'A' LEVEL

ACCOUNTING

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1.1 Acknowledgements

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S. Madzingira

Bulawayo

1.2 Preface to the 8th Edition

Since the publication of our Advanced Level study pack in 2004, a lot of changes have been made in this edition

A student who is doing accounting for the first time is recommended to make use of both the O' and A' Level study packs. We have also added more questions multiple choice and structured and case studies. This book has also been recommended by users to be suitable for use in classroom and individual studies.

The vision of the Study Pack project is to create a self-sufficient information base for the student. With this aim in mind this Study Pack provides all the necessary topical material in a simplified manner. There after that the Study Pack provides a wide range of examination-type questions at the end of each topic area. After the adoption of the International Financial Reporting Standards (IFRSs), the following are some changes that will be noticed by the students, as compared to the previous versions which use the FRSs. The student must be familiar with the following terms which are used in this book. To aid the understandability of the terms, we have compared them, side by side with old terminology:

FRSs ***(Used in the previous books)***	**IFRSs** ***(Used in this book)***
Trading, profit and loss account	Statement of comprehensive income
Appropriation account	Statement of changes in equity *(refer to note below)*
Balance sheet	Statement of financial position
cash flow Statement	*Statement of cash flow*
Fixed assets	Property, plant and equipment
Net book Value (NBV)	Carrying Amount(in short CA)
Stock	Inventory
Debtors	Accounts receivable
Creditors	Accounts payable
Provision for bad/doubtful debts	Allowance account for credit loses

Note: The statement of changes in equity however gives more information about the equity position of the company, as compared to the appropriation account.

CHAPTER 1

INTRODUCTION TO FINANCIAL ACCOUNTING

Revision

Chapter objectives

After studying this chapter *the student should* be able to:

- *Define the terms 'Accounting' and 'transaction'.*
- *Identify the source documents and books of prime entry*
- *Enter Transactions in the books of prime entry*
- *Post to the ledgers*
- *Extract a trial Balance*
- *Prepare Financial Statements*

1.1 Financial accounting

Andrew Thomas defines accounting as a **process** of designing and operating an information system for collecting, measuring and recording business transactions, and summarizing and communicating the results of these transactions to users to facilitate financial / economic decisions.

1.2 The Accounting process

The process of accounting starts with collecting namely receipts, invoices, etc. and then recording transactions in the **books of prime entry**, using source documents. Posting to the **Ledger accounts**, extracting a **Trial Balance**, making adjustments for other payables (accruals), other receivables (prepayments) and other year-end adjustments will then follow, before preparing **Financial Statements** and communicating them to users.

1.3 Transactions

A transaction is an activity involving the exchange of money or anything with an ascertainable money value e.g. sale or purchases of goods on cash or credit. There are of two types, Cash transactions and Credit transactions.
Each transaction will result in two different accounts being affected. Whenever there is a transaction, one account is either gaining or the other one is losing. The one, which is gaining, should be debited and the one, which is losing, should be credited.

1.4 Source documents

As the organisation conducts its business on a daily basis, it generates documents, which are used by the accountant to record transactions in the books of accounts. These documents are known as source documents in accounting. The examples of these documents include: receipt, invoice, credit note, debit note, cheque counterfoil, petty cash voucher and statement of account.

1.1.1 Invoice

An invoice is a business document which is used for all credit transactions. It applies when the business acquires or sells assets on credit for example the purchase of goods on credit, acquisition of equipment on credit, purchase of delivery van on credit.

1.1.2 Debit note

This document is issued by the customer to the supplier when returning goods. It is also used to report any shortages, overcharges or damages goods.

Note:A debit note can also be issued by the supplier to the customer when the goods have been undercharged that is to correct an undercharge.

1.1.3 Credit note

A credit note is issued by the supplier to the customer to correct an overcharge. It is also used by the supplier to reduce the amount owed by the customer especially when the supplier does not have the right quality and/ quantity to replace the goods returned.

1.1.4 Statement of account (Statement)

A statement is issued by the supplier to the customer at the end of each month to show the transactions for that period. Its main purpose is to remind the customers to pay their accounts.

1.5 Books of original entry/prime entry

These are the first books of accounts where transactions are recorded before being posted to the ledger. These books include: sales journal, sales returns journal, purchases journal, purchases returns journal, cash book and general journal, petty cash book.

1.1.5 Cash book

The cash book is used to record cash and cheque transactions. It is a combination of the cash and bank accounts.

1.1.6 The sales daybook/Sales journal

The sales day book is used to record sales on credit for goods initially bought for resale. It is written from the credit sales invoices issued to customers.

1.1.7 The purchases day book/Purchases journal

This book is used to record purchases on credit for goods bought for resale. It is written from suppliers' credit invoices.

1.1.8 Sales returns day book/Sales returns journal/Returns inwards journal.

This book is used to record credit notes issued when customers return goods or when they have been overcharged.

1.1.9 Purchases returns daybook/Purchases returns journal/Returns outwards journal.

This book is used to record credit notes received from suppliers relating to goods that were initially bought for resale now returned back to suppliers.

1.1.10 The journal (General Journal)

It is used to record the following transactions:

a) Opening entries which are records prepared for the first financial period.
b) Accounting adjustment e.g. corrections of errors and year end adjustments.
c) Transfers between Ledger accounts.
d) It is also used to record transactions that are not appropriate to any other book of prime entry e.g. the Purchase or sale of non-current assets on credit.

1.6 The ledger

A ledger is a main book of accounts. This is because all the other books of original entry are posted to the ledger at the end of each period for example at the end of every month.

1.7 The trial balance

It is a list of all ledger balances at the end of a particular period. Each ledger account is balanced at the end of the month and the total transferred to the trial. The trial balance is therefore used as a control to check errors in the ledger.

1.8 Adjustments to the financial statements

These items are added as additional information to the trial balance. They include closing inventory, other payments (accruals), other receivables (prepayments), inventory taken by the owner for personal use, depreciation, Provision for credit loses and others.

