NATIONAL OPEN UNIVERSITY OF NIGERIA

SCHOOL OF MANAGEMENT SCIENCES

COURSE CODE: ACC 311

COURSE TITLE: INTERMEDIATE FINANCIAL ACCOUNTING 1

INTERMEDIATE FINANCIAL ACCOUNTING 1

ACC311

Course Guide

Course Developer/Writer:	ICAN STUDY PACK
Adapted by:	Anthony Idialu Ehiagwina National Open University of Nigeria
Course Editor:	Mr. E. U. Abianga National Open University of Nigeria
Programme Leader:	Dr. I. D. Idrisu National Open University of Nigeria
Course Coordinator:	Anthony I. Ehiagwina National Open University of Nigeria

CONTENT

INTRODUCTION

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

COURSE CONTENT

The course content consists basically of the treatment of transactions according to the provisions of accounting standards. Specifically, the published financial statements, cash flow statement and interpretation of financial statements, accounting for insurance claims and foreign branches, accounting for contract, investment, lease and hire purchase were the main focus of this course material.

COURSE AIM

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

COURSE OBJECTIVES

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

1. Explain the conceptual framework of the International Accounting Standard Board;
2. Explain Financial Statement and the underlying assumptions, concepts, principles and standards ;
3. Explain the concept of capital maintenance.
4. Familiarize yourself with the disclosure requirements for banks and non-bank financial institutions.
5. Make analysis based on the use of ratio analysis.
6. Calculate the hire purchase interest attributable to each year.
7. Show relevant ledger entries in the books of the seller and buyer.
8. Prepare balance sheet extract reflecting the balances as at the end of the period.

COURSE MATERIAL

The course material package is composed of:

The Course Guide

The study units

Self-Assessment Exercises

Tutor Marked Assignment

References/Further Reading

THE STUDY UNITS

The study units are as listed below:

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Unit 1: Accounting and Reporting Concepts

Unit 2: Company Accounts and Report

Unit 3: Preparation of Published Financial Statements of Limited Liability Companies

Unit 4: Preparation of Published Financial Statements for Bank and Non-Bank Financial Institutions

Unit 5: Preparation of Published Financial Statements of Insurance Companies

MODULE 2: CASH FLOW STATEMENT AND INTERPRETATION OF FINANCIAL STATEMENTS

Unit 1: Basic Principles Governing the Preparation of Cash Flow Statements and the Approved Formats

Unit 2: Format of Cash Flow Statement for Banks and Insurance Companies

Unit 3: Analysis and Interpretation of Financial Statements

Unit 4: Accounting Ratio Interpretation, Value Added Statement and Report Writing

MODULE 3: ACCOUNTING FOR INSURANCE CLAIMS AND FOREIGN BRANCHES

Unit 1: Accounting for Insurance Claims 1

Unit 2: Accounting for Insurance Claims 2

Unit 3: Accounting for Independent and Foreign Branches

MODULE 4: ACCOUNTING FOR CONTRACT, INVESTMENT, LEASE AND HIRE PURCHASE

Unit 1: Contract Accounts

Unit 2: Accounting Procedures for Long-Term Projects

Unit 3: Sinking Fund and Annuity

Unit 4: Underwriter and Stock Brokerage Account

Unit 5: Accounting for Lease

Unit 6: Accounting for Hire Purchase

ASSIGNMENTS

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

TUTOR MARKED ASSIGNMENT

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

SUMMARY

It is important you know that this course material was actually adapted from ICAN study pack. This provides you the opportunity of obtaining a BSc. degree in Accounting and preparation for your professional examinations. Therefore, it is very important that you commit adequate effort to the study of the course material for maximum benefit. Good luck.

INTERMEDIATE FINANCIAL ACCOUNTING 1

ACC311

Main Content

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Unit 5: Preparation of Published Financial Statements of Insurance Companies

UNIT 1: ACCOUNTING AND REPORTING CONCEPTS

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1.0 INTRODUCTION

In this unit, you will learn that financial statements possess certain qualitative characteristics that enhance the usefulness of the information they convey to a wide range of users. In this unit, we shall look at the elements and desirable qualities of financial statements. W e shall also look at the concepts of capital and capital maintenance, from the point of view of accountants. A number of these issues are covered in the framework for the preparation and presentation of statements issued by the International Accounting Standards Board (IASB).

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Define a conceptual framework.
2. State the purpose, status and scope of the IASB framework.
3. State the objectives of financial statements.
4. State the underlying assumptions in respect of accrual basis and going concern basis.
5. Define and describe four qualitative characteristics.
6. State and describe the elements of financial statements.
7. Explain the concept of capital maintenance.

3.0 MAIN CONTENT

3.1 THE IASB FRAMEWORK

In July 1989, the International Accounting Standards Committee (IA SC), now replaced by the International Accounting Standards Board (IASB), produced a document titled, (or 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 are issued by the IASB is constructed.

3.11 PURPOSE OF THE IASB FRAMEWORK

The framework is expected to serve the following purposes:

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

(b) Assist the IASB in promoting harmonisation 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 (IA S).

(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 w ho are interested in the work of the IASB with information on its approach to the formulation of accounting standards.

SELF ASSESSMENT EXERCISE

Outline the purposes of International Accounting Standards Board

3.12 STATUS AND SCOPE OF THE IASB FRAMEWORK

As stated above, the framework describes the basic concepts that guide the preparation of financial statements for presentation to a wide range of users. The framework is not an accounting standard; neither does it override the requirements of any specific Standard. Thus, in the event of a conflict between the Framework and an International Financial Reporting Standard (IFRS), the latter will prevail. Such conflicts will gradually cease to exist as future accounting standards will be produced in accordance with the guidelines set by 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.

3.2 THE 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 wide spectrum of users in making useful economic decisions. It identifies the following users of financial information: investors, employees, lenders, suppliers, customers, government and the public.

Information relating to financial position is normally found in the balance sheet of an entity, and is affected by the following:

(a) Economic resources controlled by the entity. This information will enable users to predict the ability of the entity to generate cash.
(b) Financial Structure of the entity. Users can predict borrowing needs, distribution of future profits and the ability of the entity to raise new finance.
(c) Liquidity and solvency of the entity. Users need this information to predict the ability of the entity to meet its financial commitments as they fall due.

Information on the financial 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 and how the cash generated is utilized.

SELF ASSESSMENT EXERCISE

What could affect the information relating to financial position in the balance sheet?

3.3 UNDERLYING ASSUMPTIONS

The Framework specifies and explains the two main assumptions that underlie the preparation of financial statements. These assumptions are the accrual basis of accounting and the going concern principle.

Accrual Basis: When 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.

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

Exotic Furniture Nig. Ltd recorded the following transactions in the first week of January 2009:

(a) Rented an office space in Port Harcourt for ₦1 million per annum and paid ₦5 million, being rent for five years demanded by the landlord.
(b) Bought office equipment for ₦240,000 on credit from Modern Business machines Ltd. The expected useful life of the equipment is four years.
(c) Received cheque of ₦1.3 million from Rivers State Polytechnic, Bori, being final payment for sales made to the Institution in 2007.
(d) Sold furniture items on credit to a local government in Rivers State for ₦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, 2009, on the assumption that financial statements are prepared under (a) the accrual basis and (b) the cash basis accounting.

SUGGESTED SOLUTION 1

Exotic Furniture Nigeria Ltd
Income Statement for the year ended 31 December 2009 (extract)

	Accrual Basis	Cash Basis
	₦'000	₦'000
Sales	4,000	1,300
Rent	1,000	5,000
Depreciation (₦240,000 x ¼)	60	-

Exotic Furniture Nigeria Ltd
Balance Sheet as at 31 December, 2009 (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, 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. This is why the sales of ₦1.3 million made in 2007 was not recorded in that year but was recorded in 2009, when the cash was received.

ILLUSTRATION 2

The values of the following noncurrent assets have been presented by the accountant of Antsa farms Ltd. The figures are in respect of the year ended 31 December 2008.

	Net book value	Market value
	₦m	₦m
Land	24	42
Plant and machinery	8	5
Equipment	4	2
Motor vehicles	6	7

What would be the carrying values of the assets in the balance sheet of Antsa Farms Ltd, as at 31 December 2008, 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 2009. Assume that the liquidating values of the company's assets are equal to the market values given above.

SUGGESTED SOLUTION 2

Antsa Farms Ltd

Carrying value of assets as at 31 December, 2008

	Where going concern principle is applicable	Where going concern principle is not applicable
	₦m	₦m
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.

SELF ASSESSMENT EXERCISE
What do you understand by the following terms 'accrual concept' and 'going concern concept'?

3.4 QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS
Meaning of Qualitative Characteristics
According to the Framework, qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The Framework identifies four principal qualitative characteristics, namely: understandability, relevance, reliability and comparability.

Understandability
Information in financial statements should be readily understandable by users who have business, economics and accounting knowledge and willingness to study the information carefully. Although financial reports should be understandable, complex matters that are relevant to economic decision-making should not be excluded merely because they are too difficult for users to understand.

Relevance
To be useful, financial information should be relevant to the decision-making needs of users. According to the Framework, information has the quality of relevance when it influences the economic decision of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations. Information may be considered relevant either because of its nature (e.g. employee benefit expense) or because it is material. Financial information is material if its omission or misstatement could affect the economic decisions of users. Although materiality is not classified as a threshold or cut-off point any information that fails the test of materiality need not be disclosed separately in the financial statements.

Reliability
According to the framework, information is said to be "reliable" when it is free from material bias and can be depended upon by users to represent faithfully that which it either purports to represent

or could reasonably be accepted to represent. In view of the inherent difficulties in identifying certain transactions or in finding appropriate methods of measurement or presentation, financial statements cannot be perfectly "accurate", hence faithful representation might be regarded as describing the closet that accountants can come towards the absolute of total accuracy (Lewis and Pendrill, 1996).

Reliability is enhanced when the following principles are observed in the presentation of financial statements:

(a) Substance over form. Transactions should be accounted for according to their substance and economic reality even if their legal form is different.
(b) Neutrality. Information should be objective and free from bias.
(c) Prudence. Reasonable effort should be made to ensure that the position, or degree of success of an entity is not overstated (Alexander and Britton, 1996); and
(d) Completeness. Financial information must be complete, if the information is to be reliable.

Comparability

(a) Users should be able to compare the financial statements of an entity through time (that is, over a period of time), to identify trends in its financial position and performance.
(b) Users should also be able to compare the financial statements of different entities to determine their relative financial positions, performance and changes in financial positions.

To effectively compare an entity's financial information over time, accounting transactions should be consistently treated and correspondingly, information of preceding periods should be disclosed. Similarly, to compare financial information across entities, the financial statements of the different entities should comply with the requirements of a set of accounting standards and their separate accounting policies should be disclosed.

'Trade-Offs' between Qualitative Characteristics of Financial Statements

There is usually a 'trade-off' between the different qualitative characteristics discussed above. Emphasis on one of the attributes may lead to a reduction in the application of another desirable quality. Under such circumstances, it is necessary to strive to achieve an appropriate balance among the characteristics in order to meet the objectives of financial statements.

Examples of these 'trade-offs' are as follows:

(a) Timeliness. In some cases it may take some time for every detail of a transaction to be determined. In such cases, financial information cannot be presented on a timely basis if financial statements are to be reliable. On the other hand, delay in presenting financial statements may affect the relevance of the information. A balance has to be struck between the benefits of reliability and relevance. The overriding consideration should be how best the information satisfies decision-making needs.
(b) 'Trade-off' between cost and Benefit
    There is also 'trade-off' between cost and benefit of preparing and presenting financial information. In principle, the benefit derived by users should exceed the cost of providing and presenting the information.
(c) 'Trade-off' between Qualitative Characteristics

‘Trade-offs’ may also arise between the qualitative characteristics in other circumstances. For instance, market values are more relevant but less reliable than historical costs. On the other hand, historical costs are usually not relevant for decision-making purposes.

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. The framework does not define these concepts but it states that the application of qualitative characteristics of financial information and compliance with appropriate accounting standards will lead to financial statements that give a true and fair view.

SELF ASSESSMENT EXERCISE
Explain the term ‘Reliability’

3.5 ELEMENTS OF FINANCIAL STATEMENTS
The financial effects of transactions and events are grouped into broad classes in the Framework. These classes comprise the elements of financial statements, namely: assets, liabilities, equity, income and expenses. The first three elements are shown in the balance sheet and are 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 statement, otherwise known as the profit and loss account or income and expenditure account. The Framework defines the elements as follows.

(a) Assets
An asset is a resource controlled by an entity as a result of past events and from future economic benefits is expected to flow to the entity.
Note the following key terms/phrases used in the above definition:
   (i) Resource Controlled by an Entity
   An entity has control over a resource if it can direct the use of the resources for its benefit.
   (ii) Past Events
   The events should have occurred before the ownership of the asset.
   (iii) Future Economic Benefits
   The resource controlled by the entity should have the potential to contribute directly or indirectly to the receipt of cash and cash equivalents by 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. Based on this definition, a liability is not merely an obligation; it is a present obligation. A present obligation is different from a future commitment. Other key terms include past events and outflow of an economic benefit, for example, transfer of cash or other assets by the enterprise.

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

(d) Income items
These 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

These 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

Recognition of the Elements of Financial Statements

Recognition Criteria

According to the Framework, recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the following criteria for recognition:

(a) It is probable that any future economic benefit associated with the item will flow to or from the entity; and

(b) The item has a cost or value that can be measured reliably.

It is necessary to note that the first recognition criterion is that the items should meet the definition of an element of financial statements.

Recognition Stages

Under the framework, the recognition of assets and liabilities fall under three stages. These are:

(a) Initial recognition

This occurs when an item first meets the definition of an asset or a liability (for instance, the acquisition of a building).

(b) Subsequent re-measurement

This involves changing the value at which an asset or a liability was initially recognized (that is, if a building is partly destroyed or when assets are re-valued by professional revaluers, the carrying values will be restated).

(c) De-recognition

This occurs when an item no longer meets the definition of an asset or liability (for instance, if the building is sold or completely destroyed).

Measurement of the Elements of Financial Statements

The Framework defines "measurement" as the process of determining the monetary amount at which the elements of financial statements are to be recognized and carried in the balance sheet and income statement. It identifies four bases of measurement, namely: historical cost, current cost, realisable (settlement) value and present value.

(a) Historical cost

Assets are recorded at the amounts of cash and cash equivalents paid or the fair value of the consideration given in exchange for them at the time of acquisition. Liabilities are recorded at the amounts of proceeds received in exchange for the obligations.

(b) Current cost

Assets are carried at the amount of cash or cash equivalent required to acquire the same or identical assets currently. Liabilities, on the other hand, are carried at the undiscounted amount currently required to settle the obligation.

(c) Realisable (settlement) value

According to the Framework, a realisable value is the amount of cash or cash equivalents that will currently be obtained by selling an asset in an orderly disposal, while “settlement value” refers to the undiscounted amount of cash and cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

(d) Present value
This refers to a current estimate of the present discounted value of the future net cash flow in the normal course of business.

The Framework does not require the application of any particular basis. In practice, historical cost is the most common basis; the other bases are applied as appropriate. For instance, stock is valued at the lower of cost and net realisable value, in accordance with the prudence concept of “not counting chickens before they are hatched”.

SELF ASSESSMENT EXERCISE
State and explain the bases of measurement

3.6 CONCEPTS OF CAPITAL AND CAPITAL MAINTENANCE

Concepts of Capital: The Framework identifies two concepts of capital: Financial concept of capital and physical concept of capital. Under the financial concept, capital is the net asset or equity of the enterprise; but under the physical concept, capital is the productive capacity of the enterprise.

Concepts of capital Maintenance: As with the concepts of capital, the framework identifies two types of capital maintenance concepts: financial capital maintenance and physical capital maintenance. Generally, capital is maintained when an enterprise has as much capital at the end of the year as it had at the beginning. Thus, financial capital is maintained when the nominal money capital at the end of the year to the figure at the beginning. Similarly, physical capital is maintained when the physical productive capacity at the year end is equal to the productive capacity at the beginning. Financial capital maintenance is sometimes classified into money financial capital maintenance (already explained above) and real financial capital maintenance which is achieved when the purchasing power of an entity’s shareholders’ fund is as much at the end of the year as at the beginning.

SELF ASSESSMENT EXERCISE
What do you understand by the concepts of capital maintenance?

4.0 CONCLUSION

In this unit, it is concluded that an enterprise records a profit when its capital at the end of the year exceeds its capital at the beginning of the same year. The Framework defines “profit” as the residual amount that remains after expenses (including capital maintenance adjustments, where applicable) have been deducted from income. Any amount over and above that required to maintain the capital at the beginning of the period is “profit”.

5.0 SUMMARY

This unit examined the basic concepts that guide the production and presentation of financial statements. These concepts include the objectives, elements, and attributes of financial statements, the concept of capital and capital maintenance and the IASB conceptual framework. Financial reports that do not apply the principal qualitative characteristics of financial statements will not show a true and fair view of the financial position and performance of the reporting entity.

6.0 TUTOR MARKED ASSIGNMENT

1. What do you understand by the term “conceptual framework”?
2. Sea-Glass Ltd paid N3 million for three years rent for an office apartment at Awka on 2 January 2006. During the year to 31 December 2006, the company sold goods valued at N25 million, to pay the balance on 30 January, 2007.
   You are required to show how these transactions would appear in the income statement of the company for the year ended 31 December, 2006, using the accrual basis of accounting.
3. Mary Jude Hospitals ltd has been experiencing low patronage due to increasing private medical practice. The Directors of the centre, Dr (Mrs) Mary Adesina and Dr Jude Adesina, are wondering whether the business should be closed permanently. The accountant of the enterprise has provided the following asset values relating to the year ended 31 December 2007.

	Net book value	Fair value	Market value
	₦’000	₦’000	₦’000
Plant and equipment	10,000	14,000	15,000
Furniture and fittings	2,000	1,800	2,200
Motor vehicles	4,000	3,000	5,000

   You are required to state the carrying values of these assets in the balance sheet of the hospital at 31 December, 2007, if the going concern assumption cannot be applied to the company.
4. State one scope of IASB Framework
5. Briefly explain the trade-off between two qualitative characteristics of financial statements. How can a balance be achieved?

7.0 REFERENCES/FURTHER READING

Institute of Chartered Accountant of Nigeria, Financial Accounting, Study Pack Lagos.

International Accounting Standard Board, International Accounting Standard.

Jennings, A. R., (2001), Financial Accounting, London, Letts Educational

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MODULE 1: PUBLISHED FINANCIAL STATEMENTS

UNIT 2: COMPANY ACCOUNTS AND REPORT

CONTENT

1.0 INTRODUCTION

In this unit we shall be discussing company's account and report. Financial accounting is a specialized branch of accounting that keeps track of a company's financial transactions. Using standardized guidelines, the transactions are recorded, summarized, and presented in a financial report or financial statement such as an income statement or a balance sheet.

Financial reporting is a broader concept than financial statements. In addition to the financial statements, financial reporting includes the company's annual report to shareholders, its annual report to the Securities and Exchange Commission, its proxy statement, and other financial information reported by the company.

It's important to point out that the purpose of financial accounting is not to report the value of a company. Rather, its purpose is to provide enough information for others to assess the value of a company for themselves.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. State the provision of CAMA relating to company financial reporting.
2. State the users of financial statements.
3. Note the content of financial statements
4. State issues that requires notes to the accounts.
5. Outline the steps in cash flow statements.

3.0 MAIN CONTENT

3.1 THE PROVISION OF COMPANIES AND ALLIED MATTERS ACT

Section 331 of companies and allied matters Act (CAMA), Cap C20 LFN 2004, states that:

(a) Every company shall cause accounting records to be kept.

(b) The accounting records shall be sufficient to show and explain the transactions of the company and shall be such as to:
   (i) Disclose with reasonable accuracy, at anytime, the financial position of the company; and
   (ii) Enable the Directors to ensure that financial statements prepared comply with the requirements of the Act with regard to form and content.
(c) The accounting records shall, in particular, contain;
   (i) Entries from day-to-day of all sums of money received and expended by the company, and the matters in respect of which the receipts and expenditure take place, and
   (ii) A record of assets and liabilities of the company.
(d) If the business of the company involves dealing in goods, the accounting records shall contain:
   (i) Statements of stock held by the company at the end of each accounting year of the company;
   (ii) All statements of stock takings from which any such statement of stock has been or is to be prepared; and
   (iii) Except in the case of goods sold by way of ordinary retail trade, statement of all goods sold and purchased, showing the goods and the buyers and sellers in sufficient detail to enable all these to be identified.

Section 334 of CAMA 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, in the case of a company not trading for profit, 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' 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.
(c) 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.

3.2 USERS OF ACCOUNTING INFORMATION

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

(a) Individuals, financial institutions or group of investors who need accounting information to determine the liquidity, profitability and viability of the enterprise.
(b) Mangers in an enterprise require accounting information to measure performance, plan and control operations.
(c) Customers and employees of an enterprise need accounting information in order to assess the ability of the enterprise to produce goods or render services on a continuous basis.
(d) Governments and regulatory bodies, such as the Central Bank of Nigeria (CBN), Securities and Exchange Commission (SEC), Nigeria Stock Exchange (NSE), Federal Inland Revenue Services (FIRS) and State Internal Revenue Service (SIRS) need accounting information to regulate certain business and plan, execute and evaluate government projects. The Federal Inland Revenue Service (FIRS) and State internal Revenue Service (SIRS) need accounting information so as to impose and collect taxes.
(e) Quasi-government established need accounting information in order to meet their statutory obligations.
(f) Competitors need accounting information to assist in formulating policies to counter competition.
(g) Creditors need accounting information to assess companies' liquidity and ability to meet their obligations to creditors as and when due.
(h) Financial analysts need accounting information in order to facilitate comparison of a company' financial statements from year to year, evaluation of results of companies within the same industry and between one industry and the other, as well as determining the industry average.

The information expected to be provided in financial statements are those that are quantitative and qualitative in nature, to aid their users in making informed economic decisions. To meet the objectives of its divers users, some of whom may not have accounting knowledge or background, financial statements are expected to be simple, clear and easy to understand.

SELF ASSESSMENT EXERCISE

State the users of financial statements.

3.3 CONTENTS OF FINANCIAL STATEMENTS

Financial statements are expected to be drawn up:
(a) In conformity with Generally Accepted Principles (GAAP);
(b) In accordance with the Statement of Accounting Standards (SAS) issued up-to-date by the Nigerian Accounting Standards Board (NASB);
(c) In agreement with the books of accounts of the entity; and
(d) In accordance with the Companies and Allied Matters Act, Cap C20 LFN 2004. Treatment of accounting matters that are not at present covered by the Nigerian Accounting Standards are expected to conform with the provisions of the International Accounting Standards (IAS). This is so because the Institute of Chartered Accountants of Nigeria (ICAN) is a member of International Federation of Accountants (IFAC). Consequently, ICAN members are obliged to comply with the pronouncements of IFAC. Besides, financial statements prepared in Nigeria are expected to be used globally without any problem in interpreting their contents.

All financial statements must as a matter of statutory requirement, contain the comparative figures for the preceding year (or period), to facilitate comparison of performance of the enterprise.

SELF ASSESSMENT EXERCISE
State three sources financial statements are expected to conform to.

Statement of Accounting Policies
Accounting policies are those bases, rules, principles, conventions and procedures adopted in preparing and presenting financial statements. Judgment is required in the choice of the accounting policies which are appropriate to the circumstances of an enterprise and will be best suited to present the "true and fair" view of its results and financial position. This had been dealt with in your earlier accounting courses. Therefore as a form of revision, the highlight of significant accounting policies that have to be stated in the financial statements is as follows:

(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. Where there has been revaluation of some or all the assets, it should be so stated that the historical cost concept is modified to include the revaluations.

(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:
1. The basis of depreciation of each class of fixed assets has to be stated. The methods which can be used included: straight-line, reducing balance, amortisation over lives of the assets, sum-of-the years digit.
2. The rate of depreciation for each class of fixed assets should be stated.

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

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

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

(h) Deferred Taxation: 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 in foreign currencies 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) Employee's 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 IAS 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.

Balance Sheet

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

(a) Fixed assets- property, plant and equipment
   1. Land-freehold and leasehold.
   2. Buildings
   3. Plant and equipment
   4. Other categories of assets, suitably identified, such as motor vehicles, furniture and fittings.
   5. Accumulated depreciation for each class of assets.
      Separate disclosure in a note form should be made of assets on lease and assets acquired on instalment purchase plans; that is, hire purchase. Such a disclosure should include the types of assets involved, their amounts and the periods covered.

(b) Other long-term assets
   1. Long-term investments (quoted and unquoted) distinguished between:
      - Investments in subsidiaries
      - Investments in associated companies; and
      - Other investments
   2. Long-term debts: All long term debts including their tenure
   3. Intangible assets like
      - Goodwill.
      - Patents, trademarks and similar assets.
      - Deferred charges such as: Pre-incorporation and formation expenses; and pre-production expenses and re-organisation expenses.

      Any "write-offs" during the period and the market values of investments should be disclosed.

(c) Current Assets
   1. Stocks and work-in-progress.

2. Current portion of long-term debts
3. Trade debts
4. Prepayments and sundry debtors
5. Directors debit balances.
6. Inter-company debit balances of subsidiaries and associated companies.
7. Short-term investments (including treasury bills, certificates of deposits and commercial notes, bills of exchange).
8. Foreign currency deposits for imports.
9. Deposits awaiting remittances to overseas creditors; and
10. Cash and bank balances.

(d) Capital and Reserves

1. The variety of ownership interest such as deferred shares, ordinary shares, preference shares, cumulative, non-cumulative, participating and non-participating preference shares, stating:
    - The number, nominal value and amount of shares authorised and issued.
    - The rights, preferences and restrictions with respect to the distribution of dividends and to the repayment of capital.
    - Cumulative preference dividend in arrears.
    - Shares reserved for future issue under options, sales contracts and options for conversion of loans and debentures into shares, including the terms and amounts; and
    - Movements in the share capital accounts during the period.
2. Other shareholders interests, indicating movements during the period and any restrictions on their capitalisation by way of bonus shares:
    - Capital redemption reserve fund.
    - Share premium or discount
    - Revaluation surplus.
    - Revenue and capital reserves.
    - Retained earnings.

(e) Liabilities

1. Long-term liabilities, distinguishing between:
    - Secured loans
    - Unsecured loans.
    - Loans from holding, subsidiary and associated companies
      Details of the applicable interest rates, repayment terms, covenants, subordinations, etc, should be disclosed.
2. Current liabilities, disclosing separately:
    - Amounts due to holding, subsidiary and associated companies.
    - Trade creditors
    - Other creditors and accrued expenses.
    - Dividends payable
    - Taxation
    - Current portion of long-term liabilities
    - Bank loans and overdrafts.

(f) General information to be disclosed include:
   1. Restrictions on the title to assets.
   2. Restrictions on the distribution of dividends.
   3. Securities given in respect of liabilities.
   4. The method of providing for pension or retirement scheme together with statement as to whether the scheme is funded or unfunded.
   5. Contingent assets and contingent liabilities.
   6. Amounts approved or committed for future capital expenditure; and
   7. Events that have occurred after the balance sheet date but before the financial statements are approved by the Board.

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 organization, 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) Administrative expenses.
(h) Interest charges.
(i) Taxes on income; and
(j) Unusual charges/credits, otherwise known as abnormal or exceptional items.
   These are income items or expenditure, which although unusually large, are within the normal trading activities of the business.
   Examples of exceptional items include:
   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- these are items deriving from events or transactions outside the ordinary activities of the business and which are both material 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 NOTES TO THE ACCOUNTS

The financial statements should be accompanied by appropriate explanatory notes to the figures in the balance sheet, profit and loss account and cash flow statement.

The Companies and Allied Matters Act, Cap. C20 LFN 2004 specifically requires the disclosure of the following information in the notes to the accounts:

(a) Directors' emolument stating:
   1. Chairman's emoluments
   2. Highest paid Director's emoluments.
   3. Directors' fees.
   4. Other emoluments; and
   5. 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:
   1. Average number of employees during the period and the related costs; and
   2. Number of employees earning within a stated band of emoluments

(e) Capital commitments stating value of capital expenditure authorized 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 material effect the events will have on the financial statements (if any).

SELF ASSEMENT EXERCISE

State five explanatory notes that is supposed to accompany the financial statements.

3.5 REPORT

Auditors' Report

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

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

(b) The financial statements:
   1. Are in agreement with the books of accounts;
   2. Give a true and fair view of the company's affairs;
   3. Have been prepared in accordance with relevant Statements of Accounting Standards issued by the Nigerian Accounting Standards Board; and
   4. Have been properly prepared in accordance with the Companies and Allied Matters Act, Cap, C20 LFN 2004.

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 Cap, C20 LFN 2004.
(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 share.
(f) Directors’ interest in the company’s contracts.
(g) Major shareholdings, disclosing shares held by individuals and organizations holding more than 10% of the company’s issued share capital.
(h) Employment and employees, highlighting company’s policies regarding:
    1. Employment of disabled persons.
    2. Employees’ health, safety and welfare.
    3. 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 organizations to which the company donated and amount made available.

Audit Committee’s Report
In accordance with Section 359(6) of the Companies and Allied Matters Act, Cap, C20 LFN 2004, every public company is required to elect maximum of six (6) members into the Audit Committee at every Annual General Meeting to function until the next Annual General Meeting when fresh election is conducted.

Three of the members are elected by the shareholders and the remaining three elected by the Board of Directors, from the board members.

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
(e) 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.

SELF ASSESSMENT EXERCISE
Mention two reports and explain them that should be contained in the financial statements.

3.6 CASH FLOW STATEMENT

This provides information on the derivation and utilisation of funds during the period covered by the financial statements. When cash flow statement is taken together with the balance sheet and profit and loss account, better insight is obtained as to how the activities of an enterprise have been financed.

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:
    1. Depreciation and amortization charge on fixed assets;
    2. Profit or loss on disposal of fixed assets; and
    3. Provision for unfunded pension plan.

(b) Changes in Current Assets and liabilities
    Increase or decrease in current assets and liabilities when compared to those in the preceding year is accounted for under this sub-head to reflect:
    1. Increase or decrease in stock;
    2. Increase or decrease in creditors and accruals; and
    3. Increase or decrease in foreign currency deposit for imports;
    4. Increase or decrease in creditors and accruals.

(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 flows from investing activities
    Actual cash outflows or inflows of the following, during the period covered by the financial statements, are disclosed:
    1. Purchase of fixed assets, investment or intangible assets.
    2. Proceeds from sale of assets, investment or intangible assets; and
    3. Dividends and interests received on investments.

(e) Cash flows from financing activities
    Actual cash inflows or outflows on the following during the period covered by the financial statements are disclosed:
    1. Dividends paid to shareholders;
    2. Repayment of debenture stock; and
    3. 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 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:
    1. Cash and bank balances;
    2. Bank overdrafts; and
    3. Investments in commercial papers and other short-term financial instruments.

SELF ASSESSMENT EXERCISE
What should be disclosed by the cash flow statement?

3.7 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 concept here is the difference between the cost of inputs (bought-in materials and services) and value of outputs (turnover) is the value added by the operations of the business.

The value added can then be analysed to show how it has been applied. Note that wages are not included in cost of inputs from third party (outside the business).

Thus, the statement reports the claims of social and economic groups, reaffirming the contemporary belief that enterprises do not exist for the benefit of their owners (shareholders) only; but, also for the society at large.

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) and (b) above represents value added; and
- (d) Distribution of value-added to various groups such as:
    1. Employees- salaries, wages and fringe benefits;
    2. Government – company income and education taxes, excise duties;
    3. Providers of finance – dividends, interest, etc;
    4. Retained for the replacement of assets and business growth:
        - To provide for depreciation of fixed assets; and
        - To augment reserves.

