an investee so as to obtain benefits from its activities. A parent can lose control of a subsidiary through sale of an ownership interest, or through other methods such as when a subsidiary issues new voting shares to other parties. Control can also be lost through some transactions and events that the parent is not involved in, for instance, when the subsidiary is placed under the control of government, court, regulatory body, or administrator in the event of bankruptcy.

SA S 27 prescribes the accounting procedures of a parent that loses control in a subsidiary. Under SAS 27, if a parent loses control in a subsidiary, it:

(a) derecognises the assets (including any goodwill) and liabilities of the subsidiary at their carrying amounts at the date when control is lost;

(b) derecognises the carrying amount of any non-controlling interests in the former subsidiary at the date when control is lost;

(c) recognises:
   (i) the fair value of the considerations received, if any, from the transaction, event or circumstances that resulted in the loss of control; and

   (ii) if the transaction that resulted in the loss of control involves a distribution of shares of the subsidiary to owners in their capacity as owners, that distribution;

(d) recognises any investment retained in the former subsidiary at its fair value at the date when control is lost;

(e) reclassifies to profit or loss, or transfers directly to retained earnings if required in accordance with other SASs, all amounts recognised in other comprehensive income in relation to that subsidiary; and

(f) recognises any resulting difference as a gain or loss in profit or loss attributable to the parent.

On loss of control of a subsidiary, any investment retained in the former subsidiary and any amounts owed by or to the former subsidiary shall be accounted for in accordance with other SASs from the date when control is lost.

This is a requirement of SAS 27, on consolidated and separate financial statements.

Illustration 17.7

On 12th February 20x9, Umah investment plc was wound up by a federal high court in Nigeria for default in delivering statutory reports to the corporate affairs commission. Odiwe plc had acquired 80% of the shares of umah investment plc several years ago.

The consolidated balance sheet of odiwe plc at 31 December 20x8 shows the following summarised position.

	₦ m
Assets	
Non current assets	11,350
Current assets	4,720
	16,070
Equity and liabilities	
Shareholders' fund	8,000
Non-controlling interest	380
Total equity	8,380
Non current liabilities	4,800
Current liabilities	2,890
	16,070

From the consolidation schedule and workings for the year ended 31 December 20x8, you obtained the following figures.

(a) Goodwill on acquisition of Umah plc, ₦50million.
(b) Non controlling interest in the net assets of Umah plc.
(c) Other information concerning Umah plc.

(i) Non current assets at 31 December 20x8 ₦410m
(ii) Non current liabilities ₦330m
(iii) Current assets ₦320m
(iv) Current liabilities ₦280m
(v) Consolidated post acquisition reserves ₦106m

Required:
Prepare the summarised balance sheet of Odiwe plc after adjusting for loss of control in accordance with SAS 27, on consolidated and separate financial statements.

Suggested Solution 17.7

Summarised consolidated balance sheet of Odiwe plc at 31 December 20x8

		₦ m
Non current assets ₦(11,350-410-50)	10,890	
Current assets ₦(4,720-320)		4,400
		15,290
Shareholders fund ₦(8,000-106)		7,894
Non controlling interest ₦(380-64)		316
Total equity		8,210
Non –controlling interest		4,470
Current liabilities		2,610
Total equity and liabilities		15,290

Self Assessment Exercises

Where a total disposal of a subsidiary occurs, the group's gain on disposal for the year ended should be classified under the heading ______

(a) Discontinued operations
(b) Negative goodwill
(c) Positive goodwill
(d) Investment at market value
(e) Capital reserves

4.0 CONCLUSION

Under SAS 27, when the control of a subsidiary is lost, the parent derecognises the individual assets, liabilities and equity including non controlling interests amount, previously recognised in other comprehensive income. The investment retained in the former subsidiary is recognised at fair value.

5.0 SUMMARY

This unit has dealt with how to account for the disposal.

In the next unit, we shall dwell on principles and procedures guiding group cash flow.