1.9 Financial Statements

Financial statements are sometimes known as final accounts and are prepared at the end of each financial year. A complete set of financial statements comprises of the following:

1. an Statement of comprehensive income
2. a Statement of Financial Position
3. a statement of changes in equity
4. a statement of cash flow (IAS 7)
5. notes to the financial statements, comprising a summary of significant accounting policies and other explanatory notes.

They are used to assess the financial performance (Statement of comprehensive income) and the financial status (Statement of Financial Position) of the business.

The following information relates to the books of A. Nyathi.

Jan 1. Commenced Business with a capital of $70 000 in cash.
2. Opened a business bank current account with $1 000.
3. Paid Rent $ 2 500 cash
4. Bought stationery $ 500 cash
5. Purchased goods for resale $10 000 paying in cash
6. Sold goods for $30 000 payment received by cheque.
7. Paid wages $ 5 000 cash
8. Bought goods on credit from the following:
   M. Mashava $25 000
   S. Mudzingwa $19 000
   L. Kusano $8 000 less 10% trade discount.
8. Purchased furniture for $8 000 paying by cash
9. Paid transport $1 200 by cheque
10. Paid M. Mashava $23 750 by cheque having deducted 5% cash discount from the purchase made on 7 January.
11. Paid water $ 200 by cheque

12. Paid telephone $1 900 by cheque
13. Paid wages $ 5 000 by cheque
14. Sold goods on credit to :- W. Chivhengere $42 000 less 20% trade discount
    S. Ndlovu $ 8 000
    M. Zakeo $ 3 000
15. Paid electricity $1 300 cash
16. Paid L. Kusano $6 840 in full settlement of his account by cheque.
17. We returned goods to S. Mudzingwa worth $3 000.
18. The following returned goods : M. Zakeo $ 500
    S. Ndlovu $1 000
19. Received cheques for payment of account from the following:-
    W. Chivhengere $31 920 in full settlement
    M. Zakeo $1 900 in full settlement
20. Paid stationary $300 by cheque
21. Paid wages $500 by cheque
22. Withdrew $500 cash from the bank for personal use.
23. Received a loan of $28 000 by cheque from J.B Motors for $50 000.
30. Purchased equipment for $30 000 cash.
31. Bought a motor vehicle from J.B Motors for $50 000 on account.

Required: -

(a) Enter the following transactions in the books of prime entry
(b) Post to the following ledgers:-
   i. General ledger
   ii. Sales ledger
   iii. Purchases ledger and
(c) Extract a trial balance.
(d) Prepare the financial statements

Solution.

(a) i.

Cash Book

Date	Details	Disc	Cash	Bank	Date	Details	Disc	Cash	Bank
Jan 1	Capital		70000		Jan 1	Bank		1 000	
1	Cash			1 000	2	Rent		2500	
5	Sales			30 000	3	Stationary		500	
19	W. Chivhengere	1680		31920	4	Purchases		10000	
	M. Zakeo	600		1 900	6	Wages		5000	
23	Loan – JB Motors			28000	8	Furniture		8000	
					9	Transport			1 200
					10	M. Mashava	1250		23 750
					11	Water			200
					12	Telephone			1 900
					13	Wages			5 000
					15	Electricity		1 300	
					16	L. Kusano	360		6 840
					20	Stationary			300
					21	Wages			500

					22	Drawings			500
					30	Equipment		30 000	
					31	Bal. c/d		11 700	52 630
		2 280	**70 000**	**92 820**			**1 610**	**70 000**	**92 820**
Feb 1	Bal b/d		11 700	52 630					

(a) ii. **Purchases Journal/Purchases daybook**

Date	Details	Invoice No.	Amount
Jan 7	M. Mashava		25 000
	S. Mudzingwa		19 000
	L. Kusano		7 200
Jan 31	**Total posted to the General Ledger**		**51 200**

iii. **Sales Journal/Sales day book**

Date	Details	Invoice No.	Amount ($)
Jan 14	W. Chivhengere	J001	33 600
	S. Ndlovu	J002	8 000
	M. Zakeo	J003	3 000
Total posted to the Sales Account			**44 600**

iv. **Purchases Returns Journal**

Date	Details	Invoice	Amount ($)
Jan 17	S. Mudzingwa		3 000
	Total posted to the Returns Outwards		**3 000**

v. **Sales returns Journal**

Date	Details	Invoices No.	Amount ($)
Jan 18	M. Zakeo		500
“ “	S. Ndlovu		1 000
Balance posted to the General Ledger			**1 500**

vi. **General Journal**

		Dr $	Cr $
Motor Vehicle	Jan 31	50 000	
J B Motors			50000

b)i. **General Ledger**

Rent A/C

$		
Cash	2 500	

Stationery A/C

	$		$
Cash	500		
Bank	300	Bal c/d	800
	800		**800**
Bal b/d	800		

Purchases A/C

	$		$
Cash A/c	10 000		
Payables	51 200	Bal c/d	61 200
	61 200		**61 200**
Bal b/d	61 200		

Wages A/C

	$		$
Jan 6 Cash	5000		
Jan 13 Bank	5 000	Bal c/d	10500
Jan 21 Bank	500		
	10 500		**10 500**
Bal b/d	10 500		

Furniture A/C

		$
Jan 8	Cash	8 000

Transport A/C

		$
Jan 9	Bank	1 200

Water A/C

		$
Jan 11	Bank	200

Telephone A/C

		$
Jan 12	Bank	1 900

Electricity A/C

		$
Jan 15	Cash	1 300

Drawings A/C

		$
Jan 22	Bank	500

Capital A/C

			$
	Jan 1	Cash	70 000

Loan A/C- JB Motors

			$
	Jan23	Bank	28 000

Sales A/C

		$			$
			Jan 5	Bank	30 000
	Bal c/d	74 600	Jan 14	Receivable	44 600
		74 600			**74 600**
				Bal b/d	74 600