SELF ASSESSMENT EXERCISE
State the content of a value-added statement

3.8 FIVE-YEAR FINANCIAL SUMMARY
The five-year financial summary enables an instant comparison for an enterprise's activities over the five-year period. Information to be disclosed are as follows:

- (a) Results
    1. Turnover
    2. Profit before tax
    3. Taxation
    4. Profit after taxation
    5. Dividend
    6. Retained earnings
- (b) Assets Employed
    1. Fixed assets
    2. Intangible assets

    3. Investments
    4. Net current assets
    5. Long term liabilities and deferred charges
(c) Funds Employed
    1. Issued share capital
    2. Share premium
    3. Revaluation reserves
    4. Other reserves- revenue, bonus issue
(d) Financial Statistic – (per share data)
    1. Share price at the end of period
    2. Earnings per share
    3. Dividend per share
    4. Dividend cover
    5. Net worth per share
    6. Return on capital employed
    7. Current assets: Current Liabilities

4.0 CONCLUSION

It can be concluded that an annual report is a document produced annually by companies designed to portray a true and fair view of the company's annual performance, with audited financial statements prepared in accordance with company law and other regulatory requirements, and also containing other non-financial information.

Directors are responsible for the preparation of the accounts which must give a true and fair view. A true and fair view is one where accounts reflect what has happened and do not mislead the readers. The accounts must be prepared in accordance with relevant accounting standards.

5.0 SUMMARY

This unit explores the statutory framework guiding the contents of financial statements as stipulated in the Companies and Allied Matters Act, Cap C20, LFN 2004. 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 Nigerian Accounting Standards Board, and in agreement with the books of accounts of the entity. Objectives of the various users of financial statements were reviewed.

6.0 TUTOR MARKED ASSIGNMENT

1. State one item highlighted by the Chairman's statement in a company's annual report.
2. Highlight any major difference between Auditors' report and Audit Committee's report.
3. State the information usually disclosed in form of notes to the financial statements that may not affect the figures in the accounts.
4. State one use of five-year financial summary.
5. State one report expected to be found in published financial statements of a published quoted company.

7.0 REFERENCES/FURTHER READING

Aborode, R. (2004), A Practical Approach to Advanced Financial Accounting, Lagos, El-TODA Venture

Ltd
Igben, R. O., (2004), Financial Accounting made Simple, Lagos, El-TODA Ventures Ltd, Volume 2.

Institute of Chartered Accountants of Nigeria, Financial Accounting, Study Pack, Lagos.

MODULE 1: PUBLISHED FINANCIAL STATEMENTS

UNIT 3: PREPARATION OF PUBLISHED FINANCIAL STATEMENTS OF LIMITED LIABILITY COMPANIES

CONTENT

1.0 INTRODUCTION

You must have been familiar with the purpose of trading, profit and loss account and balance sheet which is prepared by the accountant reporting to management the state of affairs of the company. To be specific, the trading account helps to determine the gross profit for the period while the profit and loss account helps determine the net profit, and the balance sheet shows the state of affairs of the company at a point in time.

However, the one you may have been familiar with is for internal purpose. That is different from the one used for external purpose. For external purpose, I mean users of the financial statements that are not the management of the company.

In this unit, you shall be shown the format of published financial statements and see illustrations that would further establish your knowledge base on published financial statements.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Identify the formats of published financial statements.
2. Examine illustrations on published financial statements of limited liability companies.

3.0 MAIN CONTENT

3.1 FORMATS OF PUBLISHED FINANCIAL STATEMENTS OF PUBLIC COMPANIES

XYZ NIGERIA PLC

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31 DECEMBER 2004

	NOTE	2004	2003
		₦	₦
Turnover	1	x	x
Cost of sales		(x)	(x)
Gross profit		x	x
Distribution expenses		(x)	(x)
Administrative expenses		(x)	(x)
Trading profit		xx	xx
Interest income		x	x

		Xx	xx
Interest payable and similar charges		(x)	(x)
Profit before taxation	2	xx	xx
Taxation	3	(x)	(x)
Profit after taxation		xx	xx
Proposed dividend	4	(x)	(x)
Retained profit for the year		x	x
Transfer to general reserve	5	xx	xx
Earnings per share (kobo)		xx	xx
Dividend per share (kobo)		x	x

XYZ NIGERIA PLC
BALANCE SHEET AS AT 31 DECEMBER 2004

		2004		2003	
	NOTE	₦	₦	₦	₦
Fixed Assets	6		x		x
Investments	7		x		x
Current Assets:					
Stocks and work-in-progress	8	x		x	
Debtors and prepayments	9	x		x	
Deposits for imports		x		x	
Bank deposits		x		x	
Cash and bank balances		x		x	
		Xx		xx	
Current Liabilities:					
Creditors: due within one year of balance Sheet date:					
Creditors and accruals	10	(x)		(x)	
Bank overdrafts	11	(x)		(x)	
Net Current assets/(Liabilities)			xxx		xxx
Creditors: due after one year of balance Sheet date:					
Gratuity and retirement benefit		x		x	
Provision for deferred tax	12	x		x	
			(x)		(x)
Total Net Assets			xxxx		xxxx
Represented by:					
Capital and reserves:					
Share capital	13	x		x	
Capital reserve	14	x		x	
General reserve	15	x		x	
Shareholders' fund		xxx		xxx	

SELF ASSESSMENT EXERCISE

Draft the format of a published profit and loss account and a balance sheet on the page of a piece of paper

3.2 ILLUSTRATIONS ON PUBLISHED FINANCIAL STATEMENTS OF LIMITED LIABILITY COMPANIES

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

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:

	Dr	Cr
	₦'000	₦'000
Freehold land	25,000	
Short-term deposits	50,000	
Sundry debtors	60,820	
Cash and bank	50,862	
Furniture and fittings- 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 debts.
(b) Stock was valued at ₦28,648,000 as at 30 April, 2008.
(c) Wages outstanding at 30 April, 2008 amounted to ₦2,400,000 and electricity accrued was ₦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 ₦8 million has been sold for N6 million in part exchange for a new machinery costing ₦12 million. A net invoice for N6 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 ₦10 million. 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 was ₦35 million.

(j) 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

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	
Administrative 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 tax			77,156
Interim dividend paid		24,000	
Final dividend proposed (8% x N200,000)		16,000	(40,000)
Retained profit for the year			37,156
Earnings per share of 50 kobo	4		19 kobo
Dividend per share of 50 kobo			10 kobo

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 Prepayment	6	58,064	
Short-term deposit		50,000	
Cash and bank balances		50,862	
		187,574	
Current Liabilities (amount falling due within one year):			
Creditors and accrual	7	(97,922)	
Bank overdrafts		(25,000)	
		122,922	

Net current assets N(187,574 – 122,922)		64,652
Net Assets		239,556
Financed by:		
CAPITAL AND RESERVES		
Share capital		
400,000 ordinary shares of 50 kobo each		200,000
Revenue Reserve	8	39,556
Shareholders' fund		239,556

WORKINGS

1. Cost of Sales:

	₦'000
Opening stock	27,160
Purchases (N306,832 – N6,000)	300,832
	327,992
Less: closing stock	28,648
	299,344
Wages (N97,280 + N2,400)	99,680
	399,024

2. Selling and distribution expenses:

Distribution expenses	2,140
Selling expenses – sales manager's commission	
(2% of gross profit of N241,100)	4,822
	6,962

3. Administrative expenses:

Salaries	76,850
Bad debt N{(60,820 x 5%) + 560}	3,601
Depreciation charge:	
Plant and machinery N{(164,000 – 10,000) + 12,000} x 10%	16,600
Furniture & fittings N(44,720 x 5%)	2,236
Insurance N(2,060 – 285)	1,775
Loss on disposal of machinery N(8,000 – 6000)	2,000
Electricity N(3,800 + 280)	4,080
Postages & telephone	2,100
General expenses	6,060
Rates	1,580
Auditors' remuneration	2,000
	118,882

4. Earnings per share = profit after tax/No. Of issued shares = 77,156 x100/400,000
   = 19.29 kobo

5. Fixed Assets

	Freehold land	Furniture & Fittings	Machinery & equipment	Total
COST:	₦'000	₦'000	₦'000	N'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)	-	13,416	47,400	60,816
Net book value:				
At 30 April 2008 (a – b)	25,000	31,304	118,600	174,904

6. Debtors & prepayments

	N'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	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

Tutorial:
The following stages of solving the question are recommended:
(a) Read through the question and note the adjustments required. Identify the figures in the trial balance that will be affected by the adjustments required.
(b) Do your workings on a separate sheet, affecting all adjustments listed. The workings should be submitted as part of your answers.
(c) Prepare the profit and loss account and balance sheet, using the recommended format, slotting in the figures from the trial balance and workings.

ILLUSTRATION 4
Excel Plc is a manufacturing company. Its trial balance as at 30 April, 2008, is as follows:

	Dr	Cr
	₦'000	₦'000
Goodwill	500	
Land and building	15,950	
Plant and machinery	68,880	
Furniture & fittings	44,530	

Accumulated depreciation:		
Land and building		2,700
Plant and machinery		51,350
Furniture and fittings		33,500
Investment – quoted	2,370	
Unquoted	3,020	
Ordinary share capital @ 50k/share		63,000
General reserve		500
Profit and loss account		750
Provision for deferred tax		3,040
Stocks- raw material	10,800	
Work-in-progress	9,780	
Finished goods	11,530	
Sales		73,470
Rent received		170
Investment income		800
Other interest received		600
Profit on sale of plant		3,600
Purchase of raw materials	28,620	
External charges on raw materials	180	
Wages and salaries	9,060	
Pension cost on employees	1,220	
Depreciation charge for the year:		
Land and building	410	
Plant & machinery	5,940	
Furniture and fittings	3,250	
Rent, rates and insurance	3,900	
Power and lighting	6,940	
Distribution expenses	2,660	
Audit fees	320	
Sundry expenses	400	
Interest paid on bank overdraft	200	
Bills of exchange payable		100
Trade creditors		12,850
Other creditors		2,060
Company income tax brought forward		3,080
Creditors due after one year:		
6% debenture 2004 – 2020		5,550
Others		680
Rationalization cost	2,070	
Prepayments	2,410	
Bank balance	9,210	
Trade debtors	13,560	
Other debtors	90	
	257,800	257,800

The following additional information are also relevant: ₦'000

1. Stocks at 30 April 2008 - raw materials 12,810
   - Work-in-progress 11,050
   - Finished goods 12,580

2. During the year, additions to fixed assets were as follows:

Plant & machinery	8,530
Furniture & fittings	780

Disposals were made as follows:

Plant & machinery- at cost (Acc. Depreciation ₦2,670,000) 3,020

Furniture & fittings- at cost (Acc. Depreciation ₦910,000) 1,250

3. Proposed dividend is 6 kobo per share.
4. Provision in the accounts for company income tax of ₦2,400,000 and capital gains tax on sale of plant of ₦450,000 is made.
5. Under-provision for company income tax in respect of year ended 30/4/07 was ₦250,000.
6. Included in salaries and wages are directors' fees of ₦0.5 million and executive directors' salaries of ₦2.5 million.

You are required to prepare the profit and loss account for the year ended 30 April 2008 and balance sheet as at that date in a form suitable for publication in line with CAMA, 2004 for Excel Plc. Show all workings.

SUGGESTED SOLUTION 4

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

	Note	₦'000	₦'000
Turnover	1		73,470
Cost of sales (w1)			(31,410)
Gross profit			42,060
Distribution expenses		2,660	
Administration expenses (w2)		24,500	
			(27,160)
Trading profit			14,900
Other income	2		1,570
			16,470
Interest paid on bank overdraft			(200)
Profit on ordinary activities before taxation	3		16,270
Tax on ordinary activities	4		(2,650)
Profit on ordinary activities after taxation			13,620
Extra-ordinary item	5	3,150	
Exceptional item	6	(2,070)	
			1,080
Un-appropriated profit for the year			14,700
APPROPRIATIONS:			
Proposed dividend (w3)			(7,560)
Retained profit for the year			7,140

EXCEL PLC
BALANCE SHEET AS AT 30 APRIL 2004

	Note	₦'000	₦'000
Fixed assets	7		41,810
Investments	8		5,390
Goodwill			500
Current Assets:			

Stocks and work-in-progress	9	36,440	
Debtors and prepayments	10	16,060	
Bank		9,210	
		61,710	
Less: current liabilities:			
Creditors: due within one year of			
Balance sheet date:	11	28,750	
Net current assets			32,960
Creditors due more than one year of			
Balance sheet date:	12		(9,270)
Net Assets			71,390
Financed by:			
Capital and reserves:			
Share capital	13		63,000
Reserves	14		8,390
Shareholders' fund			71,390

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 30 APRIL 2008

1. Turnover represents sales of manufactured products within Nigeria.
2. Other income: ₦'000

Rent received	170
Investment income	800
Other interest received	600
	1,570

3. Profit on ordinary activities before tax
   Is stated after charging directors' emolument:

Fees	500
Others	2,500
Auditors' remuneration	320
Depreciation of fixed assets	9,600
N(410 + 5,940 + 3,250)	

4. Taxation:

Tax charged for the year	2,400
Under- provision in preceding year	250
Per profit and loss account	2,650
Balance brought forward	3,080
Capital Gains tax	450
Per balance sheet (note 11)	6,180

5. Extra-ordinary items:

Profit on sale of plant	3,600
Less: capital gains tax	450
	3,150

6. Exceptional items:

Rationalization cost	2,070

7. Fixed assets

	Land &	Plant &	Furniture	Total

	Building	machinery	& fittings	
Cost:	₦'000	₦'000	₦'000	₦'000
At 1/5/2007	15,950	63,370	45,000	124,320
Additions	-	8,530	780	9,310
Disposals	-	(3,020)	(1,250)	(4,270)
At 30/04/2008 (a)	15,950	68,880	44,530	129,360
Depreciation:				
At 1/5/2007	2,290	48,080	31,160	81,530
Charge for the year	410	5,940	3,250	9,600
Eliminated on disposal	-	(2,670)	(910)	(3,580)
At 30/04/2008 (b)	2,700	51,350	33,500	87,550
Net book value:				
At 30/04/2008 (a – b)	13,250	17,530	11,030	41,810

8.	Investment:	₦'000
	Quoted	2,370
	Unquoted	3,020
		5,390
9.	Stocks and work-in-progress:	
	Raw materials	12,810
	Work-in-progress	11,050
	Finished goods	12,580
		36,440
10.	Debtors and prepayments:	
	Trade debtors	13,560
	Other debtors	90
	Prepayments	2,410
		16,060
11.	Creditors due within year:	
	Trade creditors	12,850
	Other creditors	2,060
	Taxation (note 4)	6,180
	Bills payable	100
	Proposed dividend	7,560
		28,750
12.	Creditors due after one year:	
	6% debenture (2004 – 2020)	5,550
	Other long-term creditors	680
	Deferred tax	3,040
		9,270
13.	Share Capital:	
	Authorized, issued and fully paid:	
	126,000,000 ordinary shares of 50K each	63,000
14.	Reserves:	
	General reserve	500
	Revenue reserve:	

Balance brought forward	750	
Retained profit for the year	7,140	7,890
		8,390

WORKINGS

1. Cost of sales:

	₦'000	₦'000
Opening stock – N(10,800+9,780+11,530)		32,110
Add: Purchases of raw material	28,620	
External charges on raw material	180	
		28,800
		60,910
Less: closing stock N(12,810+11,050+12580)		(36,440)
		24,470
Power and lighting		6,940
		31,410

2. Administrative expenses consist of:

Directors' emoluments	3,000
Wages & salaries	6,060
Pension cost	1,220
Rent, rates & insurance	3,900
Audit fees	320
Sundry expenses	400
Depreciation charge	9,600
	24,500

3. Proposed dividend
   6 kobo per 126,000,000 ordinary shares
   = 126,000,000 x 6/100 = 7,560

SELF ASSESSMENT EXERCISE

Without looking at the solution given above, try and solve the same questions and compare it with the solution.

4.0 CONCLUSION

In this unit, you learnt the wider base of published financial statements which would help you in presenting published financial statements whether in exams or in practice.

5.0 SUMMARY

In this unit, you were shown the presentation of published financial statement by looking at the format of financial statements. In addition, we looked at illustrations that would help you appreciate in practical terms the presentation of published financial statements.

6.0 TUTOR MARKED ASSIGNMENT

1. The stock in the trial balance shows ₦7,000,0000 and stock in additional information shows ₦16,000,000. What would be the value of stock in the balance sheet?
2. The format in which the final accounts of a limited liability company should be published in Nigeria is prescribed by what?
3. The salaries of accountants are classified under what expenses?
4. The commission of sales men are classified under what expenses?

7.0 REFERENCES/FURTHER READING

Institute of Chartered Accountant of Nigeria, Financial Accounting, Study Pack Lagos.

International Accounting Standard Board, International Accounting Standard.

Jennings, A. R., (2001), Financial Accounting, London, Letts Educational

Jennings, A. R., (2001), Financial Accounting, Solution Manual, London, Letts Educational

Nigerian Accounting Standard Board, Statement of Accounting Standard

MODULE 1: PUBLISHED FINANCIAL STATEMENT

UNIT 4: PREPARATION OF PUBLISHED FINANCIAL STATEMENTS FOR BANK AND NON- BANK FINANCIAL INSTITUTIONS

CONTENT

1.0 INTRODUCTION

In this unit, you are introduced to SAS number 10 and 15 as a guide on the accounting policies and methods that should be followed by banks and non-bank financial institutions in the preparation of their financial statements.

These statements focus on three main areas of concern relating to the accounting practices which should be followed, namely:

(a) Income recognition
(b) Loss recognition and
(c) Balance sheet classification and disclosures in financial statements.

Banks include:

(a) Commercial and merchant banks (now merged under universal banking guidelines of CBN).
(b) Community banks.
(c) Development banks such as Bank of Industry and Federal Mortgage Bank.

Non-bank financial institutions include:

(a) Finance companies
(b) Bureaux de change
(c) Mortgage institutions
(d) Discount houses
(e) Stock broking firms
(f) Other capital market operators such as issuing houses, etc.

Banks and other financial institutions are also required to comply with the accounting requirements of Banks and Other Financial Institutions Act, 1991 (as amended), in preparing their financial statements.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Identify the disclosure requirements for banks.
2. Identify the disclosure requirements for non-bank financial institutions.
3. Identify the accounting policies peculiar to banks
4. Solve questions relating to the presentation of published financial statements of banks.

3.0 MAIN CONTENT

3.1 DISCLOSURE REQUIREMENTS FOR BANKS

Banks: In addition to the disclosure requirements of SAS No 2- information to be disclosed in financial statements, banks should also disclose the following:

(a) Accounting policies in respect of identification and provision for losses of non-performing loans, nature of off-balance sheet engagements, such as letters of credits, bonds, guarantees, indemnities, acceptances, and trade related contingencies such as documentary credits and methods used to recognise income thereon.

(b) Income statements, stating each principal revenue item:
   1. Interest income, split between bank and non-bank sources.
   2. Interest expenses, split between bank and non-bank sources.
   3. Credit related fee income and expense.

A bank should not offset one item of revenue or expense by deducting it from another item of revenue or expense.

(c) Assets and liabilities in the balance sheets to be grouped according to their nature and listed in the order of their liquidity and maturity. Assets should start with cash and short-term funds while liabilities with loan stock.

(d) A maturity profile of risk assets and deposit liabilities classified into the following categories:
Under 1 month
1 – 3 months
3 – 6 months
6 – 12 months
Over 12 months
The above maturity profile should be based on the expected normal repayment periods of the assets and liabilities.

(e) The amount of provision for loan losses, segregated between principal and interest. Provision for losses of "off-balance sheet" engagements should be shown separately as component of other liabilities.

(f) An analysis of the movements in the various categories of loan loss provision should be disclosed.

(g) One item of asset or liability should not be offset by deducting another asset or liability unless a legal right of 'set-off' exists.

(h) An analysis of loans and advances between "performing" and "non-performing" loans.

(i) The nature and amount of contingencies and commitments arising from the “off balance sheet” engagements which the bank has undertaken and analysis between the different classes of contingencies. “off balance sheet” engagements should not form part of balance sheet totals.
(j) The major items that make up its “other assets” and “other liabilities” in the form of notes to the accounts.

3.2 DISCLOSURE REQUIREMENTS FOR NON-BANK FINANCIAL INSTITUTIONS (NBFIS)
In addition to the disclosure requirements of SAS No 2, all NBFIs should also disclose the following:

(a) Accounting policies in respect of:
   1. The methods and bases by which provisions for losses on loans or securities are made.
   2. The nature of “off-balance sheet” engagements and the method used to recognise income or loss thereon.
(b) Income statement to include all important revenue items and expenses as applicable to ‘NBFIs’.
(c) Grouping of assets and liabilities in the balance sheet according to their nature, liquidity and maturity.
(d) “off-balance sheet” engagements should not form part of balance sheet totals.
(e) A loan granting NBFI should disclose an analysis of the facilities given, distinguishing between “performing” and “non-performing”, and their maturity profiles.

Specific Requirements – NBFIs

In addition to the above disclosure requirements, all NBFIs should disclose the following, in their financial statements, as they relate to their specific activities:

(a) Brokers/Dealers
   1. Value of outstanding deliveries at the ruling market price.
   2. Value of share box load (that is, aggregate value of shares held in stock-broker’s portfolio) at the ruling market price.
   3. Investment profile- that is, the amount of money market/capital market assets of the company.
   4. Balances on clients’ accounts.
(b) Capital Market Underwriters should disclose: Value of securities underwritten but not yet disposed of, distinguished between “listed” and those awaiting listing.
(c) Discount Houses
   1. Deposits, split between call and term deposits, with their maturity profiles.
   2. Securities, analysed into treasury bills and certificates, other government securities and private sector securities.
   3. Deposits, split between call and term deposits, with their maturity profiles.
(d) Finance Houses
   1. Total value of placements with other finance houses with analysis of the period to maturity/period from maturity.
   2. Schedule of sectorial allocation of risk assets such as trade finance, lease, and money and capital market instruments.
   3. Breakdown of items that constitute “other assets” and “other liabilities”.

(e) Bureaux De Change (BDC)
1. BDC establishments should treat their foreign currencies as stocks. The stock of foreign currencies as stocks. The stock of foreign currencies held at the balance sheet date should be valued at the lower of cost and market value.
2. Quantity and naira equivalent of the different foreign currencies traded in, during the period.
3. Value of foreign currencies held and conversion rates used at the balance sheet date.

(f) Mortgage Institutions
1. Total liabilities to National Housing Fund.
2. Total value of mortgage assets and movements thereon, showing:
    - Assets brought forward
    - Additions during the year/period
    - Disposals and realisations during the year
    - Balance carried forward.
3. Other sources of funds, apart from share capital and National Housing Fund.
4. Classification of mortgage loans receivable and mortgage backed securities into those for sale and those for long-term investments.
5. Detailed breakdown of servicing rights acquired during the year, stating the:
    - The amount capitalised;
    - The method of amortization; and
    - The amount amortized.

SELF ASSESSMENT EXERCISE
State what should be disclosed in the financial statements regarding finance houses and mortgage institutions

3.3 ACCOUNTING POLICIES PECULIAR TO BANKS

(a) Loans and Advances

Loan and advances are stated net of provision for doubtful debts. This provision is determined from a specific assessment of each customer's account, in accordance with the prudential guidelines, as summarized below:
1. Credit facilities should be classified as either "performing" or "non-performing".
2. A credit facility is deemed to be performing if payments of both principal and interest are up-to-date in accordance with the agreed terms.
3. A credit facility should be deemed as "non-performing when interest or principal is due and unpaid for 90 days or more.
4. "Non-performing credit" facilities should be classified into three categories, namely: sub-standard, doubtful or los on the following criteria:

    Sub-standard- unpaid principal and/or interest remain outstanding for more than 90 days, but less than 180 days after due date. 10% provision is made for facilities in this category.

    Doubtful- unpaid principal and/or interest which remain outstanding for at least 180 days, but less than 360 days, after due date and are not secured by legal title to lease assets or perfected realisable collateral in the process of collection or realisation. 50% provision is made for facilities in this category.

Lost- unpaid principal and/or interest which remain outstanding for 360 days or more and are not secured by legal title to leased assets or perfected realisable collateral in the course of collection or realization. 100% provision is made for facilities in this category.

5. A general provision of at least 1% is made on risk assets not specifically provided for.
6. Each microfinance bank is expected to review, at least once a month, its loans and advances, and make appropriate provisions for loan losses, as follows:

0	Performing	1%
1 – 30 days	Pass and watch	5%
31 – 60 days	Substandard	20%
61 – 90 days	Doubtful	50%
91 or more days and / or restructured loans	Lost	100%

(b) Income Recognition

Interest income is recognised on accrual basis. Interest overdue for more than 90 dyas is suspended and recognised on cash basis only.

(c) Foreign Currency:

1. Transactions in foreign currencies are translated to naira at the rate of exchange ruling at the date of the transaction.
2. Balances in overseas branches are converted to naira at the rate of exchange ruling at the balance sheet date.

SELF ASSESSMENT EXERCISE

State how "non-performing" loan should be classified?

3.4 FORMAT OF PUBLISHED FINANCIAL STATEMENT OF BANKS

ABC BANK PLC

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31 DECEMBER 2008

		2008		2007	
	NOTE	₦	₦	₦	₦
Gross Earnings	1		x		x
Interest expenses	2		(x)		(x)
Net income from operations			xx		xx
Operating expenses		(x)		(x)	
Provision for risk assets	3	(x)		(x)	
Depreciation		(x)		(x)	
			(xx)		(xx)
Profit before taxation	4		xxx		xxx
Taxation	5		(x)		(x)
Profit after taxation			xx		xx
APPROPRIATIONS:					
Transfer to Statutory reserve	6		(x)		(x)
Transfer to small scale industries					
Reserve	7		(x)		(x)
Proposed dividend	8		(x)		(x)
Retained profit for the year			x		x
Transfer to general reserve	9		x		x
			Xx		xx
Earnings per share (kobo)			x		x

Dividend per share (kobo)	x	x

ABC BANK PLC
BALANCE SHEET AS AT 31 DECEMBER 2008

		2008	2007
ASSETS	NOTE	₦	₦
Cash and short-term funds	10	x	x
Placements with other banks			
And financial Institutions	11	x	x
Bills discounted	12	x	x
Other investments	13	x	x
Loans and advances	14	x	x
Advances under finance lease	15	x	x
Other assets	16	x	x
Equipment on lease	17	x	x
Fixed assets	18	x	x
Total assets		xx	xx
Financed by:			
Liabilities:			
Deposits, current and other accounts	19	x	x
Taxation	20	x	x
Deferred Taxation	21	x	x
Other liabilities	22	x	x
		Xx	xx
Capital and Reserves:			
Called-up share capital	23	x	x
Share premium	24	x	x
Statutory reserve	25	x	x
Small scale industries reserve	26	x	x
Fixed assets revaluation surplus	27	x	x
General reserve	28	x	x
Shareholders' fund		xx	xx
Total liabilities		xx	xx
Acceptances and guarantees	29	x	x

FINANCIAL STATEMENTS OF BANKS

ILLUSTRATION 5

The following balances were extracted from the books of Reliable Bank Plc as at 31 March, 2008:

	₦'000	₦'000
Land and building	322,850	
Plant and machinery	183,000	
Motor vehicles	120,000	
Furniture & fittings	118,500	
Computer equipment	325,000	
Accumulated depreciation:		
Building		99,020
Plant and machinery		80,710
Motor vehicle		30,930
Furniture		55,360

Computer equipment		31,540
Interest paid on call money	172,350	
Interest on staff current accounts	68,270	
Interest on short term fixed deposits	393,550	
Interest on savings accounts	98,820	
Interest on sundry operations	10,800	
Bad debts	39,250	
Salaries & allowances	521,400	
General statutory expenses	143,240	
Computer stationery expenses	204,140	
Printing of cheque booklets	62,100	
Legal fees	3,710	
Transport & travelling expenses	38,960	
Advertisement & public relations	89,330	
Deposit insurance	124,840	
Property insurance	39,720	
Loans & advances	3,682,630	
Social insurance charges	14,990	
Suspense account	210,610	
Investment in debenture stocks	350,000	
Investment in commercial papers	210,000	
Investment in associated company	623,350	
Cash in hand	112,300	
CBN current account	3,958,390	
Cash reserve at CBN	1,500,000	
Foreign bank current account	5,500,000	
Call money with local banks	4,113,500	
Treasury bills	220,000	
CBN stabilization securities	193,460	
Ordinary share capital of N1 per share		2,200,000
Reserve for bonus issue		2,800,000
Profit and loss account		750,660
Statutory reserve		812,210
Small-scale industry reserve		220,500
Domiciliary account		5,837,250
Customers deposits for foreign currencies		217,300
Savings account balances		1,385,330
Current account balances		3,285,140
Deposit account balances		621,350
Call money with local balances		1,428,840
Company income tax over-provision		2,360
Deferred taxation		2,000
Interest on treasury bills		681,600
Interest on call money		896,020
Interest on discounted bills		153,890
Interest on advance and overdraft		1,004,120
Commission on discounted bill		28,130
Commission on bill collected		4,930
Commission on turnover		107,090
Commission on guarantee/bonuses		6,580
Commission on NITEL bills collected		2,210

Forex earnings		650,540
Other sundry income		111,710
Interest suspense account		3,720
Bad debts recovered		78,610
Provision for bad and doubtful debts		179,410
	23,769,060	23,769,060

The following additional information was provided:

1. Loans and advances were made up of:

	₦'000
Loans secured against real estate	1,120,650
Otherwise secured	1,641,320
Unsecured	920,660
	3,682,630

2. Performance of loans and advances are analysed as follows:

Performing loans	70.5%
Sub-standard facilities	21.0%
Doubtful facilities	8.0%
Lost facilities	0.5%
	100%

   Provision for bad and doubtful debts should be made on loans and advances in accordance with the provisions of the prudential guidelines.
3. Salaries and allowances include directors' emolument of ₦25 million.
4. The balance on reserves for bonus issue should be transferred to ordinary share capital account.
5. Make the necessary transfers to statutory and small-scale industries reserve.
6. A dividend of 12 kobo per share should be paid, based on the new share capital.
7. Accruals include the following: legal fees – ₦2,290,000
   Audit fees- ₦12,000,000
8. Fixed assets are to be depreciated, applying the following rates:

Building	- 2%
Plant & machinery	- 10%
Motor Vehicles	- 20%
Furniture & fittings	– 12%
Computer equipment	– 15%

9. A provision of ₦330,640,000 should be made in the profit and loss account to cover companies income and education taxes while ₦20 million should be set aside for deferred tax.
10. N5 million out of interest on loans and advances should be transferred to suspense account.

You are required to prepare the company's profit and loss account for the year ended 31 March 2008 and balance sheet as at that date, in a form suitable for publication.