6.0 TUTOR-MARKED ASSIGNMENT

1. List an instance that is regarded as deemed disposal of shares in a subsidiary by a parent company.

2. Investor company's loans to the associate is disclosed separately as _____ in the farmer's balance sheet.

7.0 REFERENCES/FURTHER READINGS

Adapted from the ICAN Study Packs (2011)

UNIT SIX GROUP CASHFLOW

CONTENTS

1.0 INTRODUCTION

In the last unit, we dealt extensively with the basic principles and accounting for associated companies.

In this unit, we shall dwell on principles and procedures guiding group cash flow.

2.0 OBJECTIVES

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

- Prepare consolidated cash flow statements;
- Know how to account for cash flows involving associates in group cash flow statements;
- Account for acquisition and disposal of subsidiaries in group cash flow statements.

3.0 MAIN CONTENT

3.1 Preparation of Consolidated Cash Flow Statement

The group cash flows are analyzed under the same major headings as for a single company. The statement will eliminate the cash flows that are internal to the group in the preparation of consolidated cash flow statement. There are specific points to note in relation to the following events as they affect the preparation of group cash flow statement:

(a) Subsidiaries with non-controlling interests;
(b) Associated companies;
(c) Joint ventures;
(d) Investments acquired during the accounting period.

3.2 Subsidiaries with Non-Controlling Interest

Dividends paid to minority shareholders are cash flows that are extended to the group and will be shown as a cash outflow under 'financing activities'.

Illustration 18.1

The following information has been extracted from the consolidated balance sheet of Ola plc for the year ended 31 December:

	2008	2007
	₦ m	₦ m
Dividend payable to minority shareholders	500	800
Non controlling interest in group net assets	3,900	3,450
Non controlling interest in consolidated Profit after tax	600	1,150

Calculate the dividend paid to the minority shareholders.

Suggested Solution 18.1

Non controlling interest

	₦ m		₦ m
Dividends paid (bal fig)	450	bal b/d dividends payable	800
Bal c/d dividends payable	500	bal b/d non controlling int.	3,450
Bal c/d minority interest	3,900	share of profits in the year	600
	4,850		4,850

3.3 Associated Companies

Associated companies are accounted for by the equity method; therefore, the associate should be included in the group cash flow statement only to the extent of the actual cash flows between the group and the associate.

The only instance when the cash flow of the group is affected by investments in associates is when:

(a) Dividends are received out of the profits of the associate;
(b) Trading occurs between the group and the associate; or
(c) Change in investment is made in associate.

(a) Dividends
Dividends received from associates should be shown as separate inflow in the group cash flow statement under `operating activities.

(b) Trading between group and associate
Trading between the group and associate will give rise to inter-company balances at the balance sheet date. Therefore, when cash is paid or received in respect of inter-company balances, the cash is included in the cash received from customers or in the cash payments to suppliers in the cash flow.

(c) Change in investment in associates

The change may occur as a result of:

(i) Additional shares being purchased or part of the shares held being sold;

(ii) Loans made to or received from associates or loans that have been previously taken that are being repaid.

The cash consideration involved in any of these activities will be shown under investing section of the cash flow statement.

Illustration 18.2

The following information has been extracted from the consolidated financial statements of pious plc for the year ended 31 December 2007.

Consolidated profit and loss account

	₦ m	₦ m
Group profit before tax		1,000
Share of associated profit		167
Tax on profit:	-	-
Group tax	366	-
Share of tax of associate	82	448
		1,615

Consolidated balance sheet

	₦ m	₦ m
Investment in associates:		
Share of net assets	635	621
Loan to associates	518	409
Current assets:		
Debtors	345	258
Included within the group:		
Debtors are the following amounts-		
Dividend receivable from associate	65	39
Current account with associate	54	95

Show the relevant figures to be included in the group cash flow statement for the year ended 31 December 2007 and the amount at which debtors will be shown in the reconciled net cash inflow.