Sales Returns A/C

		$			
Jan 18	Receivables	1 500			

Purchases Returns A/C

					$
			Jan 17	Payables	3 000

Motor Vehicle A/C

		$			
Jan 31	J. B Motors	50 000			

J.B Motors A/C

					$
			Jan31	Motor vehicle	50 000

Discount Allowed A/C

		$			
Jan 31	Receivables	2 280			

Discount Received A/C

					$
			Jan 31	Payables	1 610

b)ii. **SALES LEDGER**

W. Chivhengere A/C

		$			$
Jan 31	Sales	33 600	Jan 19	Bank	31 920
			Jan 19	Disc	1 680
		33 600			**33 600**

S. Ndlovu A/C

		$			$
Jan 31	Sales	800	Jan 18	Returns	1 000
			Jan 31	Bal c/d	7 000
		8 000			**8 000**
Jan 31	Bal. b/d	7 000			

M. Zakeo A/C

		$			$
Jan 14	Sales	3 000	Jan 18	Sales Returns	500
			Jan 19	Bank	1 900
			Jan 14	Discount	600
		3 000			**3 000**

b) iii. **PURCHASES LEDGER**

M. Mashava A/C

		$			$
Jan 7	Discount	1 250	Jan 7	Purchases	25 000
Jan 10	Bank	23 750			

S. Mudzingwa A/C

		$			$
Jan17	Returns	3 000	Jan7	Purchase	19 000
Jan 31	Ba c/d	16 000			

25 000		25 000		19 000		19 000
					Bal b/d	16 000

L. Kusano A/C

		$			$
Jan 7	Discount	360	Jan 7	Purchases	7 200
Jan 16	Bank	6 840			
		7 200			**7 200**

Receivables are determined by adding all customers in the Sales Ledger with outstanding balances (i.e. those with balance brought down). And in this example total receivables is equal to $7 000 of S. Ndlovu as there were no outstanding balances for W. Chivengere and M. Zakeo. The same procedure is used in determining payable figure in this example is equal to $16 000 of S. Mudzingwa.

TRIAL BALANCE OF A. NYATHI AS AT 31 JANUARY 2002

	DR	CR

	$	$
Sales Returns	1 500	
Rent	2 500	
Bank	52 630	
Stationery	800	
Purchases	61 200	
Wages	10 500	
Cash on hand	11 700	
Furniture	8 000	
Discount received		1 610
Transport	1 200	
Water	200	
Telephone	1 900	
Electricity	1 300	
Drawings	500	
Capital		70 000
Loan		28 000
Sales		74 600
J.B Motors-Loan		50 000
Motor Vehicle	50 000	
Discount Allowed	2 280	
Receivables	7 000	
Payables		1 600
Purchases Returns		3 000
Office equipment	30 000	
	243 210	**243 210**

A Nyathi

Statement of comprehensive income for the month of January 2002

	$	$
Sales		74 600
Less sales return		1500
Less COGS.		
Purchases	61200	
Less returns	3000	58200
Gross profit		14 900
Discount received		1610
		16510

Less expenses

Rent	2500	
Stationery	800	
Wages	10500	
Transport	1200	
Water	200	
Telephone	1900	
Electricity	1300	
Discount allowed	2280	20680
Net loss		4170

A Nyathi

Statement of Financial Position as at 31 January 2002

	$	$
Assets		
Non current assets		
Motor vehicle		50000
Office equipment		30000
Furniture		8000
		88000
Current assets		
Receivables	7000	
Bank	52630	
Cash	11700	71330
Total assets		159330
Equity and liabilities		
Capital		70000

Less net loss	4170
	65830
Less drawings	500
	65330
<u>Non current liabilities</u>	
Loan 28000 + 50000	78000
<u>Current liabilities</u>	
Payables	16000
	159330

CHAPTER 2

ADJUSTMENTS TO FINANCIAL STATEMENTS

2.1 Chapter objectives

After studying this chapter *the student should* be able to:

1. Explain why adjustments to final accounts are necessary
2. Explain and effect the treatment of accrued and prepaid expenditure at year end.
3. Explain and effect the treatment of accrued and prepaid income at year end
4. Make adjustments for expense stock and differentiate between stock in hand, prepaid expense stock and accrued expense stock, in the same account.
5. Explain the prudence concept and matching concept as well as the materiality concept with regards to year- end adjustments made on final accounts.
6. Distinguish between bad debts and provision for bad and doubtful debts.
7. Prepare the bad debts and Provision for credit loses accounts.
8. Prepare the provision for discount allowable account.

10 Show the amounts to be charged in the profit and loss account for bad debts, Provision for credit loses and provision for discounts allowable.

9. Describe the term consignment inventory and show how it is recorded in the financial statements.

11 Draw up the Statement of comprehensive income and Statement of Financial Position having been adjusted for Accruals and Prepayments, Provision for credit loses, Capital and Revenue Expenditure, Goods on sale or return basis, Goods for resale lost or destroyed by fire and Provision for depreciation.

2.2 Introduction

The objective of preparing year-end financial statements is to measure as accurately as possible the results of trading, i.e. if the organisation has traded at a profit or loss in the period in question and also fairly in doing that the Accounting principles present the entity's standing financial position as objectively as possible. This justifies the need to apply the matching concept in the preparation of financial statements by ensuring that expenses and incomes are matched to the financial period to which they pertain. Furthermore prudence is exercised by ensuring that assets and profits are not overstated, by anticipating losses pertaining to the financial period. In addition only material adjustments need to be made e.g. If a box of office pins has remained in stock at the end of financial period, whose value is, say $0,50. It is not material enough to warrant adjustments being made to the accounts.

2.3 Accrued Expenses

These are expenses pertaining to the financial period in question which ought to have been paid for by the end of the financial period but were not paid. They are also known as expenses owing as they are not paid by year end. The matching/ accruals concept demands that expenses pertaining to a financial period are accounted for in that period regardless of actual payments made, therefore the total expense for the period is recorded in the final statements by debiting the Statement of comprehensive income with the total expense and recording the amount outstanding in the statement of financial position (Statement of Financial Position) as a liability which could either be short-term (current liability) or long-term liability.