SUGGESTED SOLUTION 5

RELIABLE BANK PLC

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31 MARCH 2008

	NOTE	₦'000
Interest income	1	2,730,630
Less: interest expenses	2	743,790
Net interest income		1,986,840
Provision for risk assets	3	(50,250)
		1,936,590
Other income	4	911,190
Operating income		2,847,780
Operating expenses (w1)		(1,368,450)
Profit on ordinary activities before tax	5	1,479,330
Tax on profit on ordinary activities	6	(348,280)
Profit on ordinary activities after tax		1,131,050
Appropriations:		
Transfer to statutory reserve (30% x N1,131,050)	7	339,315
Transfer to small-scale industries reserve (10% x N1,479,330)	8	147,933
Proposed dividend (5,000,000,000 x 12 kobo)	9	600,000
		1,087,248
Retained profit transferred to general reserve		43,802
		1,131,050
Earnings per share (adjusted)	10	22 kobo
Dividend per share		12 kobo

RELIABLE BANK PLC
BALANCE SHEET AS AT 31 MARCH 2008

ASSETS	NOTE	₦'000
Cash and short-term funds	11	15,597,650
Investments	12	1,183,350
Loans and advances	13	3,404,890
Other assets	14	210,610
Fixed assets	15	660,060
Total assets		21,056,560
LIABILITIES		
Deposits and other customers' accounts	16	12,775,210
Other liabilities	17	944,930
Deferred taxation	18	22,000
13,742,140		
CAPITAL AND RESERVES:		
Authorized and issued share capital	18	5,000,000
Statutory reserve	7	1,151,525
Small-scale industries reserve	8	368,433
General reserve	19	794,462
Shareholders' fund	(b)	7,314,420
	(a + b)	21,056,560

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED 31 MARCH 2004

1. Interest income:

	₦'000
Advances and overdrafts	1,004,120
Treasury bills	681,600
Call money	896,020
Discounted bills	153,890

		2,735,630
	Less: transfer to suspense account	5,000
		2,730,630
2.	Interest expense:	
	Call money	172,350
	Staff current account	68,270
	Short-term fixed deposits	393,550
	Savings accounts	98,820
	Sundry operations	10,800
		743,790
3.	Provision for risk assets:	
	Performing (1% x 70.5% x N3,682,630)	25,960
	Sub-standard (10% x 21% x N3,682,630)	77,340
	Doubtful (50% x 8% x N3,682,630)	147,310
	Lost (100% x 0.5% x N3,682,630)	18,410
		269,020
	Old provision brought forward	(179,410)
	Increase in provision for the year	89,610
	Add: bad debts written off	39,250
	Less: recoveries during the year	(78,610)
	For P&L a/c	50,250
4.	Other income:	₦'000
	Commission on turnover	107,090
	Commission on discounted bills	28,130
	Commission on bills collected	4,930
	Commission on guarantees & bonds	6,580
	Commission on NITEL bills collected	2,210
	Foreign exchange earnings	650,540
	Other sundry income	111,710
		911,190
5.	Profit before tax is stated after charging:	
	Directors' emolument	25,000
	Auditors' remuneration	12,000
	Insurance premium on deposit liabilities	124,840
	Depreciation of fixed assets	111,730
6.	Taxation:	
	Company income & education taxes	
	Based on profit for the year	330,640
	Less: over-provision in previous year	2,360
		328,280
	Add: deferred tax provision	20,000
		348,280
7.	Statutory reserve:	
	Balance brought forward	812,210
	Transfer from profit & loss account	339,315

Per balance sheet	1,151,525

8. Small scale industries reserve:

Balance brought forward	220,500
Transfer from profit and loss account	147,933
Per balance sheet	368,433

9. Proposed dividend:

The dividend proposed is 12 kobo per share, for 5 billion ordinary shares issued.

10. Earnings per share:

Earnings per share is calculated using profit after tax for the year on the 5 billion ordinary shares issued as at 31 March 2008.

11. Cash and short-term funds	₦'000
Cash in hand	112,300
CBN current account	3,958,390
Cash reserve at CBN	1,500,000
Foreign bank current account	5,500,000
Call money with local bank	4,113,500
Treasury bills	220,000
CBN stabilization securities	193,460
	15,597,650

12. Investments:

Debenture stocks	350,000
Commercial papers	210,000
Associated company	623,350
	1,183,350

13. Loans and advances

(i) Analysis by securities and quality

Secured against real estate	1,120,650
Otherwise secured	1,641,320
Unsecured	920,660
	3,682,630
Less: provision for	
Doubtful accounts (note 3)	269,020
	3,413,610
Less: interest in suspense N(3,720 + 5,000)	8,720
	3,404,890

(ii) Analysis by performance:

Performing		2,596,254
Non-performing:	₦	
Sub-standard	773,352	
Doubtful	294,610	
Lost	18,414	

	1,086,376
	3,682,630

14. Other assets

Suspense Account	210,610

15. Fixed Assets

	Land & Building	Plant & Machinery	Motor vehicle	Furniture & fittings	Computer equipment	Total
Cost:	₦'000	₦'000	₦'000	₦'000	₦'000	₦'000
At 1/4/2007	322,850	183,000	120,000	118,500	325,000	1,069,350
Additions	-	-	-	-	-	-
Disposals	-	-	-	-	-	-
At 31/03/2008 (a)	322,850	183,000	120,000	118,500	325,000	1,069,350
Depreciation:						
At 1/4/2007	99,020	80,710	30,930	55,360	31,540	297,560
Charge for the year	6,460	18,300	24,000	14,220	48,750	111,730
At 31/03/2008 (b)	105,480	99,010	54,930	69,580	80,290	409,290
Net book value:						
At 31/03/2008 (a – b)	217,370	83,990	65,070	48,920	244,710	660,060

16. Deposits

	₦ '000
Savings accounts	1,385,330
Current accounts	3,285,140
Deposit accounts	621,350
Deposits for foreign currencies	217,300
Call money from local bank	1,428,840
Domiciliary accounts	5,837,250
	12,775,210

17. Other liabilities

Accrued charges N(12,000 – 2,290)	14,290
Tax payable	330,640
Proposed dividend	600,000
	944,930

18. Authorized and issued share capital:

(a) At April, 2007

2,200,000,000 ordinary shares of N1 each	2,200,000
Bonus issue: transfer from bonus issue reserve	
2,800,000,000 ordinary shares of N1 each	2,800,000
	5,000,000

(b) Bonus issue reserve:

Balance brought forward	2,800,000
Transfer to issued share capital	(2,800,000)
	-

19. General reserve:

Balance brought forward	750,660
Transfer from profit and loss account	43,802

794,462

WORKINGS

1. Operating expenses comprises:

	₦'000
Legal fees (3,710 + 2,290)	6,000
Audit fees	12,000
Depreciation	111,730
Salaries and allowances	521,400
General stationery expenses	143,240
Computer stationery expenses	204,140
Printing of cheque booklets	62,100
Transport & travelling expenses	38,960
Advertisement & public relations	89,330
Deposit insurance	124,840
Property insurance	39,720
Social insurance charges	14,990
	1,368,450

SELF ASSESSMENT EXERCISE

After studying the above illustration, solve the same questions without looking at the solution and compare your answers to the solutions of these questions.

4.0 CONCLUSION

We shall conclude the unit by stating that the Nigerian Financial System comprises of bank and non-bank financial institutions which are regulated by the Federal Ministry of Finance, Central Bank of Nigeria, Nigeria Deposit Insurance Corporation, Security and Exchange Commission, Federal Mortgage Bank of Nigeria and the National Board for Community Banks.

5.0 SUMMARY

In this unit, we discussed the disclosure requirements for banks and non-bank financial institutions. We also discussed the accounting policies peculiar to banks. And finally, we observe the format of published financial statements of a banks and show illustrations of how such format is presented.

6.0 TUTOR MARKED ASSIGNMENT

1. One item of asset or liability should not be offset by deducting another asset or liability unless a _______ exists.

2. ________ engagements should not form part of balance sheet totals.

3. A loan granting NBFI should disclose an analysis of the facilities given, distinguishing between "performing" and "non-performing", and their _________

7.0 REFERENCES/FURTHER READING

Aborode, R. (2004), A Practical Approach to Advanced Financial Accounting, Lagos, El-TODA Venture Ltd

Igben, R. O., (2004), Financial Accounting made Simple, Lagos, El-TODA Ventures Ltd, Volume 2.

Institute of Chartered Accountants of Nigeria, Financial Accounting, Study Pack, Lagos.

MODULE 1: PUBLISHED FINANCIAL STATEMENTS

UNIT 5: PREPARATION OF PUBLISHED FINANCIAL STATEMENTS OF INSURANCE COMPANIES

CONTENT

1.0 INTRODUCTION

SAS No 16 establishes financial accounting and reporting standards for the financial statements of non-life and life assurance undertakings. This standard is applicable to only financial statements prepared in accordance with the provisions of the Insurance Act 2003 and CAMA 2004.

Classification of Insurance Business

(a) General Insurance Business: This is also referred to as non-life business. It indemnifies the policy holder against losses, which may result from occurrence of events within specified periods covered by the contracts.
(b) Life Assurance Business: It is an insurance business in which the benefits due to the policy holder become payable on the attainment of a stipulated age, at death or on the occurrence of a specified event. It is a long-term insurance business.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Identify the provision of SAS 16 as it relates with general insurance and life assurance business.
2. Discuss the accounting policies peculiar to insurance companies.
3. Note the format of published financial statements of insurance companies.

4. Discuss abridged financial statements

3.0 MAIN CONTENT
3.1 GENERAL INSURANCE BUSINESS

Basis of Accounting

There are several bases of accounting for insurance transactions. However, three bases commonly adopted are as follows:

(a) Annual Accounting: This is used where it is possible to determine the underwriting result of an insurance business written in an accounting period at the end of that period.
The underwriting results that are disclosed in the financial statements, under this basis, usually include the result of the current accounting period and adjustments, if any, made to estimates used in determining results of the previous accounting period.
(b) Deferred Annual: This is adopted where it is not possible to determine the underwriting result of an insurance business until the following accounting period.
(c) Fund Accounting: This is adopted where it takes a long time to determine the underwriting result with a reasonable degree of certainty. Under this basis, a fund is created for each underwriting year. Premiums or business written during the year and the related claims or expenses are posted to the fund. The fund for each underwriting year will remain open until there is enough information to determine the underwriting result. No profit is recognized for 'open years' but provision is usually made for any anticipated losses.

General Business

(a) Basis of Accounting
General insurers should adopt the annual basis of accounting. Where it is not possible to determine underwriting results with reasonable certainty until the following accounting period, the deferred annual basis should be adopted. The accounting basis adopted should be disclosed. Where the deferred annual basis is used, the classes of business involved and the extent of the deferral for the profit, should also be disclosed.
(b) Disclosure Requirements
In addition to the disclosure requirement of SAS No 2, general insurers should disclose the following:
1. Revenue Account:
    - Gross income
    - Direct premiums
    - Inward re-insurance premiums
    - Gross written premiums
    - Net written premiums
    - Decreased in provision for unexpired risks, and
    - Commission received
2. Deductions from income:
    - Outward re-insurance premium, and
    - Increase in provision for unexpired risks.
3. Expenses
    - Direct claims paid

- Inward re-insurance claims paid
- Increase in provision for outstanding claims

4. Recoveries from expenses
    - Outward re-insurance recoveries, and
    - Decrease in provision for outstanding claim
5. Underwriting expenses
    - Acquisition; and
    - Maintenance

      Outward re-insurance expenses should be reported separately as a deduction from premium revenue, while re-insurance and other recoveries should be reported separately as a deduction from claims expense.
6. Profit and loss account

   The disclosure in the profit and loss account and the notes to the financial statements should include the following income and expense captions (unless they have been disclosed in the revenue account):

   Income
    - Gross written premiums
    - Outward re-insurance premiums
    - Earned premiums
    - Net investment income
    - Commissions received

   Expense
    - Underwriting expenses
    - Claims incurred
    - Management expenses
    - Provision for bad and doubtful debts.
7. Balance sheet

   General insurers should arrange their balance sheet items in order of liquidity. The disclosure in the balance sheet and notes to the financial statements should include the following asset and liability captions:

   Assets
    - Cash and bank balances
    - Short-term investments
    - Debtors & prepayments
    - Deferred acquisition expense
    - Long-term investments
    - Statutory deposits
    - Fixed assets

   Liabilities
    - Creditors and accruals

- Insurance funds (including provision for unearned premiums, outstanding claims and unexpired risks).

Shareholders' fund

- Authorised and issued share capital
- Statutory contingency reserves
- Capital reserve
- General reserve

SELF ASSESSMENT EXERCISE
Mention and explain three bases of accounting for insurance transactions

3.2 LIFE ASSURANCE BUSINESS
Life assurance business transactions should be accounted for on the fund accounting basis.

Disclosure requirements

In addition to the disclosure requirements of SAS No 2, life assurers should disclose the following:

(a) Revenue account
1. Income:
    - Direct premiums;
    - Inward re-insurance premiums
    - Gross written premiums
    - Net written premiums
    - Commission received.
2. Deduction from income
    - Outward re-insurance premiums
3. Claims incurred
    - Direct claims
    - Inward re-insurance claims
    - Re-insurance recoveries
    - Surrenders
4. Underwriting expenses
    - Acquisition
    - Maintenance.

(b) Profit and loss account
The following should be disclosed in the profit and loss account, unless they have been disclosed in the revenue account:
1. Income:
    - Gross written premiums
    - Earned premiums
    - Net investment income
    - Commission received
    - Shareholders' portion of life assurance surplus/deficit
    - Other income

2. Deductions from income
    - Outward re-insurance premiums
3. Expenses:
    - Claims incurred;
    - Underwriting expenses;
    - Management expenses;
    - Provision for bad and doubtful debts.

(c) Balance sheet
Balance sheet items should be arranged in the order of liquidity to include the following:
Assets:

- Cash and bank balances
- Short-term investments
- Debtors & prepayments
- Loans to policy holders
- Long-term investments
- Statutory deposit
- Fixed assets.

Liabilities:

- Creditors and accruals.
- Outstanding claims;
- Insurance fund;
- Deposit administration.

Shareholders' fund:

- Called-up share capital;
- Statutory contingency reserves;
- General reserves;
- Retained earnings/accumulated losses.

Composite Business (Life and General)

An insurer carrying on both life and general business should follow the same disclosure requirements as set out above. In addition, its financial statements should include a separate life business balance sheet.

SELF ASSESSMENT EXERCISE
What should be disclosed under revenue in life assurance financial statement?

3.3 ACCOUNTING POLICIES PECULIAR TO INSURANCE COMPANIES

(a) Investment income:
Credit is taken for all dividends when received while interest receivable on unquoted investments are credited to income when due for payment. Interests on doubtful investments are not credited to the profit & loss account until the investments are realised.

(b) Statutory reserves:

1. Reserve for unexpired risks:
   In accordance with the Insurance Act, 2003, the reserve for unexpired risk for all the classes of general business is provided at the rate of 45% of net premium.
2. Outstanding claims:
   Provision is made for the expected loss to the company up to the date of the balance sheet, plus additional provision of 10% of net outstanding claims, in accordance with Insurance Act, 2003.
3. Contingency reserve:
   The reserve is calculated in accordance with the insurance Act, 2003 at the higher of 3% of total premium or 20% of the net profit.
4. General reserve for life business:
   General reserve is calculated as the net liabilities on policies in force at the time of the actuarial valuation.
5. Contingency reserve for life business:
   The reserve is calculated in accordance with the Insurance Act, 2003, at the higher of 1% of gross premium or 10% of net profit.

Agents/Brokers Balances

Agents/Brokers balances are stated net of commissions after deduction of provision for debts considered to be doubtful of collection.

SELF ASSESSMENT EXERCISE
State and explain the peculiar accounting policies of the insurance companies

3.4 FORMATS OF PUBLISHED FINANCIAL STATEMENTS OF INSURANCE COMPANIES

EFG INSURANCE PLC

COMPANY BALANCE SHEET AS AT 31 DECEMBER 2008

			2008	2007
ASSETS		NOTE	₦	₦
Cash and bank balances			x	x
Short-term investments		1	x	x
Debtors and prepayments		2	x	x
Loans to policy holders				
Long term investments		3	x	x
Statutory deposit		4	x	x
Fixed assets		5	x	x
TOTAL ASSETS	(a)		xxx	xxx
Liabilities:				
Creditors and accruals		6	x	x
Outstanding claims		7	x	x
Insurance fund		8	x	x
Taxation		9	x	x
Deferred taxation		10	x	x
Dividend payable		11	x	x
Total liabilities	(b)		xx	xx
Net assets	(a – b)		x	x
Financed by:				
CAPITAL AND RESERVES:				

Called-up share capital	12	x	x
Share premium	13	x	x
Contingency reserve	14	x	x
Fixed assets revaluation reserve	15	x	x
Quoted investment revaluation reserve	16	x	x
General reserve	17	x	x
Shareholders' funds		x	x

EFG INSURANCE PLC

BALANCE SHEET FOR LIFE BUSINESS AS AT 31 DECEMBER 2008

		2008	2007
ASSETS	NOTE	₦	₦
Cash and bank balances		x	x
Short term investments	1	x	x
Debtors and prepayments	2	x	x
Loans to policy holders			
Long term investments	3	x	x
Statutory deposit	4	x	x
Fixed assets	5	x	x
Total Assets (a)		xxx	xxx
Liabilities:			
Creditors and accruals	6	x	x
Outstanding claims	7	x	x
Insurance fund	8	x	x
Taxation	9	x	x
Deferred taxation	10	x	x
Dividend payable	11	x	x
Total liabilities (b)		xx	xx
Net Assets (a – b)		x	x
Financed by:			
Capital and reserves:			
Called-up share capital	12	x	x
Share premium	13	x	x
Contingency reserve	14	x	x
Fixed assets revaluation reserve	15	x	x
Quoted investment revaluation reserve	16	x	x
General reserve	17	x	x
Shareholders' fund		x	x

EFG INSURANCE PLC

COMPANY PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31 DECEMBER 2008

		2008		2007	
	NOTE	₦	₦	₦	₦
Premium			x		x
Deposit	18		x		x
			Xx		xx
Investment and other income	19		x		x
			Xx		xx
Re-insurance		x		x	
Maturities, surrenders and bonuses		x		x	
Claims paid and admitted		x		x	

Net commission		x		x	
Guaranteed interest on pension		x		x	
Other direct expenses		x		x	
Overhead expenses		x		x	
Increase/(decrease) in claims reserve		x		x	
			(xx)		(xx)
Profit before taxation	20		x		x
Taxation			(x)		(x)
Profit after taxation			xx		xx
APPROPRIATIONS:					
Transfer to contingency reserve			x		x
Dividend			x		x
Transfer to general reserve			x		x
			Xx		xx

EFG INSURANCE PLC

LIFE REVENUE ACCOUNT FOR THE YEAR ENDED 31 DECEMBER 2008

		2008		2007	
	NOTE	₦	₦	₦	₦
Premium			x		x
Life-re-insurance			(x)		(x)
			Xx		xx
Less: direct expenses:					
Claims paid		x		x	
Maturities, surrenders & bonuses		x		x	
Commission		x		x	
Other direct expenses		x		x	
Increase/(decrease) in insurance fund		x		x	
Increase/(decrease) in outstanding claims		x		x	
			X		x
Transfer to profit and loss account			x		x

NON-LIFE REVENUE ACCOUNT FOR THE YEAR ENDED DECEMBER 2008

	Fire	Motor	Workmen's Compensation	Energy & Casualty	Marine	Personal Accident	2008	2007
	₦	₦	₦	₦	₦	₦	₦	₦
Gross premium	x	x	x	x	x	x	xx	x x
Outward re-insurance	x	x	x	x	x	x	xx	xx
Net premium	x	x	x	x	x	x	xx	xx
Commission received	x	x	x	x	x	x	xx	xx
	X	x	x	x	x	x	xx	xx
Direct expenses:								
Claims paid less:								
Re-insurance	x	x	x	x	x	x	xx	xx
Increase/(decrease) in								
Unexpired premium	x	x	x	x	x	x	xx	xx
Increase/(decrease) in								
Outstanding claims res.	X	x	x	x	x	x	xx	xx
Commission paid	x	x	x	x	x	x	xx	xx
Other direct expenses	x	x	x	x	x	x	xx	xx
	X	x	x	x	x	x	xx	xx

Transfer to profit & loss								
Account (a – b)	x	x	x	x	x	x	xx	xx

ILLUSTRATION 6

NORTH-SOUTH ASSURANCE PLC is a company in the Non-life insurance business with authorised ordinary share capital of ₦80 million. The following balances were extracted from its ledger as at 31 December 2008.

	₦'000	₦'000
Ordinary share capital of N1 per share		80,000
General reserve		3,625
Contingency reserve at 1/1/2008		11,287.5
Reserve for outstanding claims at 1/1/2008		14,017.7
Premium		69,432
Re-insurance premium	5,000	
Claims	23,007.25	
Investment income		4,356.5
Interest on loan granted		6,258.84
Sundry income		5,238.62
Balances due from/to agents	14,178.97	6,683.24
Commission receivable		12,459.67
Provision for bad debts		4,366.50
Property at cost	14,000	
Provision for depreciation on property		4,500
Audit fees	535	
Actuary consulting fees	2,358	
Commission paid	4,221.50	
Advertising & publicity	2,500	
Entertainment	900	
Vehicle running expenses	1,850	
Electricity	625	
Telephone & postages	489	
Rent & rates	2,356	
Salaries & wages	5,487.25	
Transport & travelling	1,625	
Repairs & renewals	875	
Statutory deposit	25,000	
Directors' fees & expenses	1,978	
Depreciation	842	
Legal & other professional fees	3,475	
Staff pension	1,658	
Federal Govt. Development stock	23,781.2	
Treasury bills & certificates	15,000	
Cash at bank	8,725	
Loans on policies	65,005	-
	225,472.17	225,472.17

The following additional information are provided:

1. The estimated income tax liability of ₦2.5 million is to be provided for on the profit of the year.

2. The following analysis was provided:

	Fire	Motor	General Accident	Total
	₦	₦	₦	₦
Claims	6,258,000	10,257,000	6,492,250	23,007,250
Premiums	20,844,380	34,855,890	13,731,730	69,432,000
Agent commission	875,500	2,316,000	1,030,000	4,221,500
Re-insurance premium	1,492,540	2,537,310	970,150	5,000,000
Commission receivable	2,624,710	5,621,380	4,213,580	12,459,670
Outstanding reserves- 31/12/2008:				
Contingency	3,624,000	5,682,120	1,981,380	11,287,500
Outstanding claims	855,600	1,382,520	1,008,480	3,246,600
Unexpired risk	3,726,700	7,580,600	2,710,400	14,017,700

3. Provision for bad debts is to be increased to ₦7,641,300.
4. Unallocated management expenses to be apportioned on the basis of premium received.
5. Dividend of 10K per ordinary share is proposed on the ordinary share capital.
6. The following transfers are to be made:

	Fire	Motor	General Accident	Total
	₦	₦	₦	₦
Contingency	1,875,000	3,724,500	824,000	6,423,500
Outstanding claims	245,050	423,150	203,800	872,000
Unexpired risks	1,872,000	2,650,050	898,000	5,420,050

Required:

Prepare profit and loss account for the year ended 31 December 2008 and a balance sheet as at that date in a form suitable for publication.

SUGGESTED SOLUTION 6

NORTH-SOUTH ASSURANCE PLC

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31 DECEMBER 2008

	NOTE	₦'000	₦'000
Premium income	1		59,011.95
Commission income	2		12,459.67
Investment income			4,356.50
Other income	3		11,497.46
			87,325.58
Claims	4	23,879.25	
Commission expenses	5	4,221.50	
Management expenses	6	30,828.05	(58,928.80)
Profit before taxation	7		28,396.78
Taxation			(2,500)
Profit after taxation			25,896.78
APPROPRIATIONS:			
Proposed dividend	8	8,000	
Transfer to contingency reserve		6,423.5	

	(14,423.50)
Retained profit transferred to general reserve	11,473.28

NORTH-SOUTH ASSURANCE PLC
BALANCE SHEET AS AT 31 DECEMBER 2008

ASSETS		NOTE	₦'000	₦'000
Cash and bank balances				8,725.00
Short-term investments		9		15,000.00
Debtors & prepayments		10		6,537.67
Loan to policy holders				65,005.00
Long-term investment		11		23,781.20
Statutory deposit				25,000.00
Fixed assets		12		9,500.00
Total Assets	(a)			153,548.87
LIABILITIES				
Amount due to agents				6,683.24
Taxation				2,500.00
Proposed dividend		8		8,000.00
Insurance funds		13		41,267.35
	(b)			58,450.59
NET ASSETS	(a –b)			95,098.25
CAPITAL AND RESERVE				
Call-up share capital		14		80,000.00
General reserve		15		15,098.28
				95,098.28

NORTH-SOUTH ASSURANCE PLC

NOTES TO THE FINANCIAL STATEMENTS

		Fire	Motor	General	Total
1.	Premium income:	₦	₦	₦	₦
	Premium receivable	20,844,380	34,855,890	13,731,730	69,432,000
	Re-insurance premium payable	(1,492,540)	(2,537,310)	(970,150)	(5,000,000)
	Transfer to unexpired risk	(1,872,000)	(2,650,050)	(898,000)	(5,420,050)
		17,479,840	29,668,530	11,863,580	59,011,950
2.	Commission receivable	2,624,710	5,621,380	4,213,580	12,459,670
3.	Other income:				
	Interest on loan granted				6,258,840
	Sundry income				5,238,620
					11,497,460
4.	Claims:				
	Amount paid	6,258,000	10,257,000	6,492,250	23,007,250
	Transfer to outstanding claims	245,050	423,150	203,800	872,000
		6,503,050	10,680,150	6,696,050	23,879,250
5.	Agents' commission	875,000	2,316,000	1,030,000	4,221,500
6.	Management expenses:				₦'000
	Provision for bad debts (₦7,641,300 – ₦4,366,500)				3.274.8
	Audit fees				535
	Actuary consulting fees				2,358

	Advertising & publicity	2,500
	Entertainment	900
	Vehicle running expenses	1,850
	Legal & other professional fees	3,475
	Electricity	625
	Telephone & postages	489
	Rents & postages	2,356
	Salaries & wages	5,487.25
	Transport & travelling	1,625
	Staff pension	1,658
	Repairs & renewals	875
	Directors' fees & expenses	1,978
	Depreciation charge	842
		30,828.05
7.	PROFIT BEFORE TAX is stated after charging:	₦
	Directors' emoluments	1,978
	Auditors' remuneration	535
	Depreciation of fixed assets	842
8.	Proposed dividend: 10 kobo on 80,000,000 ordinary shares	8,000
9.	Short-term investment- treasury bills & certificates	15,000
10.	Debtors & prepayments:	
	Amount due from agents	14,178.97
	Less: provision for bad debts	7,641.30
		6,537.67
11.	Long-term investment- Fed. Govt. Development Stock	23,781.2
12.	Fixed assets:	
	Property at cost	14,000
	Less: accumulated depreciation	4,500
		9,500

13. Insurance fund:

	Unexpired Risk	Outstanding Claim	Contingency Reserve	Total
	₦	₦	₦	₦
Bal. B/fwd	14,017,700	3,246,600	11,287,500	28,551,800
Transfer in the year	5,420,050	872,000	6,423,500	12,715,550
Bal. Carried forward	19,437,750	4,118,600	17,711,000	41,267,350

14. Share capital

Authorised, issued and fully paid 80,000,000 ordinary shares of ₦1 each	80,000,000

15. General reserve

Balance brought forward at January 1, 2004	3,625,000
Transfer from profit & loss account	11,473,280
	15,098,280

SELF ASSESSMENT EXERCISE

Solve the above questions and compare with the solution

3.5 ABRIDGED FINANCIAL STATEMENTS

Introduction

(a) 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 enterprise.

(b) In recent years, there has been demand by groups of shareholders and some companies in Nigeria to reduce the size of annual reports and financial statements, as well as curtail the high cost of printing and mailing the glossy information.

(c) Section 355 of the Companies and Allied Matters Act, Cap. C20 LFN 2004 allows companies to published abridged financial statements. The Act, however, does not specify any minimum disclosure requirement of such statements.

SAS No 20 (Abridged Financial Statements)

(a) The objectives of statement of Accounting Standard No. 20 are:
    1. To specify the minimum contents of abridged financial statements.
    2. To standardize formats for presentation of abridged financial statements; and
    3. To improve comparability and usefulness of abridged financial statements.

(b) Abridged financial statements should carry a declaration that:
    1. They are abridged financial statements;
    2. The financial statements and specific disclosures included in them have been derived from the financial statements of the company;
    3. The abridged financial statements cannot be expected to provide understanding of the financial performance, financial position, financing and investing activities of the organization as the full financial statements; and
    4. Copies of the full financial statements can be obtained from the Registrar of Companies.

(c) Abridged financial statements should include the following, as in the full financial statements;
    1. Accounting policies;
    2. Profit and loss account for the financial year;
    3. Balance sheet as at end of the financial year;
    4. Statement of cash flows for the financial year;
    5. Notes in relation to exceptional and extra-ordinary items;
    6. Five-year financial summary; and
    7. Any other information necessary to ensure that the abridged financial statements are consistent with the full accounts and reports for the year.

Other information to be included in abridged financial statements are:

1. Notice of annual general meeting;
2. Names of directors during the year and their shareholding;
3. Report of the audit committee, which should confirm that the auditors' report is unqualified.
4. Financial highlights (result at a glance); and
5. Dividends paid or proposed and date of payment.

(d) A company whose auditors' report on the financial statement for a period are qualified should not publish abridged financial statements for that period.

Disclosure Requirements

The following information should be disclosed in abridged financial statements:

(a) 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.
(b) 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.

SELF ASSESSMENT EXERCISE
State the information that should be disclosed in abridged financial statements.

4.0 CONCLUSION

We shall conclude that the insurance business is technical and complex when compared to other industries. The major differences in accounting for life insurance as compared with other industries derive from the long time period between receipt of premiums and the payment of claims. This gives rise to the need for actuarial estimates of the liability in order to determine both the solvency and the profitability of life business.

5.0 SUMMARY

As a follow-up to the regulatory framework in the earlier unit, this unit illustrates with typical examination questions, practical application of the theoretical background on the preparation of financial statements insurance companies, including relevant notes to the financial statements in the recommended formats.

Companies in Nigeria are allowed to publish abridged financial statements under Section 355 of CAMA 2004 Cap C20 LFN. Such statements should comply with the requirements of SAS 20: Abridged Financial Statements

6.0 TUTOR MARKED ASSIGNMENT

1. In the process of preparing the financial statements of your client , you were informed that about a quarter of the company's workforce were laid off, resulting in payment of

substantial severance package to the staff laid-off. How would you treat the amount paid in the financial statements for the period?

2. In what way are extraordinary and exceptional items different?
3. List any one disclosure required in notes to the financial statements in respect of directors' emolument.
4. State how contingency reserve for life assurance business is calculated.
5. On what basis is interest on loan recognised by banks in their profit and loss accounts?

7.0 REFERENCES/FURTHER READING

Aborode, R. (2004), A Practical Approach to Advanced Financial Accounting, Lagos, El-TODA Venture Ltd

Igben, R. O., (2004), Financial Accounting made Simple, Lagos, El-TODA Ventures Ltd, Volume 2.

Institute of Chartered Accountants of Nigeria, Financial Accounting, Study Pack, Lagos.

MODULE 2: CASH FLOW STATEMENT AND INTERPRETATION OF FINANCIAL STATEMENTS

Unit 1: Basic Principles Governing the Preparation of Cash Flow Statements and the Approved Formats

Unit 2: Format of Cash Flow Statement for Banks and Insurance Companies

Unit 3: Analysis and Interpretation of Financial Statements

Unit 4: Accounting Ratio Interpretation, Value Added Statement and Report Writing

UNIT 1: BASIC PRINCIPLES GOVERNING THE PREPARATION OF CASH FLOW STATEMENTS AND THE APPROVED FORMATS

CONTENT

1.0 Introduction
2.0 Objectives
3.0 Main Content
    3.1 Usefulness of a Cash Flow Statement
    3.2 Preparation of Cash Flow Statement
    3.3 The format of Cash flow statement for a Limited Liability Company
4.0 Conclusion
5.0 Summary
6.0 Tutor Marked Assignment
7.0 References/Further Reading

1.0 INTRODUCTION

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, and 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.

2.0 OBJECTIVES

After studying this unit, you be able to:

1. State the usefulness of cash flow statement.
2. Outline the steps required in preparing a cash flow statement.
3. Familiarize yourself with the format of cash flow statement for a limited liability company.

3.0 MAIN CONTENT

3.1 USEFULNESS OF A CASH FLOW STATEMENT

The information provided in this statement, if used with related disclosure and other information in the financial statements, will assist users to:

(a) Assess the impact of its transactions; that is, operating, investing and financing activities of its performance and financial position;
(b) Assess the ability of an enterprise to meet its debt obligations, pay dividends and meet other claims;
(c) Assess the ability of an enterprise to finance on-going operations and growth from internal sources and determine the amount of external financing required;
(d) Reconcile profit or loss and net cash flows; and
(e) Assess the ability of the enterprise to generate positive net future cash flows.