Suggested Solution 18.2

Extracts from cash flow statement

	₦ m
Cash flow from operating activities	
Profit before tax ₦(1,000+167)	1,167
Share of associate's profit	(167)
Increase in debtors (w1)	61

Dividend received from associate (w2)	45

Investing activities

Loan to associate ₦(518-409)	(109)

Workings

W1: increase in debtors	2007	2006
	₦ m	₦ m
Debtors per balance sheet	345	258
Less dividends receivable	(65)	(39)
	280	219
Increase ₦ m (280-219) =		61

W2: dividend received from associate

Associate

	₦ m		₦ m
Balance b/d		share of tax	82
Share of net assets	621	dividend received (bal fig)	45
Dividend receivable	39	balance c/d	
Share of profit	167	share of net assets	635
		Dividend receivable	65
	827		827

3.4 Joint Venture

If the joint venture is accounted for by the proportional consolidation, the consolidated cash flow statement will include the investing company proportionate share of all the cash flows of the jointly controlled enterprise.

If the equity method is used, the accounting for joint venture in the cash flow statement is exactly the same with an associate.

3.5 Acquisition of Subsidiaries during the Accounting Period

(a) The cash flow of the subsidiaries acquired during the year will be included in the cash flow statement from the date of acquisition

(b) Payments to acquire the subsidiary should be reported separately in the cash flow statement under investing activities. Balances of cash and cash equivalents acquired should be shown separately

(c) A note to the cash flow statement should show a summary of the effects of acquisitions including how much of the consideration is made up in cash and cash equivalents, and the assets and liabilities acquired

Illustration 18.3

Given below is the information concerning Dudu group:

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

	₦'000	₦'000
Profit from operations:		
Group companies		23,240
Associated company		1,372
Profit before taxation		24,612
Taxation:		
Group companies	11,060	
Associate	588	(11,648)
Profit after tax		12,964
Minority interests		(2,170)
Group profit		10,794
Proposed dividend		(2,940)
Retained profit		7,854
Retained profit brought forward		10,080
Retained profit carried forward		17,934

Consolidated balance sheet as at the year ended

		31/12/07		31/12/06	
		₦'000	₦'000	₦'000	₦'000
Tangible fixed assets			29,680		23,660
Goodwill			616		392
Investment in associate			8,680		7,980
			38,976		32,032
Current assets:					
Stocks		23,240		17,080	
Debtors		21,000		13,020	
Cash in hand		70		2,023	
	(a)	44,310		32,123	
Less: current liabilities					
Trade creditors		10,780		8,120	
Taxation		12,740		6,860	
Proposed dividend		2,940		1,960	
Bank overdraft		1,792			
	(b)	28,252		16,940	
Net current assets	(a-b)		16,058		15,183
			55,034		47,215
Financed by:					
Ordinary share capital			19,600		18,200
Share premium			3,703		2,303
Consolidated reserves			17,934		10,080
			41,237		30,583
Minority interest			11,480		9,240
			52,717		39,823
10% debentures			2,317		7,392
			55,034		47,215

Notes:

(i) On July 2007, dudu group acquired 80% of the issued share capital of osun plc, whose net assets at that date were as follows:

₦'000

Tangible fixed assets	3,640
Stock	1,260
Debtors	1,372
Cash	280
Creditors	(1,932)
Taxation	(420)
	4,200

The purchase consideration was ₦3.9million in cash

(ii) Depreciation charged in the year amounted to ₦3,080,000. There were no disposals of fixed assets during the year

Required: prepare a cash flow statement of dudu group.

Suggested Solution 18.3

Step 1: movement on:
At 1/1/07 + new acquisition – at 31/12/07 = as per cash flow statement

	₦'000	₦'000	₦'000	₦'000
Stock	17,080 +	1,260 -	23,240 =	4,900
Debtors	13,020 +	1,372 -	21,000 =	6,608
Creditors	8,120 +	1,932 -	10,780 =	728

Step 2: amortization of goodwill/ impairment loss written off

	₦'000
Opening balance	392
Increase due to acquisition ₦3.9- (80% x ₦4.2)	540
Amortization (bal fig)	(316)
Closing balance	616