Example 1

Ngezi Distributors is in the process of constructing its own trading premises but has in the meantime rented premises from AB Ltd at a quarterly rental of $3 600. The rent payment schedule for the year ended 31 December 2011 is as follows:

Amount paid	**Date**
$3 600	1 January 2011
$3 600	1 May 2011
$3 600	1 Nov 2011

Required

Prepare the rent payable account as at 31 December 2011.

Rent Payable a/c

2011		$	2011	$	
Jan 1	Bank	3 600	Dec 31	SCI	14 400
May 1	Bank	3 600			
Nov 1	Bank	3 600			
Dec 31	Owing c/d	3 600			
		14 400			**14 400**
			2012		
			Jan 1	Owing b/d	3 600

Note:

1) A year has 4 quarters and only 3 quarterly payments were made, meaning there is one quarter which was not paid for. Alternatively, you could calculate rent payable per month by (3 600:-3) = $1 200/month, taking into account that a quarter of a year is 3 months long. Multiply $1 200 x 12 months in the year to get the charge to the profit and loss a/c =$14 400, then deduct total payments made in the year to establish amount outstanding by [4 400- (3 600 x 3)] = $3 600.
2) In the Statement of comprehensive income (Profit and Loss a/c the full amount for rent payable is recorded i.e. $14 400, and the amount outstanding is treated as a current liability $3 600, in the Statement of financial Position (Statement of Financial Position)

Exercise 1

The following information pertains to the motor insurance a/c for the year ended 31 December 2011. The insurance premium is $450 per month, paid once at a time for 4 months at the beginning of the insured period in question.

Amount paid	**Date**
$1 800	1 October 2010
$1 800	1 February 2011
$1 800	3 June 2011

Due to a breakdown in communication, no further payments were made for the year.

Required

Prepare the Motor Insurance a/c for the year ended 31 December 2011.

Prepaid Expenses

These are expenses paid for in the current financial period but pertain to the next financial period. In other words, they are expense payments made in advance. In line with the matching concept, prepaid expenses are deducted from the total amount paid so that only the amount paid and due in the current period is recorded in the Statement of comprehensive income. The prepaid portion is then recorded in the Statement of financial position (Statement of Financial Position) as a current asset.

Example 2

Using data in Example 1, suppose that Ngezi Distributors has finished the construction of its own premises and moves into them on 31 May 2011, ceasing to rent AB's premises on that date, prepare the rent payable a/c, assuming books will be closed on that date.

Rent payable a/c

2011		$	**2011**		$
Jan 1	Bank	3 600	May 31	SCI	6 000
May 1	Bank	3 600		Prepaid c/d	1 200
		7 200			7 200
June 1	Prepaid b/d	1 200			

Note:

1) Only the charge pertaining to the period in question is recorded in the (profit and loss) a/c. Statement of comprehensive income, that being $1 200/month x 5 months = $6 000
2) Seeing that a total of $3 600 x 2= $7 200 had been paid, the difference $7 200-$6 000 is a prepayment which is recorded as a current asset in the statement of financial position.

Exercise 2

In addition to the data supplied in Exercise 1, assume that a further payment of $1 800 was made on 1 October 2011, prepare the Insurance account for the year ended 31 December 2011.

Prepaid and accrued income at the end of a financial period.

Income accounts may need to be adjusted in a similar manner as outlined above in the case of expense accounts, bearing in mind that when drafting ledger accounts, what is debited in an expense a/c will be credited in an income account and what is credited in an expense account will be debited in an income account.

Example 3

The premises constructed by Ngezi distributors are quite large and management decides to sub-let part of the premises to A. Another, at a monthly rental of $300 with effect from 1 July 2011. The following receipts are made available as at 31 December 2011.

Amount received	Date
$600	15 July 2011
$300	3 September 2011
$600	1 November 2011

Prepare the rent receivable account for 31 December 2011

Rent Receivable a/c

		$			$
Dec 31	SCI	1 800	July 1	Bank	600
			Sept 3	Bank	300
			Nov 1	Bank	600
			Dec 31	Owing c/d	300
		1 800			1 800
Jan 1	Owing b/d	300			

Note:

1) There are 6 months from 1 July to 31 December and rent due per month is $300, therefore the total rent receivable from A. Another by year end is $300 x 6 = $1 800
2) Total rentals received in the period are (600 +300 + 600) = $1 500, meaning $300 is outstanding by year end.
3) In the Statement of comprehensive income, total rent due of $1 800 is credited (i.e. added) to gross profit and the amount outstanding of $300, is recorded in the statement of financial position under current assets as a debtor balance.

Example 4

Trade alert sells advertising space on commission on behalf of various traders and the following data is available for the year ended 31 Dec 2011.

Commission Receivable due		**Commission received**	
28 February	$600	28 February	$500
31 May	$900	1 June	$750
31 June	$400	30 June	$500
31 August	$800	31 Aug	$950
31 December	$920	31 Dec	$950

Prepare the Commission Receivable a/c for the six months ending 30 June 2011

Commission Receivable a/c

2011			2011		
June 30	SCI	1 900	Feb 28	Bank	500
			June 1	Bank	750
			June 30	Bank	500
			June 30	Owing c/d	150
		1 900			1 900
July 1	Owing b/d	150			

Example 5

Using the data presented in Exercise 3, prepare the commission receivable account for the year ended 31 December 2011.

Commission Receivable a/c

		$			**$**
2011			2011		
Dec 31	SCI	3 620	Feb 28	Bank	500
	Prepaid c/d	30	June 1	Bank	750
			June 30	Bank	500
			Aug 31	Bank	950
			Dec 31	Bank	950
		3 650			3 650
			2012		
			Jan 1	Prepaid b/d	30

Notes for Example 4 and 5

1) What is debited in the Commission Receivable a/c that is Profit and loss figure is the total commission due in the period in question. For example 4, it is derived for the six month period as (600 + 900 + 400) = $1 900 and for example 5, it is derived as (600 = 900 + 400 + 800 + 920) = $3 620.
2) The balancing figure is either a prepayment or an accrual and you can figure this out by comparing the actual amount due to be received with what was actually received. If more was received than was required to be received in the period it is a prepayment, and if we received less than what ought to have been received in the period, it is an accrual.