SELF ASSESSMENT EXERCISE
What is the usefulness of a cash flow?

3.2 PREPARATION OF A CASH FLOW STATEMENT

(a) A reporting enterprise should prepare a statement of cash flows in line with the provisions of this Standard as an integral part of its financial statements.
(b) 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.
(c) 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 activities
    Investing activities
    Financing activities
(d) An enterprise should adopt either the direct or indirect method in preparing its statement of cash flow.
    1. Direct method highlights cash received from customers, payments made to suppliers, employees, tax authority and other service providers, to arrive at cash inflow/outflow from operating activities.
    2. Indirect method arrives at cash inflow/outflow from operating activities by stating the profit or loss before taxation, which is adjusted for items not involving movement of funds such as depreciation charge, provision for doubtful debts, profit on sale of fixed assets; and net changes in working capital, debtors, creditors, stock etc between the current and the preceding years.
(e) The statement of cash flows should report gross cash flows except in the instances where net cash flows will be more relevant and meaningful, such as:
    1. Where the enterprise is, in substance, holding or disbursing cash on behalf of its customers, and
    2. Where turnover of investments and loans is repaid and the total volume of transactions is large.
(f) Interest paid and received
    1. 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

2. Interest received or paid should be reported gross of taxes. Interest capitalized should also be reported in the statement of cash flows.

(g) Dividends paid and received

1. 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. in such cases, dividends received should be classified as cash flow from operating activities.
2. Dividends paid and other distributions to owners should be classified as cash flows from financing activities.

(h) Foreign currency cash flows

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 transaction, if the result is substantially the same as if the rates applicable at the dates of the cash flow were used:

(i) Taxation

1. The total amount of income taxes paid should be classified as operating cash outflow.
2. 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.
3. Taxes paid or refunds received in respect of capital profits such as capital gains tax should be reported in line with the underlying transactions giving rise to them.

SUMMARY OF THE COMPONENTS OF A CASH FLOW STATEMENT

SOURCES OF CASH GENERATED	UTILISATION OF CASH GENERATED
1. Operating activities: Profit for the year before provisions for tax, dividend and depreciation.	Taxes paid
2. Downward movement in current assets	Upward movement in current assets
3. Upward movement in current liabilities	Downward movement in current liabilities
4. Financing activities: proceeds of fresh issue of shares or debenture (net of cost issue)	Redemption of preference shares and debentures, dividend paid.
5. New loans obtained	Loans and interest repayments
6. Investing activities: investment income received, proceeds from sale of fixed assets and investment disposed of	Fixed assets purchased. Investment purchase

NOTE: Cash inflow (or sources of cash generated) is reflected in positive figures while cash outflow (or utilization of the cash generated) is shown as negative figure in brackets.

3.3 FORMAT OF CASH FLOW STATEMENT FOR A LIMITED LIABILITY COMPANY

XYZ NIGERIA PLC

CASH FLOW STATEMENT

For the year ended 31 December 2004

2004 2003

	₦	₦	₦	₦
CASH FLOWS FROM OPERATING ACTIVITIES				
Profit before taxation		x		x
Depreciation of fixed assets		x		x
Profit/(loss) on disposal of fixed assets		x		x
Net interest expense/(income)		x		x
Cash flow before changes in working capital		xx		xx
CHANGES IN WORKING CAPITAL:				
(increase)/decrease in stock & work-in-progress	x		x	
(increase)/decrease in debtors & prepayments	x		x	
Increase/(decrease) in creditors & accruals	x	x	x	x
Increase/(decrease) in gratuities & retirement benefits		x		x
		Xx		xx
Tax paid		(x)		(x)
Net cash flows from operating activities		xxx		xxx
CASH FLOWS FROM INVESTING ACTIVITIES				
Interest received	x		x	
Purchase of fixed assets	(x)		(x)	
Proceeds on disposal of fixed assets	x	x	x	x
Net cash used in investing activities		xx		xx
CASH FLOW FROM FINANCING ACTIVITIES				
Proceeds from sale of shares	x		x	
Dividend paid	(x)		(x)	
Interest paid	(x)	x	x	x
Net cash inflow/(outflow) in financing activities		Xx		xx
Net increase/(decrease) in cash and cash equivalents		xx		xx
Cash and cash equivalents at January 1		x		x
Cash and cash equivalents at December 31		xx		xx
Cash and cash equivalent comprises of:				
Cash and bank balances	x		x	
Bank deposit	x		x	
Bank overdraft	(x)		(x)	
	Xx		xx	

ILLUSTRATION 7

The balance sheets of Chuks Plc at 31 December 2007 and 2008 are given below:

	2008		2007	
	₦'000	₦'000	₦'000	₦'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
Current assets:				
Stock & work-in-progress	5,717		5,735	
Debtors & prepayments	4,935		4,697	
Cash and bank balances	465		115	
11,117 10,547				
Deduct: current liabilities:				
Creditors and accruals	2,795		2,672	
Current taxation	895		985	

Bank overdraft		272		705	
Proposed dividend		637		505	
4,599	4,867				
Net current assets	(a – b)		6,518		5,680
Deferred taxation			(1,555)		(1,545)
			12,102		11,497
Represented by:					
Capital and reserves:					
Ordinary share capital			4,400		4,400
Share premium account			517		517
Other capital reserves			1,100		1,100
Revenue reserves			6,085		5,480
			12,102		11,497

Notes to the accounts show that:

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

	₦
Land and building	87,000
Plant, machinery & vehicles	600,000
Goodwill and patents	23,000

(b) Plant sold during year 2008 realised ₦40,000. It was included at cost in the balance sheet for year 2007 at ₦152,000, with depreciation accumulated at ₦132,000. The difference between realisation and written value of the asset was in the profit 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 N1,130,000.

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

SUGGESTED SOLUTION 7

CHUKS PLC
CASH FLOW STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2008

	₦'000	₦'000
Cash flows from operating activities:		
Profit before taxation (w1)		2,714
Depreciation of fixed assets N(87 + 600 + 23)		710
(Profit)/loss on disposal of fixed assets		(20)
Cash flows before changes in working capital		3,404
Changes in working capital:		
Decrease in stock	18	
Increase in debtors	(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, w3)]	(417)	
Purchase of goodwill and patents (w4)	(90)	
Proceeds from disposal of fixed assets (w3b)	40	
Net cash used in investing activities		(467)
Cash flows from financing activities:		
Dividend paid (w6)		(927)
Net increase in cash and cash equivalents		783
Cash and cash equivalents at January 1 (115 – 705)		(590)
Cash and cash equivalents at December 31		193
Cash and cash equivalents comprises:		
Cash and bank balances		465
Bank overdraft		(272)
		193

WORKINGS

CHUKS PLC

1. PROFIT BEFORE TAXATION

	N'000
Increase in revenue reserves ₦ (6,085 – 5,480)	605
Deferred tax charged for 2008 written back to P & L ₦ (1,555 – 1,545)	10
Tax charge for the year- (see working 5)	1,040
Dividends charged to P & L (see workings 6)	1,059
	2,714

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	Depreciation charge	600
	Disposal a/c (deprec.)	132	Disposal a/c (cost)	152
	Balance- representing Purchases	215	Closing balance	2,702
		3,454		3,454

3 (b) Plant Disposal

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

4. Goodwill & Patients

	₦'000		₦'000
Opening balance	785	Depreciation charge	23
Balance- goodwill Purchased	90	Closing balance	852
	875		875

5. Taxation

	₦'000		₦'000
Taxes paid- bank	1,130	Opening balance	985
Closing balance	895	charged to P & L a/c	1,040
	2,025		2,025

6. 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 EXERCISE

After studying the illustrations, solve the same questions and compare with the suggested solution.

4.0 CONCLUSION

Because of time constraint under examination condition, you are advised to approach the question, as follows:

(a) Read through the question, including the additional information, noting on the question paper, the figures on the balance sheet that will be affected.

(b) Open T – accounts for the balance sheet items that will be affected by the notes and title them "WORKINGS". Record necessary entries in the T – accounts.

(c) Prepare the cash flow statement using the approved format, first slotting in items that require no adjustment, by simply deducting 2007 figures from 2008 figures; followed by figures obtained from your "WORKINGS" schedules, which must be attached to your answer.

Workings sometimes carrying as much mark as the answer to the question, as the examiner will be interested in knowing how you arrived at the figures in your solution.

5.0 SUMMARY

In this unit, we discussed cash flow statement which was discussed under the usefulness of a cash flow statement, preparation of a cash flow statement and a format of cash flow statement for a limited liability company along with an illustration.

6.0 TUTOR MARKED ASSIGNMENT

1. A reporting enterprise should prepare a statement of cash flows in line with the provisions of the Standard as an integral part of its __________.
2. 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 _________.
3. An enterprise should adopt either the ________ or _______ method in preparing its statement of cash flow.
4. ________ method highlights cash received from customers, payments made to suppliers, employees, tax authority and other service providers, to arrive at cash inflow/outflow from operating activities.
5. _______ method arrives at cash inflow/outflow from operating activities by stating the profit or loss before taxation, which is adjusted for items not involving movement of funds such as depreciation charge, provision for doubtful debts, profit on sale of fixed assets; and net changes in working capital, debtors, creditors, stock etc between the current and the preceding years.
6. List one objective of preparing cash flow statements

7.0 REFERENCES/FURTHER READING

Institute of Chartered Accountant of Nigeria, Financial Accounting, Study Pack Lagos.

International Accounting Standard Board, International Accounting Standard.

Jennings, A. R., (2001), Financial Accounting, London, Letts Educational

Jennings, A. R., (2001), Financial Accounting, Solution Manual, London, Letts Educational

Nigerian Accounting Standard Board, Statement of Accounting Standard

MODULE 2: CASH FLOW STATEMENT AND INTERPRETATION OF FINANCIAL STATEMENTS

UNIT 2: FORMAT OF CASH FLOW STATEMENT FOR BANKS AND INSURANCE COMPANIES

CONTENT

1.0 INTRODUCTION

In the previous unit, we discussed cash flow statement and ended with the illustration of cash flow statement for a limited liability company. However, this unit is a continuation of the previous unit, as we shall be looking at the format and illustrations of cash flow statements for banks and insurance companies.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Identify the format of cash flow statement of a bank.
2. Solve questions on the preparation of cash flow statement for banks.
3. Identify the format of cash flow statement of insurance companies.
4. Solve questions on the preparation of cash flow statement for insurance companies.

3.0 MAIN CONTENT

3.1 FORMAT OF CASH FLOW STATEMENT FOR BANKS

ABC BANK PLC

CASH FLOW STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2008

	2008		2007	
CASH FLOWS FROM OPERATING ACTIVITIES:	₦	₦	₦	₦
Interest and commission received		x		x
Interest expenses		(x)		(x)
Loss/(profit) on disposal of fixed and leased assets		(x)		(x)
Provision for risk assets		(x)		(x)
Payments to employees and suppliers		<u>(x)</u>		<u>(x)</u>
Operating profit before changes in:				
Operating assets and liabilities		x		x
Changes in operating assets & liabilities:				
Loans and advances	x		x	
Advances under finance lease	x		x	
Other assets	x		x	
Deposits	x		x	

Other liabilities	x		x	
Foreign currency denominated liabilities	x		x	
		X		x
		X		x
Income & education taxes paid		(x)		(x)
Net cash from operating activities		xx		xx
CASH FLOWS FROM INVESTING ACTIVITIES:				
Purchase of fixed/leased assets	x		x	
Proceeds from sale of fixed/leased assets	x		x	
Net additions to investment	x		x	
Investment income	x		x	
Net cash used in investing activities		(x)		(x)
CASH FLOWS FROM FINANCING ACTIVITIES:				
Proceeds from sale of shares	x		x	
Dividends	(x)		(x)	
Net cash inflow/(outflow) in financing activities		x		x
Net increase in cash and cash equivalent		x		x
Cash and cash equivalents at January 1		x		x
Cash and cash equivalents at December 31		xx		xx

3.2 ILLUSTRATION OF CASH FLOW STATEMENT FOR BANKS
ILLUSTRATION 8

The balance sheet and profit and loss accounts of MEGABANK PLC as at 31 December 2008, together with the comparative figures for year 2007 are as follows:

BALANCE SHEET AS AT 31 DECEMBER 2008

	2008	2007
ASSETS:	₦'000	₦ '000
Cash and short-term fund	59,532,100	26,750,860
Bills discounted	15,300,360	9,420,000
Investments	1,206,980	1,601,400
Loans and advances	44,970,880	26,900,060
Other assets	9,159,860	5,668,520
Equipment on lease	1,998,740	3,687,920
Fixed assets	11,702,200	9,700,880
	143,871,120	83,729,640
LIABILITIES:		
Deposits and current accounts	91,498,660	51,123,320
Taxation	662,260	431,320
Dividend payable	1,362,160	1,267,340
Other liabilities	34,050,980	15,418,400
	127,574,060	68,240,380
22% floating rate redeemable		
Debenture stock	522,920	597,620
128,096,980 68,838,000		
CAPITAL AND RESERVE:		
Called-up share capital	11,304,520	11,268,520
Share premium	318,500	290,300
Statutory reserves	3,219,760	2,635,140
Debenture redemption reserve	522,920	364,840

General reserve		408,440	332,840
Shareholders' fund	(b)	15,774,140	14,891,640
	(a + b)	143,871,120	83,729,640
Acceptances, guarantees & engagements On behalf of customers' & customers' Liabilities thereof		44,721,280	59,217,140

MEGABANK PLC
PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31 DECEMBER, 2008

	₦'000	₦'000
Interest income		18,422,560
Interest expense		(9,728,840)
		8,693,720
Other income – Commissions & fees		14,486,960
		23,180,680
Expenses:		
General & Admin Overheads	12,481,980	
Provision for risk assets	4,064,420	
Depreciation on leased assets	2,141,320	
Depreciation on fixed assets	1,844,200	
		(20,531,920)
Profit before taxation		2,648,760
Taxation		(700,000)
Profit after taxation		1,948,760
Appropriations:		
Transfer to statutory reserve	584,620	
Debenture redemption reserve fund	158,080	
Proposed dividend	1,130,460	
		(1,873,160)
Retained profit transferred to general reserve		75,600

The following additional information are given:

1. The profit before taxation is after charging/(crediting):

Deposit for insurance premium	633,220
Directors' emoluments: fees	19,800
Others	29,000
Auditors' remuneration	60,000
Debenture interest	170,240
Profit on sale of fixed assets	(66,600)

2. During the year, the provision made for risk assets is arrived at as follows:

	₦'000
Provision for loans & advances	3,237,720
Other provisions	947,120
	4,184,840
Less: recoveries during the year	(120,420)
	4,064,420

3. During the year, the bank purchased fixed assets costing ₦3,923,840,000 and leased equipment at the cost of ₦456,020,000. Similarly, fixed assets and leased equipment with a net book value of ₦82,200.00 were disposed of at a value of ₦148,800,000.

4. General and administration overheads are made of payments to employees and suppliers of the bank.

You are required to prepare a cash flow statement of MEGABANK PLC using the direct method.

SUGGESTED SOLUTION 8

MEGABANK PLC
CASH FLOW STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2008

	₦'000	₦'000
CASH FLOW FROM OPERATING ACTIVITIES:		
Interest received		18,422,560
Fees & commission received		14,486,960
Interest expenses paid		(9,728,840)
Profit on disposal of fixed assets		
N(148,800,000 - 82,200,000)		(66,600)
Provision for risk assets		(4,064,420)
Cash payments to employees & suppliers		(12,481,980)
Operating profit before changes in operating assets		6,567,680
Changes in operating assets/liabilities:		
Loans and advances	(18,070,820)	
Other assets	(3,491,340)	
Deposit and current accounts	40,375,340	
Other liabilities	18,632,580	
		37,445,760
Net Cash Flow from Operating Activities before Taxation		44,013,440
Tax paid (w1)		(469,060)
Net Cash from Operating Activities		43,544,380
Cash flows from investing activities:		
Purchase of fixed assets	(3,923,840)	
Purchase of leased equipment	(456,020)	
Proceeds from sale of fixed assets	148,800	
Net change in investment	394,420	
		(3,836,640)
		39,707,740
Cash flows from financing activities:		
Proceeds from issue of shares	64,200	
Redemption of debenture	(74,700)	
Dividends paid (w2)	(1,035,640)	
		(1,046,140)
Net increase in cash and cash equivalents		38,661,600
Cash and cash equivalents at January 1, 2008		
N(26,750,860 + 9,420,000)		36,170,860
Cash and cash equivalents at December 31, 2008		
N(59,532,100 + 15,300,360)		74,832,460

WORKINGS

1. Taxation

	₦'000
Opening balance 1/1/08	431,320
Change for the year per P & L account	700,000
	1,131,320

Closing balance at 31/12/08	662,260
Tax paid	469,060
2. Dividend	
Opening balance 1/1/08	1,267,340
Add: proposed dividend per P & L account	1,130,460
	2,397,800
Less: closing balance at 31/12/04	1,362,160
Dividend paid	1,035,640

SELF ASSESSMENT EXERCISE

After studying this sub-unit, solve the questions and compare them with the solutions in the illustrations.

3.3 FORMAT OF CASH FLOW STATEMENT FOR INSURANCE COMPANIES

EFG INSURANCE PLC
CASH FLOW STATEMENT FOR THE YEAR ENDED 31 DECEMBER, 2008

	2008		2007	
CASH FLOWS FROM OPERATING ACTIVITIES:	₦	₦	₦	₦
Profit before taxation		x		x
Adjustment for:				
Depreciation	x		x	
Increase/(decrease) in insurance funds	x		x	
(profit)/loss on disposal of investments	x		x	
(profit)/loss on sale of fixed assets	x		x	
Cash flows before changes in working capital		x		x
CHANGES IN WORKING CAPITAL:				
(Increase)/decrease in debtors & prepayments	x		x	
(Increase)/decrease in policy loans	x		x	
Increase/(decrease) in creditors and accruals	x		x	
Increase/(decrease) in outstanding claims	x		x	
		X		x
Cash inflow/(outflow) from operations		xx		xx
Income & education taxes paid		(x)		(x)
Net cash generated from operations		xx		xx
CASH FLOWS FROM INVESTING ACTIVITIES				
Proceeds of disposal of investments	x		x	
Proceeds from sale of fixed assets	x		x	
Purchase of investments	(x)		(x)	
Purchase of fixed assets	(x)		(x)	
Net cash used in investing activities		xx		xx
CASH FLOWS FROM FINANCING ACTIVITIES:				
Proceeds from sale of shares	x		x	
Dividends paid	(x)		(x)	
Net cash inflow/(outflow) in financing activities		xx		xx
Net increase in cash and cash equivalents		x		x
Cash and cash equivalents at January 1		x		x
Cash and cash equivalent at December 31		xx		xx

3.4 ILLUSTRATION OF CASH FLOW STATEMENT FOR INSURANCE COMPANIES

ILLUSTRATION 9

The information provided below is extracted from the books and records of:

SAFEGUARD ASSURANCE PLC
PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31 DECEMBER, 2008

	₦
Underwriting profits	150,503,000
Investment income	233,004,860
Other income	2,410,000
Profit before taxation	385,917,860
Taxation	41,082,990
Profit after taxation	344,834,870
Accretion to contingency reserve	78,677,920
	266,156,950
Reserve for bonus issue	(110,000,000)
Proposed dividend	(150,000,000)
Retained profit for the year	6,156,950

BALANCE SHEET AS AT 31 DECEMBER, 2008

	2008	2007
ASSETS	₦	₦
Cash and bank balance	74,942,630	113,995,420
Short-term investments	612,097,190	452,088,770
Amount due from agents, brokers &		
Other debtors	875,837,570	877,270,310
Loans to policy holders	27,825,210	34,317,800
Long-term investments	1,514,942,430	1,233,565,440
Statutory deposit	105,000,000	105,000,000
Fixed assets	318,262,430	283,201,670
	3,528,907,460	3,099,439,410
LIABILITIES		
Creditors and accruals	556,901,310	582,203,560
Insurance funds	1,518,229,200	1,301,361,380
Taxation	78,522,260	65,454,650
	2,153,652,770	1,949,019,590
Total assets less liabilities (a – b)	1,375,254,690	1,150,419,820
CAPITAL AND RESERVES		
Called-up share capital	880,490,160	810,490,160
Share premium account	32,981,670	22,981,670
Capital reserve	120,000,000	120,000,000
Contingency reserve	195,467,260	116,789,340
Reserve for bonus issue	110,000,000	50,000,000
General reserve	36,315,600	30,158,650
	1,375,254,690	1,150,419,820

The following additional information are relevant:

	₦
1. Fixed assets: cost at 1/1/08	553,085,590
Cost at 31/12/08	674,239,380
Accumulated depreciation at 1/1/08	269,880,650

Accumulated depreciation at 31/12/08 355,976,950

2. An item of fixed assets, which costs ₦10,850,000 and has been fully depreciated, was sold during the year for ₦2,410,000.
3. Creditors and accrual are made up of:

	₦
Re-insurance payable	294,324,680
Commission payable	15,279,060
Obligations under financial lease	14,824,020
Dividends payable	150,000,000
Accruals	65,882,230
Other payables	16,591,320
	556,901,310

Dividends payable for the year ended 31 December, 2007 and paid in 2008 was N124,760,400.

You are required to prepare cash flow statement for the year ended 31 December 2008.

SUGGESTED SOLUTION 9

SAFEGUARD ASSURANCE PLC

CASH FLOW FROM OPERATING ACTIVITIES:	₦	₦
Profit before taxation		385,917,860
Depreciation (w1)	96,946,300	
Profit on sale of fixed assets	(2,410,000)	
Increase in insurance funds	216,867,820	
		311,404,120
Cash flows from operating activities before		
Changes in working capital		679,321,980
Changes in operating assets/liabilities		
Decrease in agents, brokers & debtors balances	1,432,740	
Decrease in policy loans	6,492,590	
Decrease in creditors and accruals (w2)	(50,545,120)	
		(42,619,790)
		654,702,190
Income tax paid (w3)		(28,015,380)
Net cash generated from operations		626,686,810
Cash Flows from Investing Activities:		
Purchase of fixed assets (w4)	(132,003,790)	
Proceeds from sale of fixed assets	2,410,000	
Purchase of investments (w5)	(441,385,410)	
		(570,979,200)
Cash Flows from Financing Activities:		
Issue of shares (w6)	30,000,000	
Dividends paid	(124,760,400)	
		(94,760,400)
Net decrease in cash and cash equivalents		(39,052,790)
Cash and cash equivalents at Jan. 2008		113,995,420
Cash and cash equivalents at Dec. 31, 2008		74,942,630

WORKINGS ₦

1. Depreciation: opening balance 269,880,650

Less: disposal			10,850,000
			259,030,650
Closing balance			355,976,950
Charge for the year			96,946,300

2\. Creditors & Accruals

	2008	2007	Difference
	₦	₦	₦
Total creditors	556,901,310	532,202,550	
Less: dividends	(150,000,000)	(124,757,130)	
	406,901,310	457,446,420	(50,548,390)

3\. Income Tax Account

	₦		₦
Bank-payment	28,015,380	1/1/ balance B/fwd	65,454,650
31/12 balance C/fwd	78,522,260	P&L account	41,082,990
	106,537,640		106,537,640

4\. Fixed Assets Account

	₦		₦
1/1/ Balance B/fwd	553,085,590	Disposal	10,850,000
Bank-additions	132,003,790	Balance C/fwd	674,239,380
	685,089,380		685,089,380

5\. Investment Account

	₦		₦
Bal. B/fwd- short-term	452,088,770	Bal. C/fwd-short-term	612,097,190
Long-term	1,233,565,440	Long-term	1,518,229,200
Bank	441,385,410		-
	2,127,039,620		2,127,039,620

6\. Share Capital & Reserves

	₦		₦
Bal. C/fwd-Share capital	880,490,160	Bal. b/fwd-share capital	810,490,160
Share premium	32,981,670	Share premium	22,981,670
		Reserve for bonus	50,000,000
	-	Issue of share- bank	30,000,000
	913,471,830		913,471,830

7\. Dividends Account

	₦		₦
Bank	124,760,400	Bal. b/fwd	124,760,400
Bal. C/fwd	150,000,000	Profit & Loss account	150,000,000
	274,760,400		274,760,400

4.0 CONCLUSIONS

Cash flow statements provide information about the cash receipts and cash usefulness and formats of cash flow statement of limited liability companies, banks and insurance companies, in accordance with SAS No 18.

5.0 SUMMARY

Preparation of cash flow statement which adopts the direct and indirect methods for companies, banks and insurance businesses were illustrated in this unit with standard examination questions, showing detailed workings of the figures in the cash flow statements.

6.0 TUTOR MARKED ASSIGNMENT

1. State a broad heading under which cash flow statements are prepared.
2. State one source of cash generated from operating activities
3. How would you treat expenditure on leased equipment in the cash flow statement of a bank?
4. How would you treat increase or decrease in insurance funds in the cash flow statement of an insurance company?

7.0 REFERENCES/FURTHER READING

Institute of Chartered Accountant of Nigeria, Financial Accounting, Study Pack Lagos.

International Accounting Standard Board, International Accounting Standard.

Jennings, A. R., (2001), Financial Accounting, London, Letts Educational

Jennings, A. R., (2001), Financial Accounting, Solution Manual, London, Letts Educational

Nigerian Accounting Standard Board, Statement of Accounting Standard

MODULE 2: CASH FLOW STATEMENT AND INTERPRETATION OF FINANCIAL STATEMENTS

UNIT 3: ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS

CONTENT

1.0 INTRODUCTION

The analysis of financial statement is for the benefits of users of financial statement. You would recall that financial statements are prepared to satisfy the needs of its users. The financial statements are prepared to serve not just one user but several of them. Basically, these users are classified into two, which are internal users and external users.

Financial statement analysis is used by internal users for planning, evaluating and controlling company operations. On the other hand, financial statement analysis is used by external users for assessing past performance and current financial position, and making predictions about the future profitability and solvency of the company as well as evaluating the effectiveness of management.

Fundamentally, analysis and interpretation of financial statements are the basic tools to meet the need for information by the users of financial statements.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Outline the areas of interest to various users of financial statement,
2. Make analysis based on the use of ratio analysis.
3. State the limitation of ratio analysis.

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 known as "gross profit %" or gross margin, which is computed as follows:

Gross profit % = $\frac{Gross\ profit}{\boldsymbol{Sales}}$ x 100 = Y%

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

(a) Company management;
(b) Present and potential shareholders;
(c) Present and potential loan creditors;
(d) Trade suppliers and customers;
(e) Employees;
(f) Financial analysts and journalists; and
(g) Government agencies (inland revenue and regulatory authorities like CBN, Nigerian Stock Exchange, Securities and Exchange Commission).

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, and 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 important device for interpreting the performance of companies from their financial statements. Other tools used in the analysis and interpretation of financial statements include:

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

SELF ASSESSMENT EXERCISE
List the matters that may interest users of the financial statement.

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

ILLUSTRATION 10

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 N50 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			
100 million ordinary shares of ₦1 each			100,000
20 million preference shares of ₦1 each			20,000
			120,000
Revenue reserve			80,000
			200,000
Loan capital			
Debenture stock			140,000
			340,000

ABC PLC

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31 DECEMBER 2008

	₦'000
Turnover	600,000
Cost of sales	(450,000)
Gross profit	150,000
Administrative & distribution expenses	(116,000)
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

SUGGESTED SOLUTION 10

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 and loss account and the capital employed from the balance sheet. There are two major pitfalls.
First of all, remembering that the objective of calculating the ratios is to compare figures for different companies or for different periods, one should ensure that the figures have been arrived at on consistent basis, and that asset values are up to date. It may well be necessary to eliminate from the accounts non-trading income and the assets producing it.

Secondly, compare like with like. When capital employed means, shareholders' fund plus long-term loans, that should be compared with profit, before deducting interest paid on these loans.

If bank borrowings become a major source of long-term finance, then they should be included in the capital employed and the profit figure used, should be before charging interest paid on such borrowings. This should be established from the facts of the case.

ROCE can be calculated in several ways as shown below

Definition of capital employed	Relevant profit figure	Ratio using ABC Plc' figures
1. Shareholders' fund plus long-term loan plus current liabilities	Profit before loan interest and bank overdraft interest	$\frac{34,000}{420,000}$ = 8.1%
2. Shareholders' funds plus long-term loans	Profit before loan interest	$\frac{34,000}{340,000}$ = 10%
3. Shareholders' funds only, that is, equity + preference shares + reserves.	Profit after tax and before preference dividend	$\frac{16,000}{200,000}$ = 8%
4. Equity shareholders' funds	Profit after tax and after preference dividend	$\frac{15,000}{180,000}$ = 8.3%

Tutorial:

For examination purposes, the most important definitions are probably 2 and 4 above. Use 2 if looking for overall profitability of the company, and use 4 if looking at the position from the point of view of a prospective shareholder. Note that the definition of profit in 4 is that used for calculating earnings per share (EPS) and price/earnings (P/E) ratios.

(b) Return on Sales

1. 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.

   Illustrations of the uses of the parameter are:

   - Detection of errors and fraud affecting items in trading account.
   - Used by inland revenue officials to detect suppression of sales.
   - Head office control over branches.

     For ABC PLC, gross profit percentage

     = 150,000/600,000 = 25%

2. Net profit percentage

   For ABC PLC, Net profit percentage = 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.

A company may try to maximize its profit by cutting prices and going for sales volume; for example, motor parts stores- or by putting on a higher mark up and aiming for the luxury market such as boutique.

(c) Asset Turnover

Asset turnover = sales/capital employed = 600,000/340,000 = 1.8 times

A low asset turnover rate shows that a 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.

To prove that the two ratios (b) and (c) are a sub-division of return on capital employed, multiply profit margin (that is, net profit %) by asset turnover. (5.7% x 1.8 times) = 10% approximately = return on capital employed. The asset turnover ratio may be further subdivided into fixed assets turnover ratio and the net current assets turnover ratio (or working capital turnover ratio). These ratios help to measure efficiency in the use of capital, since the higher the indices, the greater the utilization of assets.

Fixed assets turnover (times per year)

= sales/fixed assets = 600,000/260,000= 2.3 times

The importance of the net current asset turnover ratio is that it provides an early warning of strained liquidity, since a very high ratio may mean that the company is short of funds needed to pay creditors

Working Capital Turnover (times per year)

= sales/net current assets = 600,000/80,000 = 7.5 times

Liquidity

The standard measures of liquidity are:

(a) Current ratio = current assets/current liabilities

For ABC PLC = 160,000/80,000 = 2:1

(b) Acid test or quick ratio = $\frac{current\ asset - stock}{current\ liabilities}$

For ABC PLC = 100,000/80,000 = 1.25:1

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

1. Companies and trades vary greatly in their working capital requirements (working capital is current assets less current liabilities). A retail company with rapid stock turnover with mainly cash sales basis, 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 maybe 3:1, depending on the trade. Be weary of the statement often seen in textbooks 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. If the current ratio or liquid ratio is unnecessarily high, having regard to the nature of the business, this may indicate that the company is not using its resources as efficiently as it ought to be. Further explanation could be that 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 well give rise to a 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.
   However, although creditors and debtors are likely to change daily, a tax liability or a proposed dividend will be payable at a future determined date, which will be disclosed in the accounts. The importance of this, is that, the company may have a period of credit, probably for a significant length of time, in which ti achieve the cash or credit necessary to make the payment.

Management Efficiency
Here, the skill with management looks after the assets, under its control, especially stock, debtors, and the use of cash to pay its creditors is analysed.