Step 3: dividend paid to minority shareholders

	₦'000
Minority interest at 1/1/07	9,240
Minority interest in profit for the year	2,170
Increase in minority interest due to acquisition	840
Dividend paid to minority shareholders (bal fig)	(770)
Minority interest at 31 December 2007	11,480

Increase in minority interest due to acquisition in the identifiable net asset acquired times 20%/ i.e ₦4.2m x 20% = ₦840,000

Step 4: dividend received from associates	₦'000
Investments in associates at 1/1/07	7,980
Share of associate profit before tax	1,372
Share of tax charged for the year	(588)
Dividend received in the year (bal fig)	(84)
	8,680

Step 5: tax paid during the year

	₦'000
Balance at 1/1/07	6,860
Increase due to acquisition of Osun	420
Charge for the year	11,060
Cash paid (bal fig)	(5,600)
Balance at 31/12/07	12,740

Step 6: movement in fixed assets

	₦'000
Balance at 1/1/07	23,660
Additions in the year:	
Due to acquisition of osun	3,640
Others (bal fig)	5,460
Depreciation charge for the year	(3,080)
Balance at 31/12/07	29,680

Step 7: ordinary shares

	Nominal value	Premium
	₦'000	₦'000
Bal b/d	18,200	2,303
Issue of share (bal fig)	1,400	1,400
Bal c/d	19,600	3,703

Step 8: prepare cash flow statement

Dudu plc
Consolidated cash flow statement for the
Year ended 31 December 2007

	₦'000	₦'000
Cash flows from operating activities		
Profit before tax		24,612
Adjustments for:		
Amortization (for step 2)		316
Depreciation charges		3,080
Share of associate's profit		(1,372)
Operating profit before working capital changes		26,636
Increase in stock (step 1)		(4,900)
Increase in debtors (step 1)		(6,608)
Increase in creditors		728
Cash generated from operations		15,856
Dividend received from associates (step 4)		84
Income tax paid		(5,600)
		10,340
Net cash from investing activities		
Acquisition of Osun net of cash acquired (note 1)	(3,620)	
Purchases of fixed assets (step 6)	(5,460)	
Net cash used in investing activities		(9,080)
Cash flow from financing activities		
Issue of ordinary shares (step 7)	2,800	

Redemption of debentures	(5,075)	
Dividend paid to minority shareholders	(770)	
Dividends paid to dudu shareholders	(1,960)	
Net cash used in financing activities		(5,005)
Net decrease in cash and cash equivalents		(3,745)
Cash and cash equivalents at the beginning		2,023
Decrease in cash		(1,722)

Notes to the cash flow statement

Cash and cash equivalents

	2007	2006
	₦'000	₦'000
Cash in hand	70	2,023
Bank overdraft	(1,792)	-
Net cash and cash equivalents	1,722	2,023

The cash outflow in respect of the purchase of Osun in the accounting period is the amount paid (₦3.9) less the cash balance of Osun at the date of acquisition, obtained as follows:

	₦'000
Cash paid on acquisition	3,900
Cash balance of Osun	(280)
Cash outflow	3,620

Self Assessment Exercises

1. Payments to acquire a subsidiary is reported separately in the cash flow statement under ________

(a) Investing
(b) Trading
(c) Financing
(d) Operating
(e) Out sourcing

2. Dividends paid to minority shareholders are ________ that are extended to the group and will be shown under financing activities.

(a) Expenses
(b) Cash flows
(c) Incomes
(d) Services
(e) Adjustments

4.0 CONCLUSION

This unit discloses the treatment of group cash flow when dealing with subsidiaries with non controlling interest, associates, and investments acquired during the accounting period.

5.0 SUMMARY

The unit goes on to further throw more light on cash flows statements in terms of group accounts.

With the conclusion of this unit, we have come to the end of this course. We congratulate you on the successful conclusion of this course.

6.0 TUTOR-MARKED ASSIGNMENT

Try your hands on all the illustrations in the three modules to keep abreast of the principles and procedures guiding the preparation of the accounts.

7.0 REFERENCES/FURTHER READINGS

Adapted from the ICAN Study Packs (2011)