Example 6, a comprehensive example

The following balances were extracted from the books of Anthony Able at 30 June 2010. His financial year end.

	DR	Cr
	$	$
Rates	720	
Rent receivable	130	
Insurance		48
Commission receivable		127

The following payments were handled in the year ending 30 June 2011.

	DR	**Cr**
	$	$
Rates	1 650	
Insurance	1 020	
Rent receivable		2 110
Commission receivable		989

At 30 June 2011, the following was established

i) Rates of $220 were outstanding
ii) Insurance of $80 was paid for the period covering 1 July 2011 to 31 July 2011.
iii) Tenants had paid $75 as towards rental payments for the year July 2011- June 2012.
iv) Commission worth $150 is due.

A. Prepare the following ledger accounts
a) Rates a/c
b) Insurance a/c
c) Rent Receivable a/c
d) Commission Receivable a/c

B. Show the following extracts

a) Statement of comprehensive income

b) Statement of financial Position.

a) **Rates a/c**

2010		$	2011		$
July 1	Prepaid b/d	720	June 30	SCI	2 590
2012					
June 30	Bank	1 650			
	Owing c/d	220			
		2 590			**2 590**
			2011		
			July 1	Owing b/d	220

b) **Insurance a/c**

$			$		
2011			2010		
July 31	Bank	1 020	July 1	Owing b/d	48
				Prepaid c/d	80
				SCI	892
		1 020			1 020
2011					
July 1 Prepaid b/d		80			

Rent Receivable a/c

2010			2011		
July 1	Owing b/d	130	June 30	Bank	2110
2011					
June 30	SCI	1905			
	Prepaid c/d	75			
		2110			2110
			2011		
			July 1	Prepaid b/d	75

d) **Commission Receivable a/c**

2011		$	2010		$
June 30	SCI	1 266	July 1	Prepaid b/d	127
			2011		
			June 30	Bank	989
				Owing c/d	150
		1 266			1 266
2011					
July 1	Owing b/d	150			

a) **Statement of comprehensive income/Profit and Loss Account (extract)**

	Dr	Cr
		$
Gross Profit		xxx
Add Rent receivable		1 905
Commission receivable		1 266
Less expenses		
Rates	2 590	
Insurance	892	

b) **Statement of Financial Position(extract)**

Current assets	**$**
Prepaid insurance	80
Commission receivable accrued	150
Current liabilities	
Rates owing	220
Prepaid rent receivable	75

2.4 Adjustments for expense stock

Expense stock refers to various tangible items of stocks or assets used in the day-to-day running of the business, such as stationary for use in the office fuel for the vehicles, packing materials etc. Essentially, when these things are bought they are an expense which ensure the effective and efficient day- to- day running of an entity, but if they happen to be in stock at the end of a given financial period, they are not really treated as an expense per as they exist and are tangible, but as assets classified as expense stock. If such stock were acquired on credit and there is an amount outstanding to a creditor, such amount will be shown in the relevant account as an accrual c/d. Conversely if prepayments were made, they will also appear in the account, such that the account will show at the end of a given period the amount prepaid or accrued as well as the balance of stock in hand.

Expense stock is not the same as trading inventory as it is not meant for resale but for the ordinary day-to-day operations of the business to ensure the smooth and efficient operation of the entity.

Example 7

The following details are given

i) Jan 2009, stationary stock in hand amounted to $1 345, and $375 has been prepaid for stationery
ii) During the year to 31 December 2009, stationery was purchased as follows
- $6 300 by cheque
- $850 on credit and has not yet been paid for by 31 December 2009

iii) Stationery stock in hand is valued at $668

Required

a) Prepare the stationery account as at 31 December 2009
b) Draft the Statement of comprehensive income (extract)
c) Draft the statement of financial position (extract).

Stationery a/c

2009		**$**	**2009**		**$**
Jan 1	stock b/d	1 345	Dec 31	SCI	8 202
	Prepaid b/d	375		Stock c/d	668
Dec 31	Bank	6 300			
	Owing c/d	**850**			
		8 870			8870
2010				2010	
Jan 1	Stock b/d	668	Jan 1	Owing b/d	850

Statement of comprehensive income extract for the year ended 31 Dec 2009

	Dr	Cr
31 Dec 2009	$	$
Gross profit		xx
Less expenses		
Stationary	8 202	

c) **Statement of financial Position (extract)**

Current assets

	$
Stock of stationery	668
Current liabilities	
Expense creditors- stationery stock	850

Exercise 3

Ngundu's books show the following data in the year ended 30 September 2008.

1 October 2007

Rent in arrears	$200
Rates in advance	$55

The following payments were made during the period ended 30 September 2008.

Date	Payment details	Amount
1 October 2007	Rent	$200
31 Dec 2007	Rates	$95
1 Jan 2008	Rates	$1 000
31 Jan 2008	Rates	$150
1 June 2008	Rates	$195
1 June 2008	Rent	$1 400
1 August 2008	Rent	$600

Notes

i) Monthly rent has remained at a rate of $200 month for the last two years
ii) Quarterly rates is a fixed charge which increased from $150 to $195 per quarter on the 1st of April 2008
iii) All payments are made through the business bank account

Required

a) Prepare a combined Rent and Rates a/c for the year ended 30 September 2008.
b) State how much should be charged to the Profit and Loss Account (Statement of comprehensive income) for rent and rates separately.
c) Prepare a Statement of financial Position (extract) to show the treatment of balances remaining in the account.

Exercise 4

Mary- Anne has been carrying on her sole trader's business on premises she rents from Akim since 1 January 2009. She also sublets part of the premises to Joane a friend. The data is available.

Date	**Rent Paid by Mary Anne**	**Rent paid to Mary-Anne**
1/1/2009	$120 for two months	$100 for 5 months
	Ended 28 February	ended 31 May
30/6/2009	$240 for the 4 months	$180 for the 6 months ended 30 Nov
	Ended 30 June	
31/12/2009	$525 for the 7 months	
	Ended 31 Jan 2010.	