The following ratios are relevant, and are frequently expressed in terms of days. For example, the number of day's credit given is calculated as: Trade debtors/credit sales x 365

(a) Stock ratios
   1. Raw materials stock holding = raw material stock /annual raw material consumption x 365
   2. Number of days work-in-progress = work-in-progress/annual cost of sales x 365
   3. Number of days sales covered by finished goods = finished goods stock/annual cost of sales x 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 = stock/cost of sales x 365

   For ABC PLC 60,000/450,000 x 365 = 49days

   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. Obviously, the optimal level is entirely dependent upon the trade being carried on. Stock ratio may also be expressed in terms of the number of times that stock is turned over in the year.

   Using ABC PLC (illustration)

   Stock turnover ratio = cost of sales/stock = 450,000/60,000 = 7.5 times

(b) Debtors ratio
   Illustration ABC PLC

= trade debtors/credit sales x 365

= 90,000/600,000 x 365 = 55days

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.

Tutorial

Students are advised to state whatever assumption is made, in the examination environment.

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 debtor ratio.

(c) Creditors ratio

Using illustration ABC PLC

= trade creditors/credit purchase x 365

For ABC PLC 40,000/460,000 x 365 = 32days

Notes: credit purchases is arrived at thus: cost of sales + closing stock – opening stock

= N(450,000 + 60,000 – 50,000) = N460,000

This ratio appears to indicate very prompt settlement of creditors, subject to special factors discussed for debtors.

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 N100,000

Loan capital N900,000

Gearing ratio is being expressed as

1. Loan capital/equity capital: 9/1 or 9:1
2. Loan capital/total capital x 100: 9/10 x 100 = 90%

This is high gearing situation in which N100,000 worth of equity capital controls N1 million of total capital.

In the case of ABC PLC, the gearing ratio is:

1. $\frac{Preference\ shares + debentures}{Ordinary\ shares + reserves}$ = 160,000/180,000 = 0.9:1
2. $\frac{fixed\ interest\ capital}{total\ capital}$ = 160,000/340,000 = 47%

The ratio above reveals a moderate gearing situation for many companies.

Gearing ratio is important for two reasons. First, it is one measure of risk being taken by an equity investor. An ordinary shareholder in a highly geared company stands to gain disproportionately in good times (because the investor has the benefit of all the profit in excess of fixed interest charged), but losses disproportionately in bad times (because the fixed interest must be paid regardless of profit).

Secondly, it assist a prospective lender, who may hesitate before lending a company more than (say) twice the equity stake in it. The borrowing power of a company are frequently restricted by its Articles of Association.

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 assets attributable to the ordinary shareholders. Assuming no goodwill in the illustration, the net tangible assets of ABC 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
Net tangible assets		180,000

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

The asset value per share is therefore:

₦180,000,000/₦100,000,000 x 100 = 180kobo

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 quoted companies's net worth per share and its share market price,

Investment Appraisal

A prospective or an existing investor will look at the following ratios in deciding whether to buy or sell shares in a company:

(a) Earnings per share
(b) Price/earnings ratio (P/E ratio)
(c) Dividend yield
(d) Dividend cover

The ratios are discussed as follows:

(a) Earnings per share (EPS)

Statement of Accounting Standard (SAS) No. 21 was issued to underline its importance and explain the various factors involved in arriving at earnings per share.

1. Earnings per share (EPS) refers to earnings per ordinary share. Basically, EPS is 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.
2. Operating profit or loss after income tax is the figure for the financial year before extra ordinary items and after applicable income tax expense. It is an amount of profit or loss that includes exceptional items but excludes extra-ordinary items.
3. EPS is a performance indicator that is primarily of interest to existing and potential shareholders, and their advisers. An appropriate method of calculating EPS plays a major role in arriving at earnings growth over time, and the price/earnings (P/E ratio). These are crucial indices to financial decisions.
4. Statement of Accounting Standards (SAS No 21)
    - In calculating EPS, an enterprise should not include extra-ordinary items before arriving at profit after tax.
    - Potential ordinary shares should be treated as dilutive when, and only when, their conversion to ordinary shares would decrease net profit per share from continuing ordinary operations.
    - The amount of net profit attributable to preference shareholders including preference dividend for the period, should be deducted from the net profit or loss for the period attributable to ordinary shares.
    - In order to determine earnings for EPS calculation, the full dividend for the year on cumulative preference shares should be deducted (the net amount) from the net profit or added to the net loss, whether or not it has been earned or declared while only the actual dividend paid or proposed on non-cumulative preference shares, should be deducted from the net profit.
    - A weighted average number of shares outstanding during the period should be used as a denominator for the EPS calculation. Shares issued during the year included the weighted average number of shares which should reflect the date the consideration was received.
    - In calculating diluted earnings per share (EPS), the number of shares, should be determined as the total of the following:
        1. The weighted average number of ordinary shares.
        2. Potential ordinary shares of the entity outstanding as at the beginning of the financial year that remain outstanding as at the reporting date that are dilutive.
        3. Potential ordinary shares issued during the financial year that are dilutive, weighted by reference to the number of days from the date of issue of those potential ordinary shares to the reporting date as proportion of the total number of days in the financial year.
        4. Potential ordinary shares issued outstanding during the financial year that are dilutive and have been converted or have lapsed or cancelled during the financial year, weighted by reference to the number of days to the date of conversion, lapse or cancellation.

- The computation of convertible potential ordinary shares that are dilutive should assure the most advantages conversion rate or exercise price from the standpoint of the holders of potential ordinary shares.
- Where the financial statements have been adjusted as a result of the introduction of fresh capital during the year or between the balance sheet dates of publication, an enterprise should not adjust its EPS figures for the previous years and should not present adjusted EPS.
- The weighted average number of ordinary shares outstanding during the period and for the immediate preceding year should be adjusted only when ordinary shares outstanding is increased or reduced without a corresponding change in resources.

5. Disclosure Requirements
    - An enterprise should present basic and diluted EPS on the face of the income statement, and the historical financial summary with equal prominence.
    - An enterprise should present basic and diluted EPS, even if the amount disclosed are negative (i.e. loss per share).
    - An enterprise should present basic and diluted EPS statistics for EPS before extra-ordinary items.
    - An enterprise should disclose the following:
        - The amount used as the numerator in calculating basic and diluted EPS, and a reconciliation of those amounts to the net profit or loss for the period.
        - Disclose any changes in the number of shares used to compute EPS.
        - The financial effect on diluted EPS of any adjustment resulting from changes in accounting policy applied in preparing and presenting the financial report.
        - Any conversion to calling of, or subscription for, ordinary shares that occurs between the reporting date and the time of completion of the financial report.
    - An enterprise should disclose, by way of notes ordinary share or potential ordinary share transactions that occur after the balance sheet date when they are of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions.

Using the Illustration of ABC

Basic EPS $=\frac{Profit\ after\ tax\ and\ preference\ dividend}{Ordinary\ share\ capital}$

=100/100,000 x 15,000 = 15k/share

(b) Price Earnings Ratio (P/E 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 assume that the market value is the same as the par value of each ordinary share.

P/E ratio market value per share
Basic EPS = 100k/15k = 6.7times
The significance of P/E ratio of a particular company can be judged only in relation to the ratios of other companies in the same kind of business. If the median P/E ratio is less than 7, it can be deduced that the investing members of the public do not favour the company, either because of poor past performance or growth prospects.
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.
Using the illustration
Dividend yield $= \frac{gross\ dividend\ per\ share}{market\ value\ per\ share} = \frac{10\ x\ 100}{100} = 10\%$
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:
For ABC PLC, dividend cover will be:

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

That is: =15,000/10,000 = 1.5times
Therefore, the profit of the company will have to be reduced by more than half, before the ordinary shareholders' dividends will be unrecovered by current earnings.

SELF ASSESSMENT EXERCISE
Explain what you understand by return on capital employed.

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 are mostly computed from historical accounts. Consequently, they suffer from the same limitations which historical accounts have, one of which is, the fact that historical information is of little use in assessing future prospects of a company.
(b) Another limitation is the fact that 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. For example, different depreciation policies adopted by different companies will influence the carrying amounts of fixed assets which

will influence ratios like ROCE. For inter-company analysis to be meaningful therefore, cognizance must be taken of the different accounting policies so that necessary adjustments are made where the need arises

SELF ASSESSMENT EXERCISE

What are the limitations to the usefulness of ratios?

4.0 CONCLUSION

Tutorial: Techniques for examination questions

Examination questions on interpretation may be:

(a) Written- asking for explanation of terms or ratios used:
(b) Computational- required to calculate ratios;
(c) Request to state conclusions drawn from ratios calculated; and
(d) A combination of a, b, and c above

Hint 1

Do not be dogmatic in what you say. There are often several possible reasons for any divergence from "normal" in a ratio.

Example:

Where you find the debtors ratio showing a period of credit of 120days, some candidates will jump to the conclusion that, the period of credit of 120 days is too high indicating a serious weakness in credit control, which may or may not be true.

A well-informed candidate will conclude as follows:

Using the figures in the published accounts, the debtors ratio shows a period of credit of 120 days, indicating possible weakness in credit control;

The ratio could be distorted, however, by one or more of the following factors:

(a) Existence of large non-trade debtors;
(b) Seasonal trade, with high sales in the period immediately before the balance sheet date;
(c) A special sale on long-term payment terms; and
(d) Sales to an associated company on favourable credit terms.

Further investigation to eliminate these factors is necessary before a firm conclusion can be drawn.

Hint 2

State your assumption

Taking the same situation as in the illustration on debtors ratio, (Hint 1), an alternative way to answer would be:

Debtors ratio = period of credit of 120days

On the assumption that no special factor affects the figures in the published accounts, that is, seasonal trade, inclusion of non-trade debtors, special sales on long-term credit terms, this ration indicates serious weakness in the company's credit control procedures and the existence of a potential bad debt.

Hint 3

Note the nature of business

Do not expect a retailer, with rapid stock turnover and most sales for cash, to have the same current ratio, as a manufacturer with high stocks and sales normally on monthly credit terms.

5.0 SUMMARY

In this unit, you would recall that we discussed the analysis and interpretations of financial statements. This was discussed considering the nature and objectives of accounting ratios, computation of ratio analysis and the limitation of ratio analysis.

6.0 TUTOR MARKED ASSIGNMENT

1. _________ is 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.
2. _________ the figure for the financial year before extra ordinary items and after applicable income tax expense.
3. _________ is a performance indicator that is primarily of interest to existing and potential shareholders, and their advisers.
4. What is the formula for determining creditor's ratio?
5. What is the formula for determining gearing ratio?

7.0 REFERENCES/FURTHER READING

Institute of Chartered Accountant of Nigeria, Financial Accounting, Study Pack Lagos.

International Accounting Standard Board, International Accounting Standard.

Jennings, A. R., (2001), Financial Accounting, London, Letts Educational

Jennings, A. R., (2001), Financial Accounting, Solution Manual, London, Letts Educational

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MODULE 2: CASH FLOW STATEMENT AND INTERPRETATION OF FINANCIAL STATEMENTS

UNIT 4: ACCOUNTING RATIO INTREPRETATION, VALUE ADDED STATEMENT AND REPORT WRITING

CONTENT

1.0 INTRODUCTION

In this unit, we shall proceed further to complete what has been done in the previous unit. Besides the computation and interpretation of accounting ratios, we shall proceed in discussing value added statement and report writing.

You may 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.

2.0 OBJECTIVES

After studying this unit, you shall be able to:

1. Compute ratios.
2. Comment on ratios computed in respect of strength or weakness in an organization.
3. Prepare the statement of value added of a typical company.
4. Write a report

3.0 MAIN CONTENT

3.1 COMPUTATION & INTERPRETATION OF ACCOUNTING RATIOS

ILLUSTRATION 11

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 CUURENT ASSETS		6,700
NET ASSETS		21,100
FINANCED BY:		
CAPITAL & RESERVES		
Ordinary share capital- issued & 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 was N39 million, (2006 – ₦42million) and that in the first half of 2008 was ₦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 judgment 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 was 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 11

(a) Current ratio = current assets/current liabilities = 23.9/17.2 = 1.39:1
(b) 1. 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.
Current assets are defined as those held for conversion into cash in the ordinary course of business while current liabilities are obligations to pay money at a future date, usually within 12 months.

By relating these two figures at a particular date, one can assess the company's ability to pay debts due within 12 months, 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 current assets to convert quickly to cash. It is, therefore, common to measure the company's immediate ability to pay its debts by computing the "liquidity ratio" (or acid test ratio as it is otherwise known) as follows:

$$\frac{current\ assets\ less\ stock\ \&\ WIP}{current\ liabilties} = \frac{23.9-11.9}{17.2} = 12/17.2 = 0.7:1$$

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 answer: 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.

2. Effect of the nature of the 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 – Business which sell for cash (such as supermarkets) will not have material figures for trade debtors compared with business 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 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.

(c) Working Capital Ratios

It is possible to take an overall 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 cause and effects of these deviations (which may be justified).

1. Working capital/capital employed = 6.7/21.1 = 0.32:1

   Or

   Working capital/fixed assets = 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.

2.

	2007	2006
Stock turnover ratio = $\frac{sales}{stock\ \&\ WIP}$ =	39/11.9 = 3.3times	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, we can re-compute the ratio using cost of goods sold as being 60% of sales.

	2007	2006
Cost of goods sold/(stock + WIP) =	23.4/11.9 = 1.97times	25.2/2.1 = 12times

3. Average collection period
   Trade debtors/sales per day = ₦11.7m/₦106.850 = 109.5days
   Sales per day = ₦106,850 (3.9m/365)
   This ratio, when 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.

(d) Comment on the average collection period
Funfair ltd has a collection period of 105.5 days based on annual turnover of N39million 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 109.5 days 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 were ₦13million and doubled in the second half to ₦26million (N39m – N13m). for example, if it could be established that the company's normal terms of credit were for 2months and that sales for the forth quarter of 2007 were ₦18million, we could re-compute the ratio as follows:

Sales per day over the last quarter = ₦18m/90 = ₦200,000

Collection period = ₦11.7m/₦200,000 x 365 = 58.5days

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 credit control.

(e) Major weaknesses 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 ₦2.1million 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.

ILLUSTRATION 12

The summarized balance sheets and operating results of Landers Plc for the two years ended 31 December 2007 and 2008 were as follows:

BALANCE SHEET AS AT 31 DECEMBER 2008

	2008		2007	
	₦'000	₦'000	₦'000	₦ '000
Fixed assets (net)		162,220		69,410
Current Assets:				
Stock & work-in-progress	622,940		521,960	
Debtors & prepayments	548,590		500,520	
Bank & cash balances	72,340		145,650	
	1,243,870		1,168,130	
Current Liabilities				
Creditors & accruals	470,550		428,850	
Taxation	41,540		32,190	
Dividends	25,000		22,500	
	537,090		483,540	
Net Current Assets		706,780		684,590
Net Assets		869,000		754,000
Financed by:				
Ordinary shares of N1 each		125,000		125,000
Revenue reserve		358,740		297,870
Shareholders' fund		483,740		422,870
10% debenture stock 2010 -12		250,000		250,000
Deferred taxation		135,260		81,130
		869,000		754,000

Operating Results for the year ended 31/12/2008

	2008	2007
	₦'000	₦'000
Sales	6,729,440	5,590,710
Profit before interest and taxation	234,120	208,820
Interest payable	25,000	25,000
Taxation	105,060	87,470
Dividend	37,500	35,000

The shares of the company were quoted at N1.20 at 31 December 2008.

You are required to:

(a) Calculate
   1. Two ratios of interest to creditors
   2. Two ratios of interest to management and
   3. Two ratios of interest to shareholders.

(b) Comment briefly upon the changes between 2007 and 2008.

SUGGESTED SOLUTION 12

LANDERS PLC

	2008	2007
(a) 1. Two ratios of interest to creditors:	₦	₦
Current or working capital ratio=	1,243,870/537,090	1,168,130/483,540
	= 2.3:1	1.3:1
Liquid or quick asset ratio =	$\frac{1,243,870-622,940}{537,090}$	$\frac{1,168,130-521,960}{483,540}$-
521,960)/483,540		
	= 1.2:1	1.3:1
2. Two ratios of interest to management:		
Return on capital employed =	234,120/869,000 x 100	208,820/754,000 x 100
(ROCE)	= 26.9%	27.7%
Net profit margin	234,120/6,729,440 x 100	208,820/754,000 x 100
	= 3.5%	3.7%
3. Two ratios of interest to shareholders		
Earnings per share		
=	$\frac{234,120-25,000-105,060}{125,000}$	$\frac{208,820-25,000-87,470}{125,000}$
	83 kobo	77 kobo
Dividend Cover =	$\frac{234,120-25,000-105,060}{37,500}$	$\frac{208,820-25,000-87,470}{125,000}$
=	2.8times	2.8times

(b) Comments on changes in ratios between years 2003 and 2004
   1. Ratios of interest to creditors

Both current and liquid ratios dropped slightly. In the absence of specific information on the industry in which the company operates, we can only compare these ratios against the generally accepted ideal of 2:1 for current ratio and 1:1 for liquid ratio. When compared against these ideals, it can be seen that the current liquid ratios of the company (in spite of slight deterioration) indicate that the company's liquidity is still relatively satisfactory.

2. Ratios of interest to management
   Return on capital employed dropped slightly due to the slight reduction in net profit margin from 3.7% to 3.5%. The decrease in profit margin, despite the increase in sales and profit, may have been due to:
   - Drop in selling price as dictated by the market: or
   - Increase in costs which could not be fully passed on to consumers.
3. Ratios of interest to shareholders
   Earnings per share increased because, while the number of issued ordinary shares remained the same, the absolute amount of profits increased. This is an indication of growth, even though the growth is not matched by increase in profitability.
   The dividend cover remains unchanged obviously because the dividend increased in proportion to the increase in earnings.

SELF ASSESSMENT EXERCISE
What is the purpose of current ratio?

3.2 VALUE-ADDED STATEMENT
Value-added statement represents the additional wealth which an entity has been able to create by its own and its employees' effort. 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 13
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	2007
	₦'000	₦'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)
Administrative costs	(1,366,742)	(681,787)

Trading profit	1,172,157	1,134,251
Interest payable (net)	(386,079)	(235,739)
Profit before exceptional items & taxation	786,078	898,512
Exceptional items	113,169	-
	672,909	898,512
Taxation	(314,138)	(335,520)
Profit after taxation	358,771	562,992
Proposed dividend	(351,000)	(234,000)
Retained profit	7,771	328,992

The following notes are relevant:

1. Included in cost of sales is excise duty amounting to ₦2,095,631,000 (2007 N1,028,900,000) charged on the manufactured goods.
2. Included in distribution and administration costs are staff salaries wages and fringe benefit totalling ₦495,872,000 (2007 ₦306,062,000) and depreciation charged on fixed assets of ₦200,264,000 (2007- ₦132,397,000).
3. Taxation comprises:

	2008	2007
	₦'000	₦'000
Income tax	34,982	314,479
Educational tax	17,117	21,041
Deferred tax	262,039	-
	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 13

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:				
Dividends to shareholders	351,000	9.1	234,000	9.0
Interest on borrowings	386,079	10.0	235,739	9.0
Retained in Business:				
To maintain and replace fixed assets	200,264	5.2	132,397	5.1
To augment reserves	7,771	0.2	328,992	12.6
Deferred taxation	262,039	6.8	-	-
	3,850,755	100	2,601,610	100

SELF ASSESSMENT EXERCISE

Using the same question in the illustration, prepare a value-added statement and compare your result to the solution in this sub-unit.

3.3 REPORT WRITING

Elements of a Report

A report usually consists of the following elements:

(a) Headings
(b) Terms of Reference
(c) Main body of the Report:
   1. Facts
   2. Recommendations

Headings

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:

1. The names of the recipient and the writer
2. The date; and
3. The subject being reported on.
   If the question does not contain names, invent some names but avoid use of names or real companies or persons. Above all, do not use your name.

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.

Main Body of the Report

1. Use of Appendices
   In an accounting examination, candidates will probably have to make some calculations perhaps ratios, proposals for amalgamation or absorption etc before you know what you are going to write in your report. Instead of wasting time making these calculations in a working sheet and later recopy into the body of the report, it is advisable to attached the working sheet to your report as an appendix, and refer to the appendix in the main report. In the report you write:
   "Detailed calculations of the ratios are to be found in appendix 1 to this report". You then write appendix 1 at the top of your working sheet, ad by this achieve two objectives:
   - A saving of time
   - Removal of details from the main report. This, in itself, is a good reporting style.
2. 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.
   Format of Tabulation

Month	N0. Of Accounts Students	Marks Scored
January		
February		
March		

The above shows the details of marks scored by accounting students in tests conducted in January, February and March of a particular year.

The alternative is to write a paragraph of prose incorporating the same information.

Tabulation has advantages and disadvantages. It is particularly suitable for use when listing a fairly large number of facts, each of which can be stated briefly.

It is not so suitable for a question, which asks for discussion. It can be used here to state the arguments for and against a course of action.

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; and
- 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 the tabulation makes sense with the introduction.

An example of how not to do it is:

This course of action is not recommended if :

(a) Labour unrest continues at the present level;
(b) When inflation rate increase; and
(c) Interest rate alterations.

Notice that (a) fits in satisfactorily with the introductory "if" but (b) and (c) do not. To correct, omit the "when" from "b" and rephrase (c) as "interest rates are expected to alter significantly".

3. 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 third person: for example, "it is thought that ________ " rather than "I think ________".

Qualities of a good report

A good report should have six qualities:

(a) Fullness;
(b) Accuracy
(c) Literacy;
(d) Level/consciousness of users;
(e) Interest of the users; and
(f) Clarity of purpose

Remember the Acronym – FALLIC

(a) Fullness
    All aspects of the subject must be covered. If for example, a report is drafted recommending that all employees should be disengage, it should contain:
    1. Names of employees, positions in the firm, length of service and remuneration;
    2. Reasons for dissatisfaction;
    3. Suggested dates for disengagement, periods of notice required and terminal benefits arrangements;
    4. Officers who will tell the employees of their dismissal;
    5. Steps, if any, taken to help to find other jobs for the employees;
    6. Steps taken to find replacements including details of any advertisement placed;
    7. Dates of the reports; and
    8. Signature(s) of the writer(s).
(b) Accuracy
    Information should be checked if, for example, a reporting accountant is told by the vendors of a firm under investigation that "the premises are worth N50million, at least" he must corroborate this statement before using it in his report. At the very worst, he might say, "the vendor values the premises at N50million", but "we are told the premises are worth N50million", is a dishonest statement.
(c) Literacy

You are not expected or required to write in the style of a great writer. You must, however, form correct grammatical sentences which leave no room for ambiguity. Avoid split infinitives, incorrect positioning of a key word as "only", repetition, unnecessary abbreviations and slangs. Be certain that your emphasis falls where you intend it.

(d) Level/Consciousness of users

A report is written for the readers, not for the writers. Writers of bad reports often seek to confuse their readers, by using terms they know will not be understood, in a mistaken attempt to create a favourable impression. This use of unnecessary jargon especially, appears in students' scripts, but a more common fault is that of describing a familiar process in over-simplified terms in an attempt to conceal the writers' inadequate knowledge by writing volumes.

The scope of a report is often determined by the level of the person or persons to whom it is directed, and great skill may be required if it is necessary to describe a technical process in lay terms.

An accountant may need to submit details of a new project to different groups of people. It is to be expected that his report to the Board of Directors will differ from reports to other managerial levels in the organization, both in style, scope and approach.

(e) Interest

Dull people tend to write dull reports. Good English itself commands interest.

Here is an attempt to communicate information in two different ways:

1. "The business has been trading for many years in the light engineering field, and has financed itself entirely out of internally generated profits. The management appears to be good, and the company has made fair progress in recent years. We do not consider that the price required is unreasonable, and it you intend to assume the duties of executive chairman of the company, you should find the purchase of the company a sound investment"

   Perhaps, this is a rather difficult extract to criticise, but is not the following a little more interesting?

2. "A remarkable aspect of the company is that throughout its 40years history, it has never borrowed money, nor made demands upon its shareholders, beyond their original capital. This factor, which some would consider something of an achievement, may well be largely responsible for the company's slow rate of real growth.

   If, as we believe, you intend to take over as chairman of the company, we consider that the purchase of the whole of the equity capital, even at the full asking price, should prove both absorbingly interesting and financially rewarding for you"

(f) Clarity

To be clear, a report should:

1. Contain no ambiguities;
2. Be divided logically into parts and arrive at a conclusion: and
3. Not necessarily be restricted to narrative matter.

Written information can be imparted in three different ways

- Narrative
- Tabulation

- Diagrammatic

The diagrammatic may be further analysed into:

1. Graphs;
2. Histograms or distribution patterns;
3. Time series;
4. Bar charts
5. Pictograms; and
6. Pie charts

It is often far easier for the reader to absorb information in one of these forms than to wade through pages of description.

ILLUSTRATION 14
You have been consulted by your client, Chief Richard Balinga, who has independent means. He wishes to retire and sell his business to two trusted employees who have managed this business successfully in recent years. He is particularly anxious to retain some element of control until the purchase consideration is fully paid.

The capital structure of his family business, Balinga Limited is as follows:

Authorized capital	₦10 million
Issued capital	5 million ordinary shares of ₦1 each

You are required to write to your client setting out different means by which his objective could be achieved.

SUGGESTED SOLUTION 14
Dear Chief Balinga,

Arrangements for the sale of Balinga Limited

Thank you for your letter dated 29 July 2008, in which you sought our advice on how you could retain an element of control over your company during the period between the sale and your receipt of the full consideration due.

As you will certainly be aware, there are several methods of achieving your objective, two of which we list below:

(a) Release of your shares and when you receive such instalment.
(b) Placing the shares in a nominee's name, for example, your stockbrokers who hold them in lien, until you are paid and then releases them to the buyers. Any dividend could meanwhile be placed in the nominee's name until the completion of the contract of sale.

Out first suggestion suffers from the disadvantage that once control has passed, it may be difficult for you to collect your money on the remaining shares in the event of default:

We believe the second option of introducing a trustworthy nominee, would better serve your objective and gain the confidence of the buyers. An agreement would be drawn up between yourself, the buyers and the nominee company, leading to the release of the title by the nominee company, when the last instalment is paid. During the tenure of the agreement, the nominee company would distribute any dividends, according to the proportion of the purchase price paid at the time of receipt of the dividend.

In conclusion, we suggest that the prospective buyers insure their lives, for a sum, at least equal to the purchase price, so that their estates would be released from burden and your position would not become insecure if either of them were to die while the agreement is still in force.

Please, let us know if you require further information.

Thank you.

Yours faithfully

For XYZ & Co.

SELF ASSESSMENT EXERCISE

1. State the qualities of a good report.
2. What are the advantages and disadvantages of tabulation in report writing?

4.0 CONCLUSION

A good reporting style demands appropriate skills from a qualified accountant. Practice is essentially to acquire it. It is important to read and study the construction of reports that come your way in the course of your work.

5.0 SUMMARY

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

Accounting ratios are of tremendous benefit in analysing and interpreting financial statements. However, they have their own limitations, which were discussed in this unit. Proper guide to writing a good report is also provided.

6.0 TUTOR MARKED ASSIGNMENT

1. State any party that is always interested in the interpretation of financial statements.
2. In computing returns on capital employed, (ROCE), the term capital employed could be defined as in various ways, depending on the profit figure used as the numerator. Mention one variant way of capital employed.
   Using the following information to answer question 3 & 4
   The following is the balance sheet of Gidado ltd

	N,000		N’000
Ordinary shares of capital @ N1 fully paid	10,000	Fixed assets	12,000
Reserves	5,000	Current assets	9,000
	15,000		
Current liabilities	6,000		-

21,000	21,000

The company estimates its future profits at ₦2,500 per annum and dividends on ordinary shares at ₦1,500 per annum.

Investigation reveals that similar shares should earn 7 percent and have a price earning ratio 10:1.

3. Compute future dividends per share.
4. Compute the value of ordinary shares on dividends yield basis.
5. Mention one limitation of ratio analysis.

7.0 REFERENCES/FURTHER READING

Institute of Chartered Accountant of Nigeria, Financial Accounting, Study Pack Lagos.

International Accounting Standard Board, International Accounting Standard.

Jennings, A. R., (2001), Financial Accounting, London, Letts Educational

Jennings, A. R., (2001), Financial Accounting, Solution Manual, London, Letts Educational

Nigerian Accounting Standard Board, Statement of Accounting Standard

MODULE 3: ACCOUNTING FOR INSURANCE CLAIMS AND FOREIGN BRANCHES

UNIT 1: ACCOUNTING FOR INSURANCE CLAIMS 1

CONTENT

1.0 INTRODUCTION

An insurance contract is a "contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder." [IFRS 4.Appendix A]

An insurance claim is a formal request to an insurance company asking for a payment based on the terms of the insurance policy. Insurance claims are reviewed by the company for their validity and then paid out to the insured or requesting party (on behalf of the insured) once approved.

In this unit we shall be discussing insurance claim, steps and procedures in computing insurance claims and claim for loss of stock. Other issues shall follow in the subsequent unit.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Define the terms stated by the policy on consequential loss.
2. Compute the consequential loss claim.
3. Outline the steps involved in ascertaining the value of stock destroyed if unknown.

3.0 MAIN CONTENT

3.1 INSURANCE CLAIMS

Insurance claims refer to the amounts payable under a contract of insurance on the occurrence of an insured event. Insurance claims may be broadly categorized into:

(a) Claims for loss of profit otherwise referred to as “consequential loss”;
(b) Loss of assets, e.g. stock or fixed assets.

Consequential loss

This type of insurance policy indemnifies the insured from losses arising from the suspension, wholly or partly, of the activities of the business, caused by fire or other man-made occurrences.

The terms of each policy vary according to the individual needs of the insured. However, normal policy provides for indemnity against the loss of profit due to:

(a) Reduction in turnover;
(b) Increased cost of working capital incurred, in order to avoid reduction in turnover.

In order to have better understanding of a policy on consequential loss, the following terms need to be defined:

(a) Period of indemnity: This refers to the period of dislocation, for which the policy was effected and is normally stated there-in, for example, “4 months”.
The basis of compensation is computed by reference to a percentage, which the turnover is supposed to earn. This percentage, multiplied by the amount of turnover reduced or loss as a result of fire, gives the amount of claim, subject to certain amendment and limitations, arising out of the “special circumstances clause and the average proviso”.
(b) 1. Rate of gross profit: This is calculated on the trading results of the last accounting period as follows:
$$\frac{net\ profit + insured\ standing\ charges}{turnover} \text{ x } 100/1$$
2. Rate of gross loss: Also calculated on the trading results of the last accounting period as follows:
$$\frac{insured\ standing\ charges - net\ loss}{turnover} \text{ x } 100/1$$
(c) Insured standing charges
These refer to fixed costs or expenditure specified by the business and stated in the policy, such as rent and salaries which the insured wishes to recover in the event of damage.
(d) Cost of workings
This is the expenditure which varies directly with production; that is, increase of insured standing charges due to fire for the sole purpose of avoiding or reducing the reduction in turnover.
(e) Period of damage or dislocation
This is the actual period during which the business of the insured is adversely affected.
(f) Annual turnover
This is the turnover of the period of 12 months immediately before the date of damage or fire.
(g) Standard turnover
This is the turnover of a period in the preceding year corresponding to the period of damage.
(h) Actual turnover

This is the turnover derived during the period of damage.

(i) Average clause

The average clause provides that, if the sum insured by the policy holder is less than the sum produced by applying the rate of gross profit to the annual turnover, then the amount payable shall be proportionately reduced, that is:

$$\frac{amount\ insured}{gross\ profit\%\ x\ turnover}\ x\ claim$$

The average clause is applicable when the sum insured is less than expected insurable sum (that is, gross profit% x annual turnover).

(j) Special circumstances clause

Consequential loss policy usually contains special circumstances clause, to provide for the trend of business or for special circumstances affecting the business either before or after the damage. It will affect the calculation of the following:

(a) Rate of gross profit;
(b) Reduction in turnover;
(c) Increases in cost of workings; and
(d) Savings in insured standing charges.

SELF ASSESSMENT EXERCISE

In order to have better understanding of a policy on consequential loss, what are the terms that need to be defined?

3.2 STEPS AND PROCEDURES IN COMPUTING INSURANCE CLAIMS

(a) Fixed the period of claim by taking the period of indemnity or the period of interpretation, whichever is smaller.

(b) Ascertain the 'short' or reduced turnover. That is,

	₦
Standing charges	xx
Add any expected increase (if any)	xx
	Xxx
Less actual turnover	xx
Reduction in turnover	xxx

(c) Calculate the rate of gross profit based on the accounting year preceding the fire.

(d) Compute gross profit by applying (c) to (b).

(e) Add to (d) above, the increase in cost of working, bearing in mind the following restrictions:

(i) where all the insurable standing charges are not covered by the policy, then only a proportion of the increased cost of working will be allowed, that is:

$$\frac{net\ profit + insured\ standing\ charges}{net\ profit + total\ insurable\ standing\ charges}\ x\ increase\ cost\ of\ working$$

(ii) loss of profit avoided due to increased cost of working that is, rate of gross profit x shortage of turnover avoided.

(f) Deduct any savings in insured standing charges to arrive at claims, which is subject to "average proviso".

(g) Apply, if required, any amendment arising out of "special circumstances".

(h) Determine whether the average clause is applicable or not and apply it to arrive at the actual claims.

ILLUSTRATION 15

From the following information, compute consequential loss claim:

Financial year ended 31 December 2006 with turnover of ₦200,000.

Fire takes place 1 June- 1November.

Period of indemnity is 6 months

Net profit ₦12,000; plus insured charges ₦24,000

Sum insured ₦36,300

Uninsured standing charges ₦2,000

Standing turnover; that is, corresponding months (1 June – 1 November 2006 is ₦75,000).

Turnover in the period of interruption is ₦22,500.

Annual turnover for twelve months preceding the fire (1 June – 3 May 2007) is ₦220,000.

Increase in cost of working ₦4,000, during the period of interruption (with a saving of insured standing charges N1,500).

Reduced turnover avoided, through increase in cost of working ₦10,000 (that is) but for this expenditure, the turnover after the fire would have been only ₦12,500.

Owing to reserves acceptance to the insurer, the "special" circumstances clause stipulates for:

(i) Increase of turnover (standard & annual) by 10%

(ii) Increase of rate of gross profit by 2%.

You are required to compute the consequential loss claim

SUGGESTED SOLUTION 15

Computation of consequential loss	₦	₦
(a) Loss of gross profit:		
Turnover in standard period		75,000
Add agreed increase of 10%		7,500
Adjusted standard turnover		82,500
Actual turnover during (1 June – 1 Nov.)		(22,500)
Reduced turnover		60,000
Gross profit% on reduced turnover (20% x 60,000)		12,000
(b) Claim for increase in cost of working:		
Increase in cost of working	4,000	
Subject to the lower of:		
1. Apportionment, based on the insured		

Standing charges:

$\frac{12{,}000+24{,}000}{12{,}000+(24{,}000+2{,}000)}\ x\ 4{,}000$ = 3,789

2. GP% of increase turnover

That is, ₦10,000 = 2,000

₦ (22,500 – 12,500)

Lower of (i) & (ii) = 2,000

14,000

Savings in insured standing charges 1,500

Claims 12,500

Subject to the average proviso clause:

i. Amount insured ₦36,300

ii. GP% of annual turnover ₦48,400

(20% x 220,000 + 10% x ₦220,000)

Since the amount insured is lower, the average clause applies.

Workings:

i. Gross profit% = (NP + Insured charges)/turnover

= (12,000 + 24,000)/200,000 = 18%

= Allowance increase = 2%

20%

ii. Standard period:

For period (1 June – 1 Nov) = 6 months

(Covered by the insurance period)

Application of the Average proviso clause:

$\frac{amount\ insured}{GP\%\ x\ annual\ turnover}$ x Claims

= 36,300/48,400 x 12,500

= ¾ x 12,500

= ₦9,375 (final claim for consequential loss)

SELF ASSESSMENT EXERCISE

Where all the insurable standing charges are not covered by the policy, what should be allowed and stating the formula?

3.3 CLAIMS FOR LOSS OF STOCK

When a trader loses stock as a result of fire, he should make a claim for loss of stock, provided he knows the value of stock loss. Where the exact value of stock in trade destroyed by fire is unknown, the usual method of ascertaining it, is arrived at as follows:

(a) Determining the basis of stock taking, particularly with regard to consistency of valuation and adjust for any inconsistency in price.
(b) Ascertaining the value of stock at the beginning of accounting period, that is, date of last balance sheet.

(c) Determining the value of goods purchased from the beginning of the period to the date of damage excluding goods purchased but not yet delivered to the company warehouse, where fire occurred.
(d) Determine total sales of goods from the beginning of the period to the date of damage excluding goods sold but not yet delivered to customers.
(e) Ascertain the value of stock salvaged/saved from the burnt premises.
(f) Calculate the average rate of gross profit made, in the previous accounting period, having regard to the factors likely to distort such average rate of gross profit such as:
    i. Year-end sales at required prices;
    ii. Perishable goods sold at reduced prices;
    iii. Abnormal goods taken into stock at a price other than at cost price;
    iv. Stock quantity shortage.

SELF ASSESSMENT EXERCISE
Where the exact value of stock in trade destroyed by fire is unknown, how is the usual method of ascertaining it arrived at?

4.0 CONCLUSION

A personal injury claim may require a different level of proof and persistence than a vehicle damage claim and insurance regulations vary from country to country. However, the basic steps to take information needed to file a claim are fairly similar.

Every insurance claim requires some kind of proof of damage or injury before an insurer will pay. On auto claims, someone said, there are five elements of proof that will come into play: what you tell the insurance companies, what the other party tells them, a police report, witnesses and physical damage at the scene.

5.0 SUMMARY

In this unit, we discussed accounting for insurance claim 1. This involved discussing insurance claim, steps and procedures in computing insurance claim and claim for loss of stock.

6.0 TUTOR MARKED ASSIGNMENT

1. What is refer to fixed costs or expenditure specified by the business and stated in the policy, such as rent and salaries which the insured wishes to recover in the event of damage?
2. The expenditure which varies directly with production; that is, increase of insured standing charges due to fire for the sole purpose of avoiding or reducing the reduction in turnover can be referred to as ________.
3. The turnover of a period in the preceding year corresponding to the period of damage is called what?
4. The turnover derived during the period of damage is referred to as _________?

7.0 REFERENCES/FURTHER READING

Aborode, R. (2004), A Practical Approach to Advanced Financial Accounting, Lagos, El-TODA Venture Ltd

Igben, R. O., (2004), Financial Accounting made Simple, Lagos, El-TODA Ventures Ltd, Volume 2.

Institute of Chartered Accountants of Nigeria, Financial Accounting, Study Pack, Lagos.

MODULE 3: ACCOUNTING FOR INSURANCE CLAIMS AND FOREIGN BRANCHES

UNIT 2: ACCOUNTING FOR INSURANCE CLAIMS 2

CONTENT

1.0 INTRODUCTION

In the previous unit, we discussed accounting for insurance claim one. In this unit we shall be discussing accounting for insurance claim two. This involve discussing steps or procedures in computing a claim for loss of stock, stock adjustments and accounting entries involved in accounting for insurance claim.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Outline the steps or procedure for computing a claim for loss of stock.
2. State the adjustment required for stock.
3. Calculate the amount for claim due

3.0 MAIN CONTENT

3.1 STEPS OR PROCEDURE FOR COMPUTING A CLAIM FOR LOSS OF STOCK

(a) Prepare previous year's trading account.
(b) Calculate the average rate of gross profit, using the gross profit derived in (1) above.
(c) Calculate the value of stock in warehouse at the date of damage.
(d) Calculate the value of stock destroyed in the fire.
(e) Determine whether the average clause is applicable or not, by comparing sum insured with the value of stock in the warehouse at the date of damage.
(f) Apply the average clause to derive the final claim.

SELF ASSESSMENT EXERCISE

State the steps for computing a claim for loss of stock.

3.2 STOCK ADJUSTMENTS

(a) Where opening stock includes goods whose value has been written down, the adjustment required is to deduct the written down value from the opening stock to get a normal value for the stock.

(b) Where the written down stock referred to in (a) above, was sold during the period, the amount for which it was sold must have been included in turnover, hence, the adjustment required is the deduction of the figure from sales figure.
(c) As in the case of opening stock, closing stock may include goods whose value has been written down. The value of stock that has been written down, must have been included in purchases figure. Where such goods remain unsold at the year end, it follows that they should be deducted from the goods available for sale, at the same full cost, in order that the figure or cost of goods sold, is not distorted. Adjustment required, is to add back to closing stock, in order to bring the closing stock back to its full cost.

3.3 ACCOUNTING ENTRIES

(a) Estimate the value of stock damaged and make the following accounting entries:
Dr. Stock account} with the amount computed
Cr Trading account}
(b) With the amount of agreed claim:
Dr. Insurance claim} with the amount of claim
Cr. Stock account
(c) With the value of stock loss- when claim is not payable by insurance company.
Dr. Profit and loss account
Cr. Stock account

ILLUSTRATION 16

On 30th September 2008, the premises of Highman Biscuits Ltd, was severely damaged by fire and the company's business records were completely destroyed. However, the accountant of the company had been maintaining a back-up of the company's accounting transactions in a USB Drive, from which the following data was obtained.

	₦'000
Stock at 1st January, 2007	10,600
Stock at 1st January, 2008	8,200
Sales in 2007	34,920
Purchases in 2007	21,250
Sales for nine months to 30th Sept. 2008	13,120
Purchases for nine months to 30th Sept. 2008	11,800
Purchases in Sept. 2008 not yet delivered to the company	2,890

The accounting date of Highman Biscuits is 31 December.

During the stock valuation exercise conducted at 31 December 2006, ₦50,000 was written off a particular brand of biscuits. These goods which originally cost ₦150,000 were sold in February 2007 for ₦120,000.

Similarly, in valuing its closing stock at 31 December 2007, ₦60,000 was written off from another brand of biscuits. These goods originally cost ₦160,000. They were subsequently sold for N120,000 in May 2008.

Stock valued at ₦1.8million was salvaged on the day of the fire incident. You are required to calculate the amount of claim due, from the insurers in respect of the stock.

SUGGESTED SOLUTION 16

STATEMENT OF INSURANCE CLAIM

	Normal	Stock	Abnormal	Stock	Total	
	₦'000	₦'000	₦'000	₦'000	N'000	N'000
Stock at 1/1/2008	-	8,100	-	100	-	8,200
Purchases: Jan. – Sept. 2008	-	11,800	-	-	-	11,800
Cost of goods available for sale	-	19,900	-	100	-	20,000
Cost of goods sold:	N'000		N'000		N'000	N'000
Sales Jan. – Sept. 2008	13,000	-	120	-	13,120	
Less: Gross profit @ 32.5%	4,225	-	-	-	4,225	
Profit on abnormal stock	-		(20)	-	(20)	
Cost of goods sold		(8,775)		(100)		(8,875)
Estimated value of stock		11,125				11,125
Less: value of salvaged stock						1,800
Stock lost (amount of claim)						9,325

Workings

Calculation of gross profit % for the year ended

31st December 2007		N'000	N'000
Sales			34,920
Less: sale of devalued stock			120
			34,800
Less cost of sales:			
Opening stock		10,600	
Less: amount written off stock (150 – 50)		100	
		10,500	
Purchases		21,250	
		31,750	
Closing stock	8,200		
Add stock written off	60	8,260	
Cost of goods sold (normal value)			(23,490)
Normal gross profit			11,310

Normal gross profit = (11,310 x 100)/34,800 = 32.5%

Tutorial notes

i. Observe that the purchases for September 2008 were not included in the computations above because the goods were yet to be delivered to the company before the date of the fire incident.

ii. Abnormal stock at 1st January 2008, is obtained by deducting ₦60,000 (the amount written off) from the original cost of ₦160,000.

iii. Profit on abnormal stock, is calculated by comparing the abnormal sale of N120,000 in 2008 with ₦100,000, the carrying value of stock written down.

iv. In the workings, the sales value of written down stock (₦120,000) was deducted from the overall sales value to obtain the value of normal sale.

v. Similarly, the opening value of written-down stock, was deducted from the overall opening stock, to exclude the abnormal stock from the figure of opening stock.

SELF ASSESSMENT EXERCISE
After studying this sub-unit, solve this same question without looking at the solution and compare your result to the solution in the illustration.

4.0 CONCLUSION
Accounting for insurance claim, involves the calculation of the claims payable by an insurance company, in the event of a stock loss and computing the loss of profit occasioned by interruptions in the business operations of an entity, by reason of a fire disaster. These losses are insurable and it is prudent for a business to take out an insurance policy on such eventualities.

5.0 SUMMARY
In this unit, we discussed accounting for insurance claims 2. It entails steps or procedure for computing a claim for loss of stock, stock adjustment and the accounting entries involved and the computation of claims due.

6.0 TUTOR MARKED ASSIGNMENT
1. State the double entries for value of stock loss when claim is not payable by the insurance company.
2. State the formula for calculating normal gross profit.
3. What do you understand by “special circumstances clause”?
4. Define “cost of working” as it relates to insurance claims.
5. Explain the phrase “period of indemnity” in the context of insurance claim accounting

7.0REFERENCES/FURTHER READING
Aborode, R. (2004), A Practical Approach to Advanced Financial Accounting, Lagos, El-TODA Venture Ltd

Igben, R. O., (2004), Financial Accounting made Simple, Lagos, El-TODA Ventures Ltd, Volume 2.

Institute of Chartered Accountants of Nigeria, Financial Accounting, Study Pack, Lagos.

MODULE 3: ACCOUNTING FOR INSURANCE CLAIMS AND FOREIGN BRANCHES

UNIT 3: ACCOUNTING FOR INDEPENDENT AND FOREIGN BRANCHES

CONTENT

1.0 INTRODUCTION

The term 'Dependent Branch' means a branch which does not maintain its own set of books. All records have to be maintained by the head office. When the business policies and the administration of a branch are wholly controlled by the head office, its accounts also are maintained by it. On the other hand, a branch is said to be "independent" when a branch is authorized to prepare its own accounts on its books.

As the foreign branch is an independent branch, it keeps a complete set of books on the double entry system, prepares all the necessary accounts including the account of the Head Office, prepares its own trial balance, Trading and Profit and Loss Account and Balance Sheet. In short, the accounting procedure adopted at a foreign branch is exactly the same as that adopted at an independent domestic branch.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Explain what an independent branch is.
2. Prepare a trading, profit and loss account, and a balance sheet for a branch, its head office and the business as a whole.
3. Explain the term "foreign branches".
4. Explain the closing rate method
5. Explain the temporary method

3.0 MAIN CONTENT

3.1 INDEPENDENT BRANCHES

Where branches are semi-autonomous, they are usually responsible for the maintenance of their records. This arrangement is usually common in branches with large-scale operations.

At the end of each period, the branch sends its trial balance to the head office, which will generally contain assets, liabilities, income and expenditure of the branch and its dealing with other branches and head office. Transactions between the branch and head office as well as other branches are recorded in current accounts which serve as a link between the two units and any balance in the account, represents the amount of investment by the head office in the branch.

UNREALIZED PROFITS

If goods are transferred between branches and head office (or other branches) at price other than the cost, there will arise an unrealised profit for unsold stocks at the end of the period. This would be dealt with by making a provision for unrealized profit which is debited to the profit and loss account and deducted from stocks in the balance sheet.

ILLUSTRATION 17

Johnson Enterprises Ltd, based in Lagos has a branch in Kano. The trial as at 31 December 2008, for the branch and head office are as follows:

	Head Office	Branch Office
Debits:	₦	₦
Fixed assets (NBV)	76,000	30,800
Stocks at 1 January 2008:		
Head office at cost	56,000	
Branch at selling price		34,000
Debtors	34,896	7,808
Bank and cash	66,328	11,536
Purchases	391,800	
Branch remittance to HO		225,720
Goods sent to branch		139,880
General expenses	68,000	40,000
Branch current account	253,064	-
	946,088	489,744
Credits:		
Goods sent to branch	143,080	
Bank remittance from branch	224,760	
Sales	388,040	238,800
Creditors	32,468	1,080
Current account		249,864
Capital at 1 April	149,240	
Provision for unrealized profit on stock 1 January	8,500	-
	946,088	489,744

Additional information:

i. At 31 December 2008:

	₦
Stocks at HO (at cost)	50,800
Stocks at branch (transfer price)	19,200
Stocks in transit (transfer price)	3,200
Cash in transit to HO	960

ii. Goods are invoiced to branch at cost plus 331/3%

iii. Provide for depreciation on fixed assets at 20% per annum on reducing balance.

You are required to prepare a trading and profit and loss account for the year ended 31 December 2008 and a balance sheet as at that date for the branch, head office and the business as a whole.

SUGGESTED SOLUTION 17

JOHNSON ENTERPRISES LTD
TRADING AND PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31 DECEMBER 2008

	Head Office		Branch		Adj. By HQ		Business
	₦	₦	₦	₦	₦	₦	₦
Sales	388,040	-	-	238,800	-	-	626,840
Goods sent to branch	143,080				(143,080)	-	-
		531,120	-	238,800	(143,080)	-	-
Less cost of sales:							
Opening stock	56,000	-	34,000	-	(8,500)*	81,500	-
Purchases	391,800	-	-	-	-	391,800	-
Provision for u/p	-	-	-	-	-	-	
Goods from HQ	-	-	139,880	-	(139,880)	-	-
	447,800	-	173,880	-	(148,380)	473,300	-
Less closing stock	50,800	-	19,200	-	(4,800)**	68,400	-
Cost of sales	-	397,000	-	154,680	-	-	(404,900)
Stock in transit	-	-	-	-	-	-	-
Gross profit		134,120		84,120	3,700	-	221,940
Less:							
General expenses	68,000		40,000			108,000	
Depreciation	15,200		6,160			21,360	
		83,200		46,160			129,360
Net profit		50,920		37,960	3,700		92,580

*Stock in transit ₦3,200 is included in the closing stock valuation

Workings

i. Opening stock 1 January 2008

	₦	₦
Head Office (at cost)		56,000
Branch	34,000	
Less: unrealized profit	8,500	25,500
		30,500

Stock valuation 331/3% = ¼ of ₦34,000 = ₦8,500

ii. Closing stock 31 December 2008

	N	N
Head office		50,800
Branch	19,200	
In transit	3,200	
	22,400	
Less unrealized profit	4,800	17,600
		68,400

Stock in transit ₦143,080 – ₦139,880 = ₦3,200

JOHNSON ENTERPRISES
BALANCE SHEET AS AT 31 DECEMBER 2008

Head-office		Branch		Adj.	Total	
₦	₦	₦	₦	₦	₦	N

Fixed assets		60,800		24,640			85,440
Current assets:							
Stocks	50,800		19,200		provision for	68,400	
Debtors	34,896		7,808		u/p (4,800)	42,704	
Bank and cash	66,328		11,536		stock in transit	78,824	
	152,024		38,544		3200	189,928	
Less:							
Current liability:					cash in transit		
Creditors	32,468		1,080		960		
		119,556		37,464		33,548	
							156,380
		180,356		62,104	(640)		241,820
Financed by:							
Capital							149,240
Net profit							92,580
							241,820

Note: (i) Fixed assets

	H.Q	Branch
Cost 1/1/04	76,000	30,800
Depreciation	15,200	6,160
Net book value 31/12/04	60,800	24,640

(ii) Cash in transit 960

SELF ASSESSMENT EXERCISE

What you understand by "independent branches"?

3.2 FOREIGN BRANCHES

Foreign branches are those situated outside the country where the head office is located. They are usually self-accounting and transactions are denominated in the currency of the host nation. This will necessitate the translation of the foreign currency into the head office currency (using exchange rates), before the combined trial balance and final accounts can be prepared.

In translating the trial balance of the foreign branch into the head office's currency, we can apply the temporal method or the closing rate method. The exchange rates to use for each transaction under the two methods are tabulated below:

Transactions	Temporary method	Closing rate method
Stocks	The actual rate ruling on the acquired date of purchase or transfer	The closing rate, if acquired by branch or at actual value, if acquired by head office
Fixed assets	At actual rate ruling on the date of purchase or transfer	Rate ruling on the balance sheet date
Current assets & current liabilities	Rate ruling on the balance sheet date	Rate ruling on the balance sheet date
Profit and loss items	Average rate of exchange for the year	Rate ruling on the balance sheet date
Head office current account	At actual rate	Figure in the head office book

ILLUSTRATION 18

Muyiwa Plc, is a business that engages in trading of vegetable oil in Nigeria with a branch office in Tunisia. Trial balances, from the head office and branch books as 30 September 2008 are follows:

	Nigeria		Tunisia	
	DR	CR	DR	CR
	₦'000	₦'000	₦'000	₦'000
Share capital – authorised				
Issued and fully paid		60,000		
Fixed assets	104,960		52,960	
Stocks- 1 October 2007	13,920		14,400	
Depreciation 1 October 2007		26,400		12,000
Purchases/sales	23,600	108,800	40,000	110,400
Debtors/creditors	49,296	21,600	27,200	30,720
Operating expenses	33,228		30,000	
Bank balance/overdraft		16,300	34,400	
Branch/HQ current account	8,832			45,840
Provision for unrealised profit				
On stock 1st October 2001		736		-
	233,836	233,836	198,960	198,960

Additional information:

(a) Fixed assets (except those costing t5,760,000) had been purchased in Nigeria some years ago and transferred to branch at a cost of ₦14,230,000. Other fixed assets were purchased locally on 1 October 2007.
(b) All purchases were made in Nigeria and invoiced in the branch at cost plus 10%; 6% of which relates to carriage expenses to Tunisia and 4% to profit.
(c) During the year ended 30th September 2008, the branch bought goods locally costing t12,500,000 out of which t3,600,000 worth of goods were still in stock at the end of the year.
(d) A remittance of t1,984,000 from the branch on 25 September 2008 was not received or credited by the head office until October 2008.
(e) On 30 September 2008, stocks were valued as follows:
    Nigeria ₦26,240,000
    Tunisia t12,400,000
(f) The following exchanges rates were applicable
    1 October 2007 t4.5 to ₦1
    30 September 2008 t4.0 to ₦1
    Average during the year t5.0 to ₦1

You are required to prepare the combined trading, profit and loss account balance sheet of Muyiwa Plc.

SUGGESTED SOLUTION 18
WORKINGS

TRANSLATION OF TUNISIA TRIAL BALANCE INTO NAIRA

		t'000	t'000	Rate	₦'000	₦'000
Fixed assets	HQ	47,200		actual	14,230	

Local	5,760		4.5	1,280	
Opening stock	14,400		5.0	2,880	
Depreciation 1 October		12,000	actual		3,618
Purchases/sales	40,000	110,400	5.0	8,000	22,080
Debtors/creditors	27,200	30,720	4.0	6,800	7,680
Bank balance	34,400		4.0	8,600	
Working expenses	30,000		5.0	6,000	
Closing stock- balance sheet	12,400		5.0	2,480	
Closing stock- trading account		12,400	5.0		2,480
Depreciation for the year- P&L	5,296			2,480	
Depreciation – balance sheet		5,296			1,551
Exchange gain					5,567
	216,656	216,656		51,808	51,808

NOTES

(a) Depreciation for P&L — ₦'000

	₦'000
Locally purchased assets (t576,000/5.0)	115
Assets from HQ	1,423
	1,538

(b) Depreciation for balance sheet — ₦'000

	₦'000
Locally purchased assets (t576,000/4.5)	128
Asset from HO	1,423
	1,551

MUYIWA PLC

Trading Profit and Loss Account for the Year Ended 30 September 2008

	Nigeria	Tunisia	Total
	₦	₦	₦
Transfer to Branch	5,500		
Sales	103,300	22,080	125,380
	108,800	22,080	125,380
Opening stock	13,920	2,880	16,064
Transfer from HQ		5,500	
Purchases	23,600	2,500	26,100
	37,520	10,880	42,164
Less closing stock	26,240	2,480	28,656
Cost of sales	11,280	8,400	13,508
Gross profit	97,520	13,680	111,872
Exchange gain	5,567	--	5,567
Unrealized profit (no longer required	672		
	103,759	13,680	117,439
Working expenses	33,228	6,000	39,228
Depreciation	10,496	1,538	12,034
	43,724	7,538	51,262
NET PROFIT	60,035	6,142	66,177

Balance Sheet as at 30 September 2008

	Nigeria	Tunisia	Total
	₦'000	₦'000	₦'000
Fixed assets	104,960	15,510	120,470

Depreciation	36,896	5,169	42,065
	68,064	10,341	78,405
Current assets			
Stocks	26,240	2,480	28,720
Debtors	49,296	6,880	56,176
Branch current account			19,981
Cash in transit	496		496
Bank balance		8,104	8,104
	164,077	27,805	191,882
Creditors	(21,600)	(7,680)	(29,280)
Bank overdraft	(16,300)		(16,300)
	126,177	20,125	146,302
Capital & Reserves			
Share capital	60,000		60,000
Profit and loss	66,177		66,177
HO current account		20,125	20,125
	126,177	20,125	146,302

Workings

i.	Closing stock	N'000
	Head office	26,240
	Branch	2,480
	Unrealised profit	(64)
		28,656

Using the closing rate method

Workings

Translation of Tunisia trial balance into Naira

	t'000	t'000	Rate	₦'000	₦'000
fixed assets HO	47,200		4.0	11,800	
Local	5,760		4.0	1,440	
Opening stock	14,400		5.0	2,880	
Depreciation 1st October		12,000	5.0		2,400
Purchases/sales	40,000	110,400	5.0	8,000	22,080
Debtors/creditors	27,200	30,720	4.0	6,800	
Bank balance	34,400		4.0		
Working expenses	30,000		5.0		
Closing stock – balance sheet	12,400		4.0		
Closing stock- trading account		12,400	5.0		
Depreciation- balance sheet		5,296	4.0		
Exchange gain	216,656	216,656			

SELF ASSESSMENT EXERCISE

What do you understand by the term foreign branches?

3.3 THE CLOSING RATE METHOD IN MORE DETAIL

Under this method, the amounts in the balance sheet of a foreign enterprise, should be translated into the reporting currency of the investing company, using the rate of exchange ruling at the balance sheet date. Exchange differences will, if this rate differs from that ruling at the previous balance sheet date or at the date of any subsequent capital injection (or reduction).

Amounts in the profit and loss account of a foreign enterprise, should be translated at a closing rate or at an average rate for the accounting period. The use of the closing rate is more likely to achieve the objective of reflecting the financial results and relationships as measured in the foreign branch's financial statement prior to translation. However, it can be argued that an average rate reflects, more fairly, the profits and losses and cash flows as they arise to the group, throughout an accounting period. The use of either method is therefore permitted, provided that the one selected is applied consistently from period to period.

No definitive method of calculating the average rate has been prescribed, since the appropriate method may justifiable vary, between the individual companies. Factors that will need to be considered, include the company's internal accounting procedures and the extent of seasonal trade variation; the use of a weighting procedures will, in most cases, be desirable. Where the average rate used, differs from the closing rate, a difference will arise, which should be dealt with, in reserves.

Note that:

(a) The profit and loss account may be translated either at the weighted average or the closing rate for the year.
(b) Any exchange difference arising is always a movement on reserves and never goes to the profit and loss account.

SELF ASSESSMENT EXERCISE

What do you understand by the closing rate method?

3.4 THE TEMPORAL METHOD IN MORE DETAIL

The mechanics of this method are identical with those used in preparing the accounts of an individual office. This means that;

(a) The profit and loss account is translated using actual rates where known (an average for the period tends to be used in practice), and historical rates for non-monetary items, such as opening and closing stock and depreciation; and
(b) Any exchange differences are reported as part of profit for the year.

SUMMARY OF TRANSLATION METHODS

The main stages are:	Closing rate method	Temporary method
Stage 1 Translate the closing balance sheet and use this for preparing the consolidated balance sheet in the normal way	Under closing rate at the year end for all items (but see below)	Use the closing rate at the year end for monetary items and the appropriate historical rates for non-monetary items. Shareholders' fund should be treated as balancing figure (see

		below). Note: as mentioned above, the share capital may be translated at the historical rate (under both methods). The reserves will then be the balancing figure. The advantage of this method is that it simplifies the 'cancellation' of the share capital on consolidation.
Stage 2 Translate the profit and loss account	Use the average rate or closing rate for the year, for all items (but see comment on dividends). The figures obtained can then be used in preparing the consolidated profit and loss account.	The profit and loss account should be translated, using the exchange rates ruling as at the time the amounts recorded in the financial statement were established. Note: In most examinations questions, it will be necessary to translate all items, apart from depreciation, at the average rate for the year, and to translate depreciation at the rates ruling when the relevant fixed assets were acquired (or re-valued). If, however, the information is available, you should use temporal rates specific to opening and closing stocks.
Translate the shareholders' fund at the beginning of the year.	Use the closing rate at beginning of the year (that is opening rate).	Use the closing rate at the beginning of the year for monetary items and the appropriate historical rates for non-monetary items.
Stage 3 Translate the shareholders' fund at the beginning of the year.	Use the closing rate at beginning of the year (that is opening rate)	Use the closing rate at the beginning of the year for monetary items and the appropriate historical rates for non-monetary items. Note: In many questions, it is necessary to reconstruct the opening balance sheet.
Stage 3 Calculate the total exchange difference for the year as follows: shareholders' fund at the beginning of the year (as in stage 3 above).	This stage will be unnecessary unless you are asked to state the total exchange difference or are asked to prepare a statement of the movement in reserves.	After finding the exchange differences, it will be possible to prepare the consolidated profit and loss account. The exchange differences should be included before tax.

Add: retained profit before exchange differences (stage 2) X

Less: shareholders' fund at the year end (stage 1)	X
Exchange differences (balance)	XX

Note: it may be necessary to adjust for a profit or loss taken direct to reserves during the year.

SELF ASSESSMENT EXERCISE

What do you understand by the temporary method?

4.0 CONCLUSION

Businesses sometimes carry on their operations through their branches in different places, while the operations of some branches are direct extensions of the Head Office activities. Some branches are largely independent and maintain separate records of their transactions with their head office. Unsold stocks relating to intra-company transfer of goods, give rise to the problem of unrealized profits, while foreign branches introduce the complication of foreign currency translation.

5.0 SUMMARY

In this unit we discussed accounting for independent and foreign branches. The two methods of accounting for foreign branches were dealt with in this unit.

6.0 TUTOR MARKED ASSIGNMENT

Short Answer Questions

1. State one possible reason why branch current account may not agree with head office current account.
2. State the formula for eliminating unrealised profits from goods sent to branch at cost plus 20%.
3. State how revenue and expenses are translated under the closing rate method.
4. When is the temporal method applicable for translation of the financial statements of foreign branches?
5. In the context of branch accounting, what is semi-autonomous branch?

7.0 REFERENCES/FURTHER READING

Aborode, R. (2004), A Practical Approach to Advanced Financial Accounting, Lagos, El-TODA Venture Ltd

Igben, R. O., (2004), Financial Accounting made Simple, Lagos, El-TODA Ventures Ltd, Volume 2.

Institute of Chartered Accountants of Nigeria, Financial Accounting, Study Pack, Lagos.

MODULE 4: ACCOUNTING FOR CONTRACT, INVESTMENT, LEASE AND HIRE PURCHASE

UNIT 1: CONTRACT ACCOUNTS

CONTENT

1.0 INTRODUCTION

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 Contract method or the percentage of completion method.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Explain what short-term contract is.
2. State the summary of the provision of SAS 5 in relation to short-term contract.
3. Prepare a contract account.
4. State the problems associated with accounting for long-term projects.
5. State the methods of approach for a construction business.

3.0 MAIN CONTENT

3.1 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 was 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 require completing the contract are not significant, provision should be made for such costs and the contract treated as completed.