Reqired

a) Prepare- Mary- Anne's i) Rent Payable a/c
   ii) Rent Receivable a/c

b) Show the amounts to be reported in the statement of Financial Position under the appropriate headings.

Exercise 5

Uniflex is a franchise which orders various type of goods from different manufacturers in bulk and packages in its own brand name. The following details pertaining to the Packaging materials account are available.

i) Stock of materials as at 1 April 2010- $340
ii) $5475 worth of packaging materials were purchased during the year ended 31 March 2011. Of this amount $475 had not been paid for by 31 March 2011.
iii) Closing inventories of packing materials was valued at $280.

Required

Prepare the Packing materials account.

Summary

1. Remember that accounting is a language used to communicate business information. The communication needs to be absolute, complete and clear, thus when preparing ledger accounts dates must be recorded accurately; they are of utmost importance.
2. Adjustments need to be made so as to determine the actual expense/income in the financial period in order to measure true profit and establish the financial position of the entity.
3. It is mandatory for adjustments to be made line with the prudence and matching concept. In so-doing, materiality of what is reported should be considered
4. A good understanding of the concepts discussed in this chapter will go a long way in the mastery of the subject in general.

Suggested Solutions

Exercise 1

Motor Insurance a/c

2011		$	2011		$
Jan 1	Prepaid b/d		Dec 31	SCI	5 400
(1/4 x 1 800)		4 50			
Feb 1	Bank	1 800			
June 3	Bank	1 800			
Dec 31	Owing c/d	1 350			
		5 400			5 400
			2012		
			Jan 1	Owing b/d	1 350

Exercise 2

Motor Insurance a/c

2011		$	2011		$
Jan 1	Prepaid b/d	450	Dec 31	SCI	5 400
Feb 1	Bank	1 800		Prepaid c/d	450
June 3	Bank	1 800			
Oct 1	Bank	1 800			
		5 850			5850
2012					
Jan 1	Prepaid b/d	450			

Exercise 3

a) **Rent and Rate a/c**

2007			2007		
Oct 1	Prepaid rates b/d	55	Oct 1	Rent arrears b/d	200
	Bank-rent	200	2008		
Dec 31	Bank-rates	95	Sept 30	SCI rent	
2008				(200 x 12)	2 400
Jan 1	Bank-rent	1000	Sept 30	SCI-rates	
31	Bank- rates	150		(55 + 95 +) 1st 2/4	
June 1	Bank- rates	195		+(195 x 2)	690
	Bank- rent	1400			
Aug 1	Bank- rent	600	Sept 30	Prepaid rent c/d	
Sept 30	Accrued rates c/d			(3 200- 2 400)-200	600
	690 –(55 +95				
	+150 + 195)	195			
		3 890			3 890
2008			2008		
Oct 1	Prepaid rent b/d	600	Oct 1	Accrued rates b/d	195

Note:

i) It is always best to work out costs for each component separately to avoid confusion.
ii) All workings must **always** be shown where such complex calculations are involved.
iii) Your account totals on both sides should be able to agree without the need to calculate the difference as balance c/d for the sake of accuracy.

b) Profit & Loss a/c charges
i) Rent $2 400 (12 x 200)
ii) Rates $690 (55 + 95) for 1st quarter + 150 for 2nd quarter + 195 for 3rd quarter and 195 for last quarter.

c) **<u>Statement of Financial position (extract)</u>**

Current assets

Prepaid rent		600
<u>Less Current liabilitiesQ</u>		
Accrued rates	195	

Exercise 4

a(i) **Rent Payable a/c**

	$			$
2009	$	2009	$	
Jan 1 Bank	120	Dec 31		
June 30 Bank	240		(120+240+	
Dec 31 Bank	525		(6/7 x 525) SCI	810
			Prepaid c/d	75
	885			885
2010				
Jan 1 Prepaid b/d 75				

ii)

Rent Receivable a/c

2009	$	2009	$	
Dec 31 SCI	330	Jan 1	Bank	100
		June 30	Bank	180
		Dec 31	Owing c/d	30
	310			310
2010				
Jan 1 Owing b/d	30			

b) Statement of financial position (extract)

	$	
Current assets		
Accrued rent receivable	**30**	
Prepaid rent		**75**

<u>Exercise 5</u>

Packaging Materials a/c

2010		$	2011		$
April 1 Stock b/d		340	Mar 31	SCI	5 535
2011				Stock c/d	280
Mar 31	Bank	5 000			
	Owing c/d	475			
		5815			**5 815**
2011			2011		
Apr 1 stock b/d		280	April 1	Owing b/d	475

2.5 Bad debts and provisions

Distinguish between bad and doubtful debts.

Any bad debts written off represent debts which the business is reasonably certain they cannot be recovered. However, there may also be debts outstanding at the year-end which are uncertain of recovery but which cannot be categorized as bad debts at the year end. There are categorized as doubtful debts.

Thus, the distinction lies in the degree of certainty which exists concerning non- payment.

Outline the double entry required to account for bad debts.

Bad debts arising in the period in which the associated revenue was recognized

Dr - Bad debts a/c

Cr - Individual debtor a/c

At the end of the financial period the balance on the bad debts a/c will be transferred to the profit and loss a/c

Dr - Profit & loss a/c

Cr - Bad debts a/c

Bad debts arising in a period subsequent to that in which the associated revenue was recognized

Dr - Provision for credit loses a/c

Cr - Debtors' a/c

Outline the double entry required to account for bad debts recovered.

The accounting entries will be

Dr - Cash/ bank a/c

Cr - Bad debts recovered a/c with the amount recovered.

At the end of the accounting period the balance on the bad debts recovered a/c will be transferred to the profit & loss a/c. Hence, the accounting entries will be:

Dr - Bad debts recovered a/c

Cr - SCIa/c with the total amount recovered during the period.

Example 1

The following details were extracted from the books of A. White on 31 December 2004.

	$	$
Debtors – before any adjustments for bad debts		90 000
Provision for credit loses	8 400	
Amount of bad debts		2 400

It is White's policy to make a Provision for credit loses of 10% on debtors at the year end and a provision for discounts allowable of 5% on debtors at the year end.

Prepare

(a) The Provision for credit loses account.
(b) The provision for discount allowable account.
(c) Show the amounts to be charged in the profit and loss account for bad debts, Provision for credit loses and provision for discounts allowable.

ANSWER:

(i) **Provision for credit loses a/c**

2004		2004	
Dec 31 Balance c/d	8 760	Jan 1 Balance b/d	8 400
	________	Dec 31 Profit & Loss	360
	8 760		8 760
		2005	
		Jan 1 Balance b/d	8 760

(ii) **Provision for discount allowances a/c**

	2004	2004	
Dec 31 Balance c/d	3 942	Dec 31 Profit & Loss	3 942
		2005	
		Jan 1 Balance b/d	3 942

(iii) Profit & Loss Account for the year ended 31 Dec 2004 (extract)

Gross Profit		XXX
Less expense		
Increase in Provisition for credit loses **(W1)**	360	
Bad debts written off		2 400
Provision for discounts allowance **(W2)**		3 942

Workings:

1. Increase in Provision for credit loses

Debtors	90 000
Bad debts	2 400
	87 600
Provision @ 10% of 87 600	8 760
Less opening balance	8 400
Change for the year	360

2. Provision for discount allowable for bad debts

Provision for discount allowable for bad debts	87 600
Less Provision for credit loses	8 760
	78 840

Provision for discount = 5% x 78 840 **= 3 942**

Example 2

The following is a comprehensive example covering all the aspects discussed earlier

C. Chiwara set up in business on January 1999 as a building contractor at the end of the his first year of trading, 31 December 1999 the amounts owing to him from customers totaled $18 350, after some consideration, he decided that of these debts a total of $350 was unlikely to be recovered and should be written off as bad. The figure of receivables also includes amounts of $250 owed by C. Moyo. $550 owed by E. Nkiwane and $200 owed by N. Nyathi of which are regarded as doubtful debts.

He also instructed his accountant to make a general provision of 5% of the remaining receivables. During the year ending 31 December 2000 C. Moyo was declared to bankrupt and his trustee paid the Payable 60 cents in a dollar. N. Nyathi paid his debt in full. On 31 December 2000 his Receivables totaled $40 500. This figure is after recording all money received but does not take into account an amount of $500 owed by F. Chino which considered irrecoverable. He decided to maintain a Provisition for credit loses at 5% of receivables.

During the year ending 31 December 2001 an amount $350 was received in respect of bad debts written off in 1999. At 31 December 2001, his receivables totaled $25 000 after recording all cash received except for a cheque of $350 that was received on 31 December 2001. He decided to make a general provision of 5% of the receivables after writing off a debt of $900 owed by J. Mlilo and a provision for discount allowed of 2%.

<u>REQUIRED:</u>

Show the ledger entries in respect of the above transaction and relevant Statement of Financial Position extract for each of the years.

<u>SOLUTION</u>

Year 1 -1999

Bad debts a/c

	$		$
Receivable a/c	<u>350</u>	Dec 31 I/S year 1999	<u>350</u>
	350		<u>350</u>

Provision for credit loses

$			$
Dec. 31 Bal. c/d	1 850	Dec. 31 I/D A/C	1 850
	1 850		1 850
		1 Jan 00 Bal. b/d	1 850

Workings

Specific provision

C. Moyo	250
E. Nkiwane	550
N. Nyathi	200
	1 000
Add General Provision	
(5% (18 350 – 350- 1000)	850
Total Provision	1 850

Receivables A/C

	$			$
31/12/99 Bal. b/d	18 350		Provision for credit loses	350
			Balance c/d	18 000
		18 350		18 350
Balance b/d		18 000		

Statement of comprehensive income extract for 1999

Gross Profit	xxxx
Less Expenses	
Increase in provision (1 850-0)	1 850
Bad debts	350
Net profit	xxxx

STATEMENT OF FINANCIAL POSITION EXTRACT 2001

Current Assets	
Receivables	
Less provision	24 100
Less discount allowable	(1 205)
Net receivables	(1 145)
	21 437

2.6 Goods on Sale or Return Basis or Consignment Inventory

These are goods sent for approval. They should not be treated as sales until accepted by the customers. Goods on sale or return can be to our customers or from suppliers. Care should be taken when determining the value of closing inventory. The correct treatment is that goods sent on sale or return to customers should be included in closing inventory because goods on sale or return basis are not treated as sales. If a question states that they have been treated as sales after the trial balance has been prepared we should correct it by **Debiting the Sales Account** and **Crediting the Debtors Account** with the **Selling Price** of the goods and the Closing inventory should be adjusted to include those goods at **Cost Price.**

Goods on sale or return basis from suppliers should be excluded because they are part of the supplier's inventory. If a question states that they have been treated as purchases we should correct it by **Debiting Creditors** and **Crediting Purchases** with the cost price of the goods and closing inventory should be adjusted to exclude those goods if included in our closing inventory.

Example 3

The following information was taken from the books of Edith for the month of January 2000:

a) Sales amounted to $40 000.
b) Opening and closing inventories balances were $3 000 and $5 000 respectively for the month of January 2002.
c) Inventories amounting to $4 000 were sent to a customer as a sample. The goods are included in the above sales figure and debtors ledger despite the fact that the customer did not show some intention to buy the goods.
d) 25% was added to the cost price to arrive at the selling price of these goods.
e) Purchases of goods amounted to $21 000.
f) Debtors on 31 January 2000 amounted to $25 000.

You are required to prepare Edith's Statement of comprehensive account for the month ending 31 January 2000.

Solution

Sales			40 000
Less goods sent as a sample			4 000
			36 000
less cost of sales			
Opening inventory		3 000	
Add purchases		21 000	
		24 000	
less closing inventory		5 000	
Add inventory sent as a sample	3 200	8 200	15 800
Gross profit			20 200

Notes

a) Goods sent to customers as a sample should be subtracted from both sales revenue and the total of debtors by debiting the sales account and then crediting the debtors account. The same goods should be converted back to their cost price using either mark up or margin and then add it back to inventory by debiting (increasing) inventory and crediting (reducing) the cost of sales. In this case debtors figure should be reduced by $4 000 whilst the closing inventory is increased by $3 200.

b) Goods taken for personal use should be debited to a drawings account and credited to the cost of sales or purchases account.

Example 4

The following accounts were taken from the books of J. Zimuto for the financial year ended 31 December 1999.

	DR	**CR**
	$	$
Sales		309 000
Land	96 100	
Rent received		8 200
Stationery	2 000	
Discount allowed	900	
Discount received		1 200
Debtors	47 500	
Creditors		36 900
Carriage inwards	1 700	
Bank		21 100
Cash on hand	540	
Rent paid	11 200	
Electricity & water	14 300	
Drawings	15800	
Capital		50 540
Purchases	176 400	
Opening inventory	24 400	
Wages	36 100	
	426 940	**426 940**

The following additional information is available as at 31 December 1999.

a) Inventory on 31 December 1999 was valued at 36300.
b) Rent received in advance amounted to $1200
c) Unused stationery $ 700
d) Goods sent to customers that were on sale or return basis for $16 000 were treated as sales. The cost price of the goods was $12 800
e) Included in electricity & water is an amount of $4 300 relating to Zimuto`s private residence.

f) Wages owing $1 100

Required
a) Prepare a Statement of comprehensive income for the year ended 31 December 1999.
b) Prepare a Statement of Financial Position as at 31 December 1999.

Solution

Statement of comprehensive income for J. Zimuto for the year ended 31 December 1999

	$	**$**	**$**
Sales			309 000
Less Goods on Sale or return			16 000
			293 000
Less Cost of sales			
Opening Inventory		24 400	
Add Purchases		176 400	
Add Carriage Inwards		1 700	
		202 500	
Less Closing Inventory	36 300		
Goods on Sale/ Return	12 800	49 100	153 400
Gross Profit			139 600
Add discount received			1 200
Add Rent received (8 200 – 1 200)			7 000
Gross profit		147 800	
Less Expenses			
Stationery (2 000 – 700)		1 300	
Discount Allowed		900	
Rent paid		11 200	
Electricity (14 300 – 4 300)		10 000	
Wages (36 100 +1 100)		37 200	60 600
Net profit			**87 200**

Statement of Financial Position of J. Zimuto as at 31 December 1999

ASSETS	COST	DEP	CA
Property, plant and equipment: Land	96 100	-	96 100
Current Assets			
Inventory of stationery		700	
Inventory of goods for sale (36 300 + 12 800)		49 100	
Debtors (47 500 – 16 000)		31 500	
Cash on hand		540	81 840
			177 940
Equity and liabilities			
Capital			117 640
Current Liabilities			
Creditors	36 900		
Bank	21 100		
Rent Received in advance	1 200		
Wages Owing	1 100		60 300
			177 940

Statement of changes in equity for the period ending 31 December 1999

	Capital
Balance at 1 January 1999	50 540
Add net profit	87 200
	137 740
Less drawings *(15 800 + 4 300)*	(20 100)
Balance at 31 December 1999	117 640

2.7 Accounting standards

Standards are practical accounting guidelines to be observed by accountants when preparing financial statements. The main objective of accounting standards is to enhance the usefulness of the financial information for economic decision-making process by requiring appropriate disclosures and by reducing a variety of alternative treatments. In situations where accounting fails to observe the applicable standards in such accounts and where material, a note to the effect of the departure should be disclosed in the accounts.

It is important for financial accountants to prepare financial statements in accordance with the relevant and applicable Generally Accepted Accounting Practice. In Zimbabwe, it is recommended to prepare financial statements in accordance with the International Financial Reporting Standards (IFRS). These standards are issued by the International Accounting Standard Board (IASB), which is based in London. The IASB began operations in 2001. It is committed to developing, in the public interest, a set of single high quality, global accounting standards that that requires transparent and comparable information in general purpose financial statements.

IASB publishes its Standards in a series of pronouncements called International Financial Reporting Standards (IFRS). Upon its inception, the IASB adopted the body of International Accounting Standards issued by its predecessor, the Board of the International Accounting Standard Committee (IASC). The term IFRSs includes IFRSs issued by the IASB and the IASs issued by the predecessor, the IASC. As at 1 January 2007, the IASB had issued 8 IFRSs, in addition to those adopted from the IASC.

IFRSs are developed through an international due process that involves accountants, financial analysts, and other users of financial statements, the business community, inventory exchange regulators, and legal authorities, academics, and other interested individuals and organizations from around the world. The IASB corporate with national accounting standard setters to achieve convergence in accounting standards around the world.

The IASB’s objective is to require like transactions and events to be accounted for and reported in a like way and unlike transactions and events to be accounted for and reported differently both within an entity over time and among entities.

The following standards are however examined at this level of studies. The material in this book has been prepared in accordance with the latest IFRSs statements as published by the IASB

IAS 1: Presentation of financial statements

IAS 2: Inventories

IAS 7: Statements of cash flow

IAS 10: Events after a Statement of Financial Position date

IAS 16: Property, plant and equipment

IAS 33: Earnings per share

Each of the above IFRS standard is dealt with in the relevant section of this book, except for IAS 1 which is illustrated in this chapter. The information thereto is considered adequate. Students are therefore recommended to understand the fundamental principles entailed in each of the above standard.

2.8 IAS 1: Presentation of financial statements

This standard shall be applied to all general-purpose financial statements prepared and presented in accordance with the IFRSs.

The following businesses must prepare their accounts, in accordance with this standard and following the above layout:

- limited liability companies (Private & Public)
- partnerships
- sole traders
- non-profit making organizations
- private business corporations

Statement of comprehensive income