ILLUSTRATION 19

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

	₦
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 was completed by the year ended 31 March, 2008. During which the company received N60,000 from Tolu Manufacturing ltd. The written down values of the plant and tools were N25,000 and N500, respectively.

Required:

Prepare the contract account

SUGGESTED SOLUTION 19

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

	₦		₦
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 @ cost	35,000		
Plant hire	2,000		

Sundry tools	3,000		
Contract profit taken	10,500		-
	125,500		125,500

TOLU MANUFACTURING LIMITED
CONTRACTEE ACCOUNT

	₦		₦
Value of work certified	100,000	Cash received	60,000
		Contract debtor (bal. c/d)	40,000
	100,000		100,000

SELF ASSESSMENT EXERCISE
State the provision of SAS No. 5 on short-term project.

3.2 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 involved 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.

SELF ASSESSMENT EXERCISE
What are the problems associated with accounting for businesses which carry out long term construction contract?

3.3 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.

SELF ASSESSMENT EXERCISE
Outline the method of approach for a construction business

4.0 CONCLUSION

Contractors choose from a variety of accounting procedures to account for the revenue they received from such contracts. However, the Standard has provision for such projects, especially long-term contract projects, so that contractors must account for revenue in limited ways.

5.0 SUMMARY

In this unit, we discussed contract account. This was treated considering accounting for short-term projects, accounting for long term-term projects and mode of operation. Specifically, accounting for short-term projects was treated with illustration to explain the accounting entries that should be made. More shall be done to substantiate the long-term projects in the following unit.

6.0 TUTOR MARKED ASSIGNMENT

1. Where a contract is commenced and completed within an accounting year-end, _______ is recognized immediately in that accounting year-end.
2. Where a contract is commenced in one accounting year and concluded in the next, then, there is the need to determine _________.
3. In a situation where the additional costs require to complete a contract are not significant, ________ should be made for such costs and the contract treated as completed.
4. ________ 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.
5. The period of execution of a contract may be within _______ or ________.

7.0 REFERENCES/FURTHER READING

Aborode, R. (2004), A Practical Approach to Advanced Financial Accounting, Lagos, El-TODA Venture Ltd

Igben, R. O., (2004), Financial Accounting made Simple, Lagos, El-TODA Ventures Ltd, Volume 2.

Institute of Chartered Accountants of Nigeria, Financial Accounting, Study Pack, Lagos.

MODULE 4: ACCOUNTING FOR CONTRACT, INVESTMENT, LEASE AND HIRE PURCHASE

UNIT 2: ACCOUNTING PROCEDURES FOR LONG-TERM PROJECTS

CONTENT

1.0 INTRODUCTION

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.

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).

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Prepare a contract and a contractee's accounts.
2. Prepare a contract account where cost of completing the contract can be estimated with a degree of certainty.
3. Determine the value of work-in-progress.

3.0 MAIN CONTENT

3.1 ARCHITECT'S OR ENGINEER'S METHOD

Under this method, each contract is debited with the costs of materials supplied, payments to sub-contractors, wages and contract overheads. At the end of the period, the account is credited with architectural valuation, the value of worked 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 systematically as below.

Profit recognized to date = estimated profit x $\frac{\frac{2}{3} x \ cash\ received}{value\ of\ work\ certified}$

ILLUSTRATION 20

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 31 March 2008, was ₦25,000,000 while 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 20

VULTURE NIGERIA LIMITED
CONTRACT ACCOUNT

For the year ended 31 March 2008

	₦'000		₦'000
Material	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'S 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 at cost	35,000	
Tools at cost	3,000	
	115,000	
Plant (wdv) c/d	(25,000)	
Tools (wdv) c/d	(500)	
		89,500
Estimated profit		10,500

Profit to be recognized = 2/3 x $\frac{cash\ received\ x\ estimated\ profit}{value\ of\ work\ certified}$

= 2/3 x (60,000,000 x 10,500,000)/100,000,000

= N4,200,000

Note:

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

Alternative approach to calculating profit taken

Another acceptable approach to recognised profit is as follows:

= cash received/value of work certified x estimated profit

Therefore, profit taken = 60% x N10,500,000

= N6,300,000

SELF ASSESSMENT EXERCISE
Explain what you understand by architect or engineer's method.

3.2 PERCENTAGE OF COMPLETION METHOD (SAS 5)

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

ILLUSTRATION 21
Given the details under illustration : 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 21

VULTURE NIGERIA LIMITED
CONTRACT ACCOUNT

For the year 31 March, 2008

	₦'000		₦'000
Material	30,000	Plant (wdv) c/d	25,000
Direct wages	40,000	tools (wdv) c/d	500
Direct expenses	5,000	Work in progress (bal. Figure) c/f	95,500
Plant hire	2,000		
Plant at cost	35,000		
Tools at cost	3,000		
Profit recognized	6,000		-
	121,000		121,000

Workings:
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 N(35,000 – 15,000)	20,000		
Tools N(3,000 + 2,000 – 1,900)	3,100		
		(23,100)	
Estimated contract cost to completed			(141,000)
Estimated Profit			9,000

Attributable profit $= \dfrac{value\ of\ work\ certified\ x\ estimated\ profit}{contract\ price}$

= (100,000,000 x 9,000,000)/150,000,000

= N6,000,000

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

Alternative approach to calculating profit taken

There are other conservative approaches, to calculating the profit to be taken, which are acceptable:

(a) $\frac{cash\ received}{value\ of\ work\ certified}\ x\ \frac{value\ of\ work\ certified}{contract\ price}\ x\ estimated\ profit$

(b) $\frac{cost\ of\ work\ completed}{estimated\ contract\ cost\ on\ completion}\ x\ estimated\ profit$

The profit taken under each of the above alternative methods are as follows:

(a) $\frac{60,000,000}{100,000,000}\ x\ \frac{100,000,000}{150,000,000}\ x\ 9,000,000$
= N3,600,000

(b) $\frac{89,500,000}{141,000,000}\ x\ 9,000,000$
= N5,713,000

SELF ASSESSMENT EXERCISE
After studying this unit, solve the question without looking at the solution and compare your answer to the solution given in the illustration.

3.3 VALUATION OF WORK IN PROGRESS (WIP) ON LONG-TERM CONTRACT

Under the provisions of SAS No 5: Accounting for Construction Contracts, the value of work in progress for balance sheet purposes, is calculated as follows:

	₦
Cost incurred to date	x
Plus attributable profit (if any)	x
	Xx
Less foreseeable losses	x
	X
Less progress payments received or receivable	x
Value of WIP for balance sheet	x

ILLUSTRATION 22
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
Costs to date	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 22

(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 N(500,000 – 450,000)	50,000	
	Pero N(80,000 – 76,000)	4,000	
	Igbesa	15,000	
		69,000	
Construction work in progress			96,065

Workings:

1. Profit or loss taken on projects:

Sango = N280,000 x $\frac{500,000}{800,000} x \frac{450,000}{500,000}$

= N157,500

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

= N20,565

Pero = All the foreseeable losses should be recognised immediately

Igbesa = $\frac{17,000 \, x \, 15,000}{100,000} \, x \, \frac{0}{80,000} = Nil$

SELF ASSESSMENT EXERCISE

After studying this unit, solve the question without looking at the solution and compare your answer to the solution given in the illustration.

4.0 CONCLUSIONS

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

5.0 SUMMARY

In this unit, the use of architect's or engineer's certificate method and percentage of completion method were used. The determination of the value of work-in-progress for the balance sheet disclosure was examined. The criteria stated in the statement of Accounting Standard No 5: Accounting for Construction Contracts was also examined.

6.0 TUTOR MARKED ASSIGNMENT

1. Which of the methods on accounting for contracts recognises profits as actual?
2. Briefly define long-term construction contracts.
3. Itemise one feature of a construction contract.
4. Differentiate between long-term and short-term construction contracts.
5. State one basis for recognizing losses on long-term construction contracts.

7.0 REFERENCE/FURTHER READING

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MODULE 4: ACCOUNTING FOR CONTRACT, INVESTMENT, LEASE AND HIRE PURCHASE

UNIT 3: SINKING FUND AND ANNUITY

CONTENT

1.0 INTRODUCTION

In this unit, we shall be discussing the concept of sinking fund. A sinking fund is a fund established by a government agency or business for the purpose of reducing debt by repaying or purchasing outstanding loans and securities held against the entity. It helps keep the borrower liquid so it can repay the bondholder.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Prepare the sinking fund accounts.
2. Show the difference between sinking fund for asset replacement and debenture replacement.
3. Show the accounting entries for debenture and equities investment.

3.0 MAIN CONTENT

3.1 ASSET REPLACEMENT

When an asset needs to be replaced, the funds needed could be provided by setting aside an agreed amount each year, invested with the component of compound interest. This will be sufficient to provide a sum equal to the cost of the asset, less residual value at the end of its estimated life. The advantage of this method is that cash will be available to provide for the asset replacement.

The book value of the asset remains unchanged during the period of building the sinking fund, the depreciation being reflected in the credit balance on the sinking fund account. At the end of the period, the balance in the sinking fund will be transferred to the credit of the asset, leaving the balance in the latter, as the residual balance.

At the occurrence of each of the following situations (a – e), the sinking fund account, entries for the write off of asset, will be as stated against, each (a – e).

		Dr	Cr
(a)	On setting aside the instalment annuity	P & L	Sinking Fund
(b)	On investing the instalment	Cash	Sinking fund
(c)	On receipt and reinvestment	Cash	Sinking fund
	of interest on investment	Sinking fund Inv.	Cash
(d)	On the expiry of the life of the asset	Sinking fund	Asset
(e)	On purchase of new asset	Asset	Sinking fund

ILLUSTRATION 23

Plant which cost ₦250,000 with life span of 3 years and the residual value of ₦31,250 was invested at 5%. You are to show relevant accounts, assuming that the amounts to be set aside are ₦69,250 for the first year and ₦69,500 for each of the remaining two years. Assume that the replacement cost is equal to the original cost.

You are required to prepare the sinking fund account.

SUGGESTED SOLUTION 23

SINKING FUND ACCOUNT

	₦		₦
Year 1. Balance c/d	69,250	Year 1 P & L	69,250
Year 2 balance c/d	142,250	year 2 balance b/d	69,250
		Interest	3,500
		P/L	69,500
	142,250		142,250
Year 3, balance c/f	218,750	Year 3 balance	142,250
		Interest	7,000
		P&L	69,500
	218,750		218,750
Plant account	218,750	Balance c/d	218,750

Plant Account

	₦		₦
Year 1 Cash	250,000	Sinking fund account	218,750
		Cash	31,250
	250,000		250,000

Sinking investment 5% Stock Account

Year		₦	Year		₦
1.	Cash	69,250	1	balanced c/d	69,250
2.	Bal. b/d	69,250	2	Bal. c/d	142,250

	Cash	69,500			
	Cash (out)	3,500			-
		142,250			142,250
3.	Bal. b/d	142,250	3	Bal. c/d	218,750
	Cash	69,500			
	Cash (interest)	7,000			-
		218,750			218,750
4.	Bal. b/d	218,750			

Note:

The investment will be sold for ₦218,750 which, added to the cash of ₦31,250 received for scrap value of the old plant, will provide ₦250,000 towards the cost of a new plant.

Debenture Repayment

Sinking fund can be provided to write off a loan debenture or an asset in case of amortisation. Where debenture is redeemable at a fixed date, a sinking fund can be accumulated by transferring equal amounts out of profits to create a sinking fund account. Simultaneously, a sum equivalent to the amount of each transfer will be invested in securities to create a sinking fund investment which, with compound interest at a specified rate, will sum up to the amount required to pay the debt.

Sinking fund to redeem a loan liability, etc.

	Dr	Cr
(a) On setting aside the instalment annuity	P&L account	Sinking fund account
(b) On investing the instalment	Sinking fund Investment account	cash account
(c) On receipt and re-investment Of interest on investment	Cash account	Sinking fund account
	Sinking fund Investment account	Cash account
(d) On redemption of debentures	Cash account	Sinking fund Investment account
	Debenture	Cash account
	Sinking fund Account	General reserve account

ILLUSTRATION 24

Sphere Company Limited borrowed N5,000,000 through debentures and agreed to redeem the amount at the end of 5 years by means of a sinking fund.

Prepare the necessary accounts.

SUGGESTED SOLUTION 24

Debenture Account

	₦		₦
Cash	5,000,000	Bal. c/d	5,000,000

Sinking fund account

	₦		₦
Reserve	5,000,000	Bal c/d	5,000,000

Cash Account

	₦		₦
Sinking fund investment	5,000,000	Bal. c/d	5,000,000

General Reserve

	₦		₦
Sinking fund account	5,000,000	Sinking Fund account	5,000,000

ILLUSTRATION 25

Agbon-magbe ltd has issued ₦2.5m 7 percent debenture at par, on 1 January 2007. The terms include that the company should provide a sinking fund for redemption on 31 December, a year later. It is ascertained that the annual sum to be set aside for the three years at 5% compound interest, to accumulate to ₦1.00 is ₦0.317209.

Required:

(a) Compute the first investment to be made on 31 December, following the issue:
(b) Show journal entries for the first two years; and
(c) Ledger accounts for the three years.

SUGGESTED SOLUTION 25

(a) Amount to be set aside ₦2.5m x 0.317209 = ₦793,022.5

(b) Journal entries

		Dr	Cr
		₦	₦
i.	Sinking fund account	793,022.5	
	Cash account		793,022.5
	Being annual sum invested at 5%		
	Per annum in December 2008		
ii.	Cash account	39,500	
	Sinking fund account		39,500
	Being interest received on		
	N793,022.5 at 5% per annum		
iii.	Sinking fund investment account	39,500	
	Cash account		39,500
	Being investment of interest received		

(c) i. 7% debenture

	₦'m		₦'m
31 Dec. 2009 cash	2.5	Debenture redeemed	2.5

ii. Sinking fund investment

	₦		₦
31 Dec. 2006 Cash	793,022.5	31 Dec. 2006 bal c/f	793,022.5
1 Jan. 2007 bal b/d	793,022.5	31 Dec. 2007 bal c/f	1,625,696
Cash	793,022.5		
Interest at 5% on (793,022.5)	39,651		-
	1,625,696		1,625,696

Jan 2008 bal b/f	1,625,696	31, Dec. 2008 Cash	2,500,000
Dec. 2008 Cash	793,022.5		
Interest	81,284.8		-
	2,500,000		2,500,000

The difference between the use of sinking fund for assets replacement and debenture or loan repayment, are:

(a) Amount set aside for the sinking fund for writing off the asset is debited to profit and loss account, whereas for the redemption of debentures, it is debited to the appropriation account.
The difference in the treatment is due to the fact that one is a definite charge for depreciation whilst the other is merely an appropriation to prevent the amount set aside from being used as dividend, until the debt is repaid.
(b) When the asset is written off, the fund and the assets are cleared until a new asset is purchased whilst the investment account remains. Whereas, in debenture redemption, the investment and debenture are cleared but the fund remains and is available for distribution.

SELF ASSESSMENT EXERCISE
After studying this unit, solve the question without looking at the solution and compare your answer to the solution given in the illustration.

3.2 NATURE OF INVESTMENT

(a) An investment could be either fixed interest securities (debentures/loan stocks) or equities.
(b) 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.
(c) The value of the investment is the (quoted price x nominal value) plus other cost (if purchased) or less other cost (if sold).
(d) 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 when specifically stated to be ex-div.

SELF ASSESSMENT EXERCISE
What do you understand by the term “Cum-div” and “Ex-div”?

3.3 ACCOUNTING ENTRIES FOR FIXED INTEREST SECURITIES

(a) Purchases Cum-Div
   i. Compute net purchase price as: (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

iii. Dr bank a/c

Cr investment a/c (income column) with interest including the immediate one.

(b) Purchases Ex-Div

i. Compute purchase price as: (quoted price x nominal value) + stamp duty brokerage etc.

ii. Dr investment a/c (capital column) with purchase price

Cr bank account

iii. Dr investment a/c (capital column) with interest

Credit investment account (income column)

iv. Dr bank account with the instalments of interest excluding the immediate next one

Cr investment account (income column)

(c) Sales Cum-Div

i. Calculate net proceeds as: (quoted price x nominal value) – (brokerage, stamp duty etc. + accrued interest)

ii. Dr bank a/c- with net proceeds

Cr investment account (income column) with accrued interest

Cr investment account (capital column) with balance net proceeds

iii. Calculate profit/loss on sales = net proceeds – cost

Where cost = $\frac{nominal\ value\ of\ investment\ sold\ x\ average\ cost}{nominal\ value\ of\ total\ investment}$

And average cost = purchase cum div – net purchase price

Purchase ex-div = purchase price plus interest

iv. Dr P&L account with loss on sale

Cr investment account (capital column)

Dr Investment account (capital column) with profit on sale

Cr P&L account

v. Dr bank account

Cr investment account (income column) with interest on net investment, that is, purchase- sales as from immediate next instalment.

(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

Where cost =$\frac{nominal\ value\ of\ investment\ sold\ x\ average\ cost}{nominal\ value\ of\ total\ investement}$

SELF ASSESSMENT EXERCISE

How do you treat sales cum-div in the books?

3.4 ACCOUNTING ENTRIES FOR EQUITIES INVESTMENT

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 account (normal column) }with cost of investment including expenses.
    Cr Bank account }
(b) Dr Investment account (nominal column)} with bonus shares (scrip issue)
    Cr Bank account }
(c) Dr Investment account (capital column)} with amount paid to purchase the right taken-up.
    Cr Bank account }
(d) Dr Bank account }with sales proceeds on the right sold
    Cr Investment account (capital column)}

    (no record will be made as regard the nominal value)
(e) Dr Bank account } with dividend received
    Cr Investment account (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 26
The following transactions of Ayo Investment Ltd took place during the year ended June 30, 2008.

1/7/2007 – Purchased ₦120,000 4% Rivers State Development Stock (interest payable February & August) at 60 1/2% (sixty and half percent).

- 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 Development 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 N7.75 each.

2/01/2008- Sold ₦30,000 4% River State Development Stock at 61 ex-div.

1/02/2008- Received half-year's interest on 4% River State Development 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 N5/share. Half of the right was sold on the market for N2.50 per share.

01/06/2008- Received dividend of 12 ½ % on shares in OPC PLC.

You are required to write up the relevant investment accounts as they would appear in the books of Ayo investments limited for the year ended 30 June, 2008.

SUGGESTED SOLUTION 26

INVESTMENT- 4% RIVER STATE DEVELOPMENT STOCK

	Nom	Income	Capital		Nom	Income	Capital
	₦	₦	₦		₦	₦	₦
1/7/07 Bank purchase	120,000	2,000	70,600	1/8/07 Bank interest		2,400	
2/1/08 Adj. For Ex-div		100		2/1/08 Bank sales	30,000		18,300
30/1/08 Inv. Income		4,200		2/1/08 Adj. For Ex-div			100
30/1/08 P & L a/c			750	2/1/08 bank interest		2,400	
				30/6/08 Bal. c/d	90,000	1,500	52,950
	120,000	6,300	71,350		120,000	6,300	71,350
Bal. b/d	90,000	1,500	52,950				

NDC PLC- Ordinary Shares Account

	Nom	Income	Capital		Nom	Income	Capital
	₦	₦	₦		₦	₦	₦
12/8/07 Bank purchase	200,000		400,000	15/8/07 Bank sales	250,000		250,000
15/8/07 Bonus issue	300,000			1/3/08 Bank dividend		22,500	
1/3/08 Inv. Income		22,500		30/6/08 bal. c/d	250,000		200,000
31/6/08 profit on disposal			50,000				-
	500,000	22,500	450,000		500,000	22,500	450,000
1/7/08 balance b/d	250,000		200,000				

OPC PLC- Ordinary Shares

	Nom	Income	Capital		Nom	Income	Capital
	₦	₦	₦		₦	₦	₦
1/10/07 Bank Purchase	50,000		387,500	1/4/08 Bank sales of right			31,256
1/4/08 Bank right	12,500		62,500	1/6/08 Bank Div		7,812.50	
30/6/08 Inv. Income		7,812.50		30/6/08 Bal. c/d	62,500		418,750
	62,500	7,812.50	450,000		62,500	7,812.50	450,000
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	
30/6/08 Inv. Inc.		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
1/7/04 Bal. b/d	450,000	6,750	304,375				

Note:
Securities in fixed interest (loan stock), are normally quoted in units of N100, unless otherwise specified.
Purchase price of 4% Rivers State Dev. Stock will be:

N120,000 x 0.605 =	N72,600
Accrued interest = 5/12 x 4% x 120,000 =	(2,000)
	70,600

SELF ASSESSMENT EXERCISE
After studying this unit, solve the question without looking at the solution and compare your answer to the solution given in the illustration.

4.0 CONCLUSION
Corporate stocks, bonds, and debentures can be a risky investment. However, the introduction of sinking fund is a way for companies to minimize this risk for investors.
A sinking fund is basically a pile of money a corporation sets aside to repay its dividends on stocks or other debt instruments. Since corporations must repay the principal amount and its interest at maturity to holders, there is a chance that the final amount could be too high for a company in financial trouble. Companies that can't pay the maturity debt will default. The setting aside of assets minimizes the final bill that the company must pay when an instrument's term is up. Because the amount of debt the company has is reduced, the risk of the company defaulting is lessened.

5.0 SUMMARY
In this unit, we discussed sinking fund and annuity. This was discussed considering asset replacement, the nature of investment and accounting entries for fixed interest and equities investment.

6.0 TUTOR MARKED ASSIGNMENT
1. On purchase of new asset, debit ________ account and credit _______ account.
2. Sinking fund can be provided to write off a loan debenture or an asset in case of _________ .
3. Where debenture is redeemable at a fixed date, a sinking fund can be accumulated by transferring _________ to create a sinking fund account.
4. _________ is a situation when the price includes the right of a buyer to receive the next instalment of interest, including subsequent instalments of interest.
5. _________ is a situation when price does not include the right of a buyer to receive the next instalment of interest.

7.0 REFERENCES/FURTHER READING

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MODULE 4: ACCOUNTING FOR CONTRACT, INVESTMENT, LEASE AND HIRE PURCHASE

UNIT 3: UNDERWRITER AND STOCK BROKERAGE ACCOUNT

CONTENT

1.0 INTRODUCTION

In this unit, we shall be discussing underwriter's account and stock brokerage accounts.

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.

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 transaction.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. State and explain the terms in underwriting.
2. Prepare underwriting account.
3. Prepare contract journal of the stockbroker.
4. Calculate unit valuation.

3.0 MAIN CONTENT

3.1 NATURE AND TERMS IN UNDERWRITING

Like stated above in the introduction, 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 the 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) Over-riding 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.

Book-Keeping Procedure

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

SELF ASSESSMENT EXERCISE

Define the following terms:

a. Underwriting commission
b. Sub-underwriting commission
c. Over-riding commission

3.2 ACCOUNTING ENTRIES FOR UNDERWRITER'S ACCOUNT

(a) Dr: Underwriting account} with application and allotment proceeds
Cr: Cash/Bank account } in respect of shares taken over
Note: 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 account } with commission received
Cr: underwriting accounting}
(c) Dr: Underwriting account}
Cr: Bank/Cash } with commission paid to sub-underwriter
Note: If shares are received for remuneration, debit the shares column only
(d) Dr: Underwriting account}
Cr: Bank/Cash account } with the option paid for
(e) Dr: Bank/Cash account }
Cr: Underwriting account} with option money received
(f) Dr: Underwriting account} with incidental expenses on underwriting contract
Cr: Bank/Cash account }
(g) Dr: Underwriting account}
Cr: P & L account } with profit on underwriting contract

(h) Dr: P & L account }
Cr: Understanding account} with loss on underwriting contract
(i) Dr: Closing stock of unsold shares}
Cr: Underwriting account } with value of closing stock of unsold shares

ILLUSTRATION 27

Frontline Ltd decided to issue 1,000,000 shares of N1.00 each at par, 10 kobo payable on application, 40 kobo on allotment and 50 kobo 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 was 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 27

YINKUS LTD
UNDERWRITING ACCOUNT

	Shares	₦		Shares	₦
Bank firm application	500,000	50,000	Bank-commission received		25,000
Bank-shares taken on allot		200,000	Bank-sales	100,000	45,000
Bank- Final call		200,000	Bank-sales	250,000	275,000
Bank-commission paid		5,000	Bal. c/d	150,000	150,000
P & L account		40,000			-
	500,000	495,000		500,000	495,000
	150,000	150,000			

WORKINGS

	₦	₦
Share taken over:		
Firm application		
Total issue	1,000,000	
Firm application	(200,000)	200,000
Public application	(400,000)	
	400,000	
Sub-underwriting	(100,000)	300,000
		500,000

SELF ASSESSMENT EXERCISE
After studying this unit, solve the question without looking at the solution and compare your answer to the solution given in the illustration.

3.3 STOCK BROKERAGE ACCOUNT

INTRODUCTION

Accounting Entries

A summary of the basic double entries in the books of the stockbroker is set out below:

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	Difference between 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 inland revenue buyer's stamp duty	"make-up" price of shares sold plus
(c)	Cash or jobber	Jobber or cash	Difference between gross proceed proceeds 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 account	Profit and loss account	Commission for accounting period

In practice, a contract journal will be used for the entries of purchases and sales.

ILLUSTRATION 28

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

From Mr. Ayodele- Purchased 2,000 shares of Cadbury Plc at ₦ 72

From Mr. Ayodele- Purchased 1,000 shares of Unilever Plc at ₦ 80

From Mr. Adamu- Sold 2,000 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 Nigeria Breweries Plc at ₦ 60

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

Prepare contract journal of the stockbroker.

SUGGESTED SOLUTION 28

MR. JOHNSON

CONTRACT JOURNAL

Date	Name of Party	Description of Securities	Price ₦	Total value ₦	Name of Party	Description of Securities and Commission	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	2000 BOC Gases Plc	200	9,800

	Okoro	10,000 Texaco Plc	100	1,020,000	Dealer		20,000	1,000,000
	Dealer		60	300,000	Okoro	5000 Nig Breweries	6,000	294,000
				1,558,480 (1)			30,680 (2)	1,527,800 (3)

(a) Each item is debited to dealer or client account
(b) Half credited to stamp duties account and half credited to commission account.
(c) Each item credited to dealer or client account.

SELF ASSESSMENT EXERCISE
After studying this unit, solve the question without looking at the solution and compare your answer to the solution given in the illustration.

3.4 INVESTMENT AND UNIT TRUST ACCOUNTS
Investment trusts, together with unit trusts, from a group of financial intermediaries, whose main function is to enable investors to spread their risks and obtain the advantages of professional management of their investments. They generally hold the shares of a wide range of companies, and thus the purchaser of shares in a trust, spreads his funds in small accounts over a large number of expertly selected managed investments.

There are important distinctions between investment trusts and unit trusts. The main difference being that an investment trust is not really a trusts. The main difference being that an investment trust is not really a trust at all, but a limited liability company operating under CAMA (2004), whereas a unit trust operates under a trust deed.

An investment trust raises its capital by issuing shares to the public, in the normal way and utilizes the funds obtained to invest in other securities.

Investment trusts distribute dividends annually, out of the income they receive from their investment assets, after allowing for expenses of administration and allocation to reserves

Disclosures in Investment Trust Account

As a limited liability company, investment trust companies must comply with the provisions of CAMA (2004).

However, the treatment and details of income from investments in the Revenue account (as the profit and loss account of an investment trust company is conveniently termed), should normally be shown by way of note.

Any of the following two formats could be adopted:

Extract from revenue accounts

	Note	₦
(a) Gross income:		

Dividends and interest	1	x
Relative explanatory note to revenue account:		
Note 3 Dividends and interest:		
Quoted investment		xx
Unquoted investment		xx
		X

(b) Income:

Interest and dividends	2	x
Note 4 Interest and dividends, have been Received from investments as follows:		
Quoted on Nigeria Stock Exchange		xx
Quoted on other stock exchange		xx
Unquoted		xx
Investment funds on deposit		xx
		X

Unit Trust Accounts

Unit trust is an organization whose objective is the collective investment of money subscribed by its members.

There are three parties to the Trust: the Managers, the Trustees and the Holders. Units are usually value-based; that is, the current value of the portfolio plus cash-in-hand and at Bank (that is, un-invested funds).

Accounts required – (In the books of the Trustee)

(a) Bank account
(b) Unit capital account
(c) Investment account
(d) Statement of Valuation
(e) Statement of Financial Position

Accounting Entries

(a) Dr: Bank account } with money lodged on the subscription of units by unit holder
Cr: Unit Capital account}
(b) Dr: Investment account} with purchase of securities
Cr: Bank account }
(c) Dr: Bank account } with dividends/income received on investment
Cr: Investment account}
(d) Dr: Unit Capital account} with the payment to a resigning member
Cr: Bank account }

Resigning member will be paid based on prevailing value per unit at his/her resignation.

ILLUSTRATION 30

Forty (40) people came together to form Yommy Unit Trust and they have appointed you as the trustee. The rule of the trust provides that each member will subscribe one unit per month, the value of a unit being defined as:

"The unit value shall be ₦ 5,000 ay the first monthly meeting. Thereafter, at each monthly meeting, the trust portfolio shall be valued at the monthly market price (as shown in the Stock Exchange listing), to which shall be added any un-invested cash balance, and the total sum divided by the number of units subscribed for to date, to give the current unit value."

Any member, who wishes to resign, is paid in cash, the value of the units he/she has subscribed for, up-to-date. The value for this purpose is the current unit value, fixed at the meeting at which he gives his intention to withdraw.

At the first monthly meeting, the members agreed to purchase 8000 unique products Plc ordinary shares at N22.50 each and the balance of cash-in-hand, carried forward.

At the next meeting, these shares were quoted at ₦ 24.50 and with monthly subscription they decided to buy 16,000 Excel Plc ordinary shares at ₦ 14 each. By the time members met for the third meeting, Unique Products PLC ordinary shares were quoted at ₦ 24 and Excel PLC ordinary shares at N12.50 and it was agreed to buy 60,000 ordinary shares of Bakers PLC at ₦ 3 each. Two members resigned at this meeting and they were given refund of their units in cash, at the agreed valuation.

On the day of the fourth meeting, the shares in the trust's portfolio were valued as follows:

Unique Products PLC	₦ 24
Excel PLC	₦ 13
Bakers PLC	₦ 3

On that day N5,000 and ₦ 7,000 were received as dividends on Unique and Excel respectively.

You are required to:

(a) Calculate the unit valuation on the day of the fourth meeting.
(b) Prepare a draft statement that will clearly convey to the members the trust's financial position, on that date.
(c) Show all the entries in the books of the trustee and the balances up to the end of month 3.

SUGGESTED SOLUTION 30

(a) Statement of Financial Position

Units		₦
40	Month 1 – Subscriptions: 40units at ₦ 5,000	200,000
	Purchases: 8,000 Unique Ord. @ ₦ 22.50	(180,000)
		20,000
40	Month 2- Subscriptions: 40units @ ₦ 5,400 each	216,000
	Purchases: 60,000 Excel Ord. @ ₦ 14 each	(224,000)
		12,000
38	Month 3- Repayments: 4units at ₦ 5,050 each	(20,200)

Subscriptions: 38units at ₦ 5,050 each	191,900
Purchases: 60,000 Bakers Ord. @ ₦ 3 each	(180,000)
	3,700
Investment income	12,000
	15,700

(b) STATEMENT OF VALUATION

		₦
Month 2	8000 Unique Ord. @ ₦ 24.50 per unit	196,000
	Bank Balance for month 1	20,000
		216,000
	No. Of units	40
	Value/unit 216,000/40 =	₦ 5,400
Month 3	8,000 Unique Ord. @ ₦ 24	192,000
	16,000 Excel Ord. @ ₦ 12.50	200,000
		392,000
	Bank balance for month 2	12,000
		404,000
	No. Of units (40 + 40)	80
	Value/unit 404,000/80 =	₦ 5,050
Month 4	8,000 Unique Ord. @ ₦ 24 per unit	192,000
	16,000 Excel Ord. @ ₦ 13 per unit	208,000
	60,000 Baker Ord. @ ₦ 3 per unit	180,000
		580,000
	Bank balance for month 3	3,700
		583,700
	No. Of units (80 + 38 – 4)	114
	Value/unit 583,700/114 =	N5,120

(c) Bank A/C

	₦		₦
Month 1 Unit Cap.	200,000	Month 1 Invest	180,000
2 Unit Cap	216,000	2 Invest.	224,000
3 Unit Cap.	191,900	3 Unit Cap.	20,200
3 Investment income	12,000	3 Investment	180,000
		Bal. c/d	15,700
	619,900		619,900

INVESTMENT A/C

	₦		₦
Month 1 Bank	180,000	Bal. c/d	584,000
2 Bank	224,000		
3 Bank	180,000		-
	584,000		584,000
bal. b/d	584,000		

UNIT CAPITAL A/C

	₦		₦
Month 3 Bank	20,200	Month 1 Bank	200,000

Bal c/d	587,700	2 Bank	216,000
		3 Bank	191,900
	607,900		607,900

INVESTMENT INCOME A/C

	₦		₦
Bal. c/d	12,000	Month 4 Bank	12,000

SELF ASSESSMENT EXERCISE

What are the parties to a unit trust?

4.0 CONCLUSION

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.

5.0 SUMMARY

This unit details the double entry principles and related books of accounts maintained by the operators of investment and unit trust companies, sinking funds and annuities, underwriting and stock-broking firms.

6.0 TUTOR MARKED ASSIGNMENT

1. State one function of a stockbroker
2. What is the main distinction between an investment trust and a unit trust?
3. Distinguish between investment purchase or sold cum-div and ex-div.
4. Who is an underwriter?
5. What is an underwriting commission?

7.0 REFERENCES/FURTHER READING

Institute of Chartered Accountant of Nigeria, Financial Accounting, Study Pack Lagos.

International Accounting Standard Board, International Accounting Standard.

Jennings, A. R., (2001), Financial Accounting, London, Letts Educational

Jennings, A. R., (2001), Financial Accounting, Solution Manual, London, Letts Educational

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MODULE 4: ACCOUNTING FOR CONTRACT, INVESTMENT, LEASE AND HIRE PURCHASE

UNIT 5: ACCOUNTING FOR LEASE

CONTENT

1.0 INTRODUCTION

In this unit, we shall be discussing accounting for contract, investment, lease and hire purchase. 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.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Explain a lease and the various types.
2. Show the steps involved in accounting for lease.
3. Compute the finance charge to be recognised.
4. Record detail accounting entries.

3.0 MAIN CONTENT

3.1 WHAT IS A LEASE?

This 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

This 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

This is one which ownership, risks and reward 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 property 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, who 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.

SELF ASSESSMENT EXERCISE
What are the other forms of finance lease?

3.2 ACCOUNTING FOR LEASES IN THE BOOKS OF LESSEE

The following steps are necessary:

Step 1 Calculate the total lease payments, that is, instalment 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) Instalments in arrears (that is, at year end) = $\frac{instalment\ (1-[1+r]^{n}}{r}$

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

(b) Instalments in advance (that is, at the beginning of the year) = $\frac{instalment\ 1-(1+r)^{t}+1}{r}$

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

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: finance charge/duration of lease

Sum of the year's digit method:

The financial charges will be written off to profit and loss account on the basis of the sum of the year's 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 instalment payments and adding the interest due on the cash price.

		Interest
	₦	₦
Cash price	xx	
Less year 1 instalment	x	
Balance year 1	x	
Interest: X% of balance year 1	x	xx
	X	
Less year 2 instalment	x	
Balance year 2	x	
Interest: X% of balance year 2	xx	xx
	Xxx	
Less year 3 instalment	x	
Balance year 3	x	
Interest: X% of balance year 3	x	xx
	Xx	xx

Note: The interest will be charged before the instalment payments are deducted, if it is payable in arrears.

Accounting Records:

Interest Payable Method	Interest Suspense Method
(a) Leased assets a/c	(a) Lease assets a/c
(b) Prov. For depreciation a/c	(b) Prov. For depreciation a/c
(c) Lessors a/c	(c) Lessors a/c
(d) Finance charges a/c	(d) Finance charges a/c
(e) Profit and loss a/c	(e) Profit and loss a/c
(f) Finance charges suspense a/c	

Accounting Entries

Interest payable method	Interest suspense method
(a) Dr: Leased assets account Cr: Lessor's account (with cash price/fair value of leased assets)	(a) Dr: Leased assets account Cr: Lessor's account (with cash price/fair value of leased assets)
(b) Dr: Finance charge account Cr: Lessor's a/c (with interest for each of the period)	(b) Dr: Interest suspense a/c Cr: Lessor's a/c (with total lease interest)
(c) Dr: Lessors a/c Cr: Bank a/c (with the instalment payment)	(c) Dr: Finance charge a/c Cr: Interest suspense a/c (with the interest due for each of the period)
(d) Dr: Profit and loss a/c Cr: Finance charge a/c (with the interest due for each period)	(d) Dr: Profit and loss a/c Cr: Finance charge a/c (with interest due for each of the period)
(e) Dr: Profit and loss a/c Cr: Prov. For Depreciation a/c (with the depreciation for each period)	(e) Dr: lessor's a/c Cr: Bank a/c (with instalment payment
	(f) Dr: Profit and loss a/c Cr: Prov. For depreciation a/c (with depreciation for each period).

ILLUSTRATION 31

Bakasi Haulage Contractors Limited has two alternatives. It could either buy or lease a new truck at a cost of N18million.

The term of the lease is 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 to 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 year 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.

SUUGESTED SOLUTION 31
BAKASI HAULAGE CONTRCTORS LIMITED

(a) Calculation of finance charge:

i. Total lease payment = ₦ 6million x 4 = ₦ 24million

ii. The fair value of the leased truck:

$$\frac{instalment\ [1-(1+r)^{-n}}{r} = \frac{\text{₦ 6m x } [1-(1.15)^{-4}}{0.15}$$

(Instalment payment in arrears) = ₦ 6m x 2.8550
= ₦ 17,130,000

iii. Depreciation = ₦ 17,130,000/6years = ₦ 2,855,000

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/lease period = N6,870,000/4 = N1,717,500

Sum of the years digit method:

Year	Digit	Interest Allocation	Finance Charge ₦'000
1	4	4/10 x ₦ 6,870,000	2,748
2	3	3/10 x ₦ 6870,000	2,061
3	2	2/10 x ₦ 6,870,000	1,374
4	1	1/10 x ₦ 6,870,000	687
	10		6,870

Actuarial method:

	₦'000	Interest ₦'000
Fair value/cash price	17,130	
Add: Interest- 15% x ₦ 17,130,000	2,570	2,570
	19,700	
Less 1st instalment	6,000	
	13,700	
Add: Interest- 15% x ₦ 13,700,000	2,055	2,055
	15,755	

Less 2nd instalment	6,000	
	9,755	
Add: Interest- 15% x ₦ 9,755,000	1,463	1,463
	11,218	
Less 3rd instalment	6,000	
	5,218	
Add: Interest-15% x N5,218,000	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	31/12/05 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
31/1/07 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 Financed charges	2,570
	19,700		19,700
31/12/06 Instalment	6,000	1/1/06 Bal b/d	13,700
31/12/06 Bal c/d	9,755	31/12/08 Financed 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	31/12/07 Finance 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	31/12/05 P&L a/c	2,570
31/12/05 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	31/12/05 Finance charges	2,570
		31/12/05 bal. c/d	4,300
	6,870		6,870
31/12/06 Bal b/d	4,300	31/12/06 Finance charges	2,055
		31/12/06 Bal 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

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

SELF ASSESSMENT EXERCISE

In treatment of finance charges, explain the sum of years digit method.

4.0 CONCLUSION

Leasing is a process by which a firm can obtain the use of a certain fixed assets for which it must pay a series of contractual, periodic, tax deductible payments.

The lessee is the receiver of the services or the assets under the lease contract and the lessor is the owner of the assets. The relationship between the tenant and the landlord is called a tenancy, and can be for a fixed or an indefinite period of time (called the term of the lease). The consideration for the lease is called rent. A gross lease is when the tenant pays a flat rental amount and the landlord pays for all property charges regularly incurred by the ownership.

5.0 SUMMARY

In this unit we discussed accounting for lease. The problem of computing and charging to respective periods, of finance charges for leasing, is the focal points that were extensively discussed and illustrated in this unit. Various methods of determining finance charges in the books of lessor and lessee were demonstrated. SAS 11 which stipulates detailed appropriate treatment and disclosures of lease transactions in the books of lessor and lessee was reviewed.

6.0 TUTOR MARKED ASSIGNMENT

1. In accordance with Statement of Accounting Standards (SAS 11), define finance lease.
2. Which of the two main differences between accounting entries required under interest payable and interest suspense methods of accounting for finance charge?
3. What is the main difference accounting entries required under interest payable and interest suspense methods of accounting for finance charge?
4. ___________ 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).
5. __________ is one in which the seller of the property, leases it back from the buyer.

7.0 REFERENCES/FURTHER READING

Aborode, R. (2004), A Practical Approach to Advanced Financial Accounting, Lagos, El-TODA Venture Ltd

Igben, R. O., (2004), Financial Accounting made Simple, Lagos, El-TODA Ventures Ltd, Volume 2.

Institute of Chartered Accountants of Nigeria, Financial Accounting, Study Pack, Lagos.

MODULE 4: ACCOUNTING FOR CONTRACT, INVESTMENT, LEASE AND HIRE PURCHASE

UNIT 6: ACCOUNTING FOR HIRE PURCHASE

CONTENT

1.0 INTRODUCTION

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 hire purchase interest or finance charge.

It should be noted that what the hire purchaser has, while the hire period lasts, is just possession. He 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 the first option and the item cannot be sold to another person unless he has indicated his unwillingness to exercise the option.

2.0 OBJECTIVES

After studying this unit, you should be able to:

1. Define some terminologies used in hire purchase transactions.
2. Calculate the hire purchase interest attributable to each year.
3. Compute interest payable using the actuarial method.
4. Show relevant ledger entries in the books of the seller and buyer.
5. Prepare balance sheet extract reflecting the balances as at the end of the period.

3.0 MAIN CONTENT

3.1 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 hire purchase price at the end of the hire period.

SELF ASSESSMENT EXERCISE

What is hire purchase price?

3.2 ACCOUNTING FOR HIRE PURCHASE TRANSACTIONS IN BUYER'S BOOKS

It is in the nature of hire purchase transactions that what 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 a 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 will 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".

The Hire Purchase Interest/Finance Charge

The hire purchase 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 digits method; and
(c) Actuarial method.

Equal Instalments (or Straight Line) Method

Under this method, the hire purchase interest is spread equally over the hire period. It is the simplest method.

ILLUSTRATION 32

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 31 December for 4 years, was agreed. The company makes up accounts to 31 December.

Required: Calculate the hire purchase interest attributable to each year.

SUGGESTED SOLUTION 32

	₦
Initial deposit	10,000
Add: Instalments (₦ 7,500 x 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 ₦ 12,000/4 = N3,000

Sum of the Year Digits Method

Under this method, hire purchase 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 hire purchase interest attributable to each year.

Year	Digit Allowed	Workings	Hire Purchase Interest
			₦
1	4	4/10 x ₦ 12,000	4,800
2	3	3/10 x ₦ 12,000	3,600
3	2	2/10 x ₦ 12,000	2,400
4	1	1/10 x ₦ 12,000	1,200
	10		12,000

In a situation where the number of instalments is higher, 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 = 4/12 (4-1) = 10

Actuarial Method

Under this method, hire purchase interest is written off by changing 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 33
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 4 years period.

HP interest is charged at 20% per annum.

Required: Compute interest payable using the actuarial method.

SUGGESTED SOLUTION 33
HIRE PURCHASE INTEREST

	₦	₦
Year 0 cash price	20,945	
Less deposit	8,000	
	12,945	
Year 1 HP interest @ 20%	2,589	2,589
	15,534	
1st instalment	(5,000)	
	10,534	
Year 2 H P interest @ 20%	2,106	2,106
	12,640	
2nd instalment	(5,000)	
	7,640	
Year 3 H P interest @ 20%	1,528	1,528
	9,168	
3rd Instalment	(5,000)	
	4,168	
Year 4 H P interest @ 20%	832	832
	5,000	
4th Instalment	(5,000)	-
	Nil	7,055

Accounting Entries:

(a) Asset acquired on HP terms:
Dr: HP fixed asset a/c } with the cash price
Cr: HP creditors a/c }
(b) Deposit/Instalment paid
Dr: HP creditors a/c } with amount paid
Cr: bank a/c }
(c) Recognition of HP interest included in Instalments paid:
Dr: HP interest a/c } with HP interest attributable to the
Cr: HP creditors a/c } instalment period
(d) At the accounting year-end:
Dr: profit and loss a/c } with HP interest written off
Cr: HP interest a/c } during the year
Dr: profit and loss a/c } with depreciation on HP asset
Cr: provision for depreciation a/c }

Note: The closing balance on the HP creditors account is the outstanding portion of the cash price. When HP interest suspense method is operated, the hire purchase creditors account balance is, therefore, disclosed in the balance sheet.

ILLUSTRATION 34

Jackson Ltd purchased a new car on 1 January 2005, form Sulyman Ltd, on hire purchase terms under which Jackson Ltd paid a deposit of ₦ 615,000, to be followed by four annual instalments of ₦ 500,000 each, payable on 31 December. Interest is charged on outstanding balance at 10% per annum. Cash price of the car is ₦ 2,200,000.

The accounting year of both companies ends on 31 December. Depreciation on the car is at 20% per annum on straight-line basis. All the sums due were paid on due dates.

Required:

(a) Show the relevant ledger entries in the books of Jackson Ltd.
(b) Prepare a balance sheet extract reflecting balances as at 31 December 2003.

SUGGESTED SOLUTION 34

Using HP Interest Account Method

(a) HP Creditor (Sulyman Ltd) A/c

	₦		₦
1/1/05 Bank (deposit)	615,000	1/1/05 HP Motor vehicle	2,200,000
31/12/05 Bank 1st Instalment	500,000	31,12/05 HP interest	158,500
31/12/05 Bal. c/d	1,243,500	(2,200,000 – 615,000) x 10%	-
	2,358,500		2,358,500
31/12/06 Bank (2nd inst.)	500,000	1/1/06 Bal. b/d	1,243,500
31/12/06 Bal. c/d	867,850	31/12/06 HP interest	124,350

	1,367,850		1,367,850
31/12/07 Bank (3rd inst.)	500,000	1/1/07 Bal. b/d	867,850
31/12/07 Bal. c/d	454,635	31/12/07 HP interest	86,785
	954,635		954,635
31/12/08 Bank (4th inst.)	500,000	1/1/08 Bal. c/d	454,635
	______	31/12/08 HP interest	45,365
	500,000		500,000

*N45,463.5 rounded down to N45,365

HP Interest Account

	₦		₦
31/12/05 HP Creditor	158,500	31/12/05 P&L A/c	158,500
31/12/06 HP Creditor	124,350	31/12/06 P&L A/c	124,350
31/12/07 HP Creditor	86,785	31/12/07 P&L A/c	86,785
31/12/08 HP Creditor	45,365	31/12/08 P&L A/c	45,365

HP Motor Vehicle Account

	₦
31/12/05 HP Creditor	2,200,000

Provision for Depreciation Account

	₦		₦
31/12/05 Bal. c/d	440,000	31/12/05 P&L A/c	440,000
31/12/05 Bal. c/d	880,000	1/1/06 Bal. b/d	440,000
	______	31/12/06 P&L A/c	440,000
	880,000		880,000
31/12/07 Bal. c/d	1,320,000	31/12/0 Bal. b/d	880,000
	______	31/12/07 P&L A/c	440,000
	1,320,000	31/12/07	1,320,000

Jackson Limited

(b) Balance Sheet Extract as at 31 December, 2007

	Cost	Depr.	NBV
Fixed Assets	N	N	N
Motor Vehicle	2,220,000	1,320,000	900,000
Current Liabilities			
Hire purchase creditor	454,635		

Using Hire Purchase Suspense Account Method

(a) **HP Creditors (Sulyman Ltd) A/c**

	₦		₦
1/1/05 Bank (deposit)	615,000	1/1/05 HP Motor Vehicle	2,200,000
31/12/05 Bank (1st Inst.)	500,000	1/1/05 Interest Suspense	415,000
31/12/05 Bal. c/d	1,500,000		______-

	2,615,000		2,615,000
31/12/06 Bank (2nd Inst.)	500,000	1/1/06 Bal. b/d	1,500,000
31/12/06 Bal c/d	1,000,000		-
	1,500,000		1,500,000
31/12/07 (3rd Inst.)	500,000	1/1/07 Bal b/d	1,000,000
31/12/07 Bal. c/d	500,000		-
	1,000,000		1,000,000
31/12/08 Bank (4th Inst.)	500,000	1/1/08 bal. b/d	500,000

HP Interest Suspense Account

	₦		₦
1/1/05 HP Creditors A/c	415,000	31/12/05 HP Interest a/c	158,500
(500,000 x 4) + 615,000)		N(2,200,000 – 615,000) x 10%	
- 2,200,000		31/12/05 Bal. c/d	256,500
	415,000		415,000
1/1/05 Bal. c/d	256,500	31/12/06 HP Interest A/c	124,350
		31/12/06 Bal. c/d	132,150
	256,500		256,500
1/1/07 Bal. c/d	132,150	31/12/07 HP Interest Account	86,758
		31/12/07 Bal. c/d	45,365
	132,150		132,150
1/1/08 Bal. c/d	45,365	31/12/08 HP Interest A/c	45,365

Workings:
(Initial deposit + 4 Instalments) – cash price.
N(615,000 + 2,000,000) – N2,200,000
= N415,000

HP Interest Account

	₦		₦
31/12/05 HP Int. Suspense a/c	158,500	31/12/05 P&L a/c	158,500
31/12/06 HP Int. Suspense a/c	124,350	31/12/06 P&L a/c	124,350
31/12/07 HP Int. Suspense a/c	86,785	31/12/07 P&L a/c	86,785
31/12/08 HP Int. Suspense a/c	45,365	31/12/08 P&L a/c	45,365

Note: Provision for depreciation account is the same as in solution (a) above.

Jackson Ltd
Balance Sheet (Extract) as at 31 December, 2007

	Cost	Depr.	NBV
Fixed Assets:	₦	₦	₦
Motor Vehicle	2,200,000	1,760,000	440,000
Current Liabilities:			
HP Creditor		500,000	
Less: HP Interest Suspense		45,365	454,635

Note
The basic difference between approaches (a) and (b) above are:

(a) With method (a), HP interest attributes to the instalment periods are credited to HP creditors account periodically and debited to HP interest account, when instalments are paid.
With method (b), the whole of the expected HP interest is credited to HP creditors, interest at the inception of the transaction is held in suspense in the HP interest suspense account. From this account, the interest is written off to the expense account periodically. Every time an instalment is paid, the HP interest attributable to the period is expensed by debiting the HP interest account and crediting the HP interest suspense account.
(b) With method (a), the balance on the HP creditors account is the cash price still outstanding at that date.
With method (b), the balance on the HP creditors account is the cash price outstanding plus the unamortized balance of the total expected HP interest, which is the debit balance on the HP interest suspense account. In the balance sheet, the balance on the latter account will be deducted from the balance on the former account to obtain cash price outstanding.
(c) Method (a), is recommended for solving examination question unless you are specifically required to adopt method (b).

SELF ASSESSMENT EXERCISE
To acquire trading stocks under a hire purchase arrangement, what are the reasons that make it virtually not feasible?

3.3 ACCOUNTING FOR HIRE PURCHASE TRANSACTIONS IN SELLER'S BOOKS

From the seller's point of view, goods sold on HP basis, fall into two categories:
(a) Large items: and
(b) Small items: It is impossible for HP seller to separate gross profit from HP interest because of large volume of transactions. We shall, therefore, concentrate on large items.

For large items, the amounts involved are relatively substantial and the transactions, relatively few and infrequent. It is, therefore, possible and practicable for the HP seller to separate gross profit and HP interest and account for each separately. It should be noted that sales gives rise to two kinds of profit: namely

(a) Gross profit, that is, cash price less cost of goods.
(b) HP interest, that is, hire price less cash price.

In accounting for large items, there are two possible methods:

(a) Hire purchase interest received method; and
(b) Hire purchase interest suspense account method.

(a) Accounting Entries where HP Interest Received Account Method is Used

(i) Sales of goods on HP terms:

Dr: HP Debtors account } with cash price of goods sold

Cr: HP Sales account }

(ii) Deposits/Instalments received:

Dr: Bank/Cash account } with amount received.

Cr: HP debtors account }

(iii) Recognition of HP interest included

In instalments received:

Dr: HP Debtors account } with interest attributable to the period

Cr: HP Interest received account } covered by the instalment.

(iv) At accounting year-end:

Dr: HP trading account } with cost of goods sold on HP terms

Cr: General Trading or Purchase a/c}

Dr: HP Sales a/c } with total credits on the HP sales a/c for the period

Cr: HP Trading account

Dr: HP Interest received account} with total credits on the HP interest received

Cr: HP Trading account } account for the period

Dr: HP Trading account } with the unrealized gross profit (see note (ii) below)

Cr: Provision for unrealized profit a/c}

Dr: HP Trading Account } with the credit balance on the account after

Cr: Profit & loss account } entries (a) – (d) above

(b) Accounting Entries where HP Interest Suspense Account Method is Used

i. Sales of goods on HP terms:

Dr: HP Debtors account } with HP price

Cr: HP Sales account } with cash price

Cr: HP Interest Suspense account} total HP interest

ii. Deposits/instalments received } same treatment as in (a) above

iii. Recognition of HP interest included in instalments received:
Dr: HP interest Suspense account } with interest attributable to the period
Cr: HP Interest received account } covered by the instalment.

iv. At accounting year-end } same as in method (a) above

Notes:

1. The HP seller may spread the HP interest using any of the methods already considered.
2. Unrealized profit is calculated using the formula:
   Unrealized profit = balance of cash price outstanding/cash price x (cash price – cost)
3. Subsequent movement in the provision for unrealized profit is reflected in the HP trading account and provision account.

ILLUSTRATION 35

The facts are the same as in illustration 111 (above), except for the additional information that Sulyman Ltd recognizes as profit, every year, the proportion of the expected gross profit, which the sum received every year from Jackson Ltd, bears to the cash price. The cost of the car to Sulyman Ltd, was N1,900,000.

You are required to show the ledger entries in the books of Sulyman Let and the balance sheet extract as at 31 December, 2007.

SUGGESTED SOLUTION 35

(a) Using HP Interest Received Account Method

HP Debtor's Account (Jackson ltd)

	₦		₦
1/1/05 HP sales	2,200,000	1/1/05 Bank (deposit)	615,000
31/12/05 HP Int. Rec.	158,500	1/12/05 Bank (1st Inst.)	500,000
		31/12/05 Bal. c/d	1,243,500
	2,358,500		2,358,500
1/1/06 Bal. b/d	1,243,500	31/12/06 Bank (2nd Inst.)	500,000
31/12/06 HP Int. Rec.	124,350	31/12/06 Bal. c/d	867,850
	1,367,850		1,367,850
1/1/07 Bal. b/d	867,850	31/12/07 Bank (3rd Inst.)	500,000
31/12/07 HP Int. Rec.	86,785	31/12/07 Bal. c/d	454,635
	954,635		954,635
1/1/08 Bal. b/d	454,635	31/12/08 Bank (4th Inst.)	500,000
31/12/08 HP Int. Rec.	45,365		-
	500,000		500,000

HP Sales Account

	₦		₦
31/12/05 Trading a/c	2,200,000	1/1/05 HP Debtors a/c	2,200,000

HP Interest Received Account

	₦		₦
31/12/05 HP Trading a/c	158,500	31/12/05 HP Debtors a/c	158,500
31/12/06 HP Trading a/c	124,350	31/12/06 HP Debtors a/c	124,350
31/12/07 HP Trading a/c	86,785	31/12/07 HP Debtors a/c	86,785
31/12/08 HP Trading a/c	45,365	31/12/08 HP Debtors a/c	45,365

HP Trading Account

	₦		₦
31/12/05 Purchases	1,900,000	31/12/05 HP Sales	2,200,000
31/12/05 Prov. For unreal. profit (w1)	169,560	31/12/05 HP Interest Rec.	158,500
31/12/05 P&L a/c	288,940		-
	2,358,500		2,358,500
31/12/06 P&L a/c	175,570	31/12/06 HP Int. Rec.	124,350
		31/12/06 Prov. for unreal. profit	51,220
	175,570		175,570
31/12/07 P&L a/c	143,135	31/12/07 HP Int. Rec.	86,785
		31/12/07 Prov. for Unreal. Profit	56,350
	143,135		143,135
31/12/08 P&L a/c	107,355	31/12/08 HP Int. Rec.	45,365
		31/12/08 Prov. for Unreal. Profit	61,990
	107,355		107,355

Note: ₦ 288,940 recognised as HP profit for year ended 31/12/05, is made up of:

	N
HP Interest attributable to the year	158,500
Gross profit realised in the year = (₦ 2.2m – ₦ 1.9m) – ₦ 169,560	130,440
	288,940

Provision for Unrealised Profit Account

	₦		₦
31/12/05 Bal. c/d (w1)	169,560	31/12/05 HP Trading a/c	169,560
31/12/06 HP Trading a/c	51,220	1/1/06 Bal. b/d	169,560
31/12/06 Bal. c/d (w2)	118,340		-
	169,560		169,560
31/12/07 HP Trading a/c	56,350		
1/1/07 Bal b/d	118,340		
31/12/07 Bal. b/d (w3)	61,990		-
	118,340		118,340
31/12/08 HP Trading a/c	61,990	1/1/08 Bal. b/d	61,990

After year 2005, only the movement, that is, increase or decrease in the provision for unrealised profit that will be transferred to the hire purchase trading account, for example, the provision for unrealised profit at 1 January 2006, was ₦ 169,360, while at 31/12/06, was ₦ 118,340. This represents a decrease of ₦ 51,220, which was transferred to HP Trading a/c by debiting the provision for unrealised profit a/c and crediting the HP trading account.

₦ 51,220 is the portion of gross profit considered to have been realised in the year ended 31 December 2006. It is the proportion of gross profit, which the cash price received from Jackson Ltd in 2006, bears to the cash price as shown below:

$$= \frac{500{,}000 - 124{,}350}{2{,}200{,}000}\ x\ 2{,}200{,}000 - 1{,}900{,}000$$

$= \frac{375,560 \ x \ 300,000}{2,200,000}$ = ₦51,220

Note: cash received in year 2006, is the 2nd instalment of ₦500,000 less HP interest attributable to 2006, that is, ₦500,000 - ₦124,350 = ₦375,650. The point raised above, is equally applicable to years 2007 and 2008.

Sulyman Ltd

Balance Sheet (extract) as at 31 December, 2007

Current Assets:	₦
HP Debtor	454,635
Less: Provision for Unrealised profit	61,990
	392,645

Workings

Unrealised gross profit (UGP) = $\frac{Cash\ price\ outstanding}{cash\ price}$ x cash price – cost

1. UGP at 31/12/05 = $\frac{1,243,450}{2,200,000}$ x ₦(2,200,000 – 1,900,000)

   = $\frac{1,243,450}{2,200,000}$ x ₦300,000

   =₦169,560
2. (w2) UGP @ 31/12/06 = $\frac{867,850}{2,200,000}$ x ₦300,000

   = ₦118,340
3. (w3) UGP @ 31/12/07 = $\frac{454,635}{2,200,000}$ x ₦300,000

   = ₦61,990

(b) Using HP Interest Suspense Account Method

HP Debtor's Account (Jackson Ltd)

	₦		₦
1/1/05 HP Sales	2,200,000	1/1/05 Bank (deposit)	615,000
1/1/05 HP Interest Suspense	415,000	31/12/05 Bank (1st Inst.)	500,000
		31/12/05 Bal. c/d	1,500,000
	2,615,000		2,615,000
1/1/06 Bal. b/d	1,500,000	31/12/06 Bank (2nd Inst.)	500,000
		31/12/06 Bal. c/d	1,000,000
	1,500,000		1,500,000
1/1/07 Bal. b/d	1,000,000	31/12/07 Bank (3rd Inst.)	500,000
		31/12/07 Bal. c/d	500,000
	1,000,000	31/12/07	1,000,000
1/1/08 bal. b/d	500,000	31/12/08 bank (4th Inst.)	500,000

Hire Purchase Interest Suspense Account

₦	₦

31/12/05 HP Interest Rec.	158,500	1/1/05 HP Debtor	415,000
31/12/05 Bal. c/d	256,500		
	415,000		415,000
31/12/06 HP Interest a/c	124,350	1/1/06 Bal. b/d	256,500
31/12/06 Bal. c/d	132,150		
	256,500		256,500
31/12/07 HP Interest a/c	86,785	1/1/07 Bal. b/d	132,150
31/12/07 Bal c/d	45,365		
	132,150		132,150
31/12/08 HP Interest a/c	45,365	1/1/08 Bal. b/d	45,365

Hire Purchase Interest Received Account

	₦		₦
31/12/05 HP Trading a/c	158,500	31/12/05 HP Int. Suspense a/c	158,500
31/12/06 HP Trading a/c	124,350	31/12/06 HP Int. Suspense a/c	124,350
31/12/07 HP Trading a/c	86,785	31/12/07 HP Int. Suspense a/c	86,785
31/12/08 HP Trading a/c	45,365	31/12/08 HP Int. Suspense a/c	45,365

Note: The HP sales account, HP Trading account and provision for unrealised profit account are the same as in method (a) solution above.

Sulyman Ltd

Balance Sheet (Extract) as at 31 December 2007

Current assets:	₦	₦
Hire purchase debtor		500,000
Less: HP Interest Suspense	45,365	
Provision for unrealised profit	61,990	
		107,355
		392,645

SELF ASSESSMENT EXERCISE

What are the two methods for accounting for large items?

4.0 CONCLUSION

The basic differences between the two methods illustrated are:

(a) With method (a), the HP purchase interest attributable to the instalment periods are debited to the HP debtors account periodically when the instalments are received and credited to the HP interest received account.

With method (b), the whole of the expected HP interest is debited to the HP debtor account, at inception and credited to HP interest suspense account from where the interest will be periodically released to the HP interest received account when instalments are received.

(b) With method (a), the balance on the HP debtor account is the cash price outstanding from the customer.

With method (b), the balance on the HP debtor account is the cash price outstanding plus the HP interest yet to be recognised as income. This is why on the balance sheet, the debtor’s balance will be shown less the credit balance on the HP interest suspense account.

(c) Method (a), is recommended for solving examination questions unless you are specifically required to adopt method (b).

5.0 SUMMARY

Leasing and hire purchase are like twin brothers. The identical problem of computing and charging to respective periods, of finance charges and hire purchase interest for leasing and hire purchase respectively, are the focal points that were extensively discussed and illustrated in the previous unit and this unit. Various methods of determining finance charges and hire purchase interest in the books of lessor and lessee and HP seller and buyer were demonstrated.

6.0 TUTOR MARKED ASSIGNMENT

1. How should a hire purchase seller account for unrealised profit on goods sold on hire purchase in its books?
2. What does hire purchase interest represent in a hire purchase transaction?
3. ___________ is the total sum (deposit plus instalments) payable by the hire purchaser.
4. ___________ is the normal selling price of the goods to be sold.
5. ___________ is the excess of the hire purchase price over the cash price.
6. ___________ is the initial sum payable by the hire purchaser at the inception of the hire purchase transaction.
7. ___________ is the sum payable by the hire purchaser buyer at specified intervals to liquidate the balance of hire purchase price at the end of the hire period.

7.0 REFERENCES/FURTHER READING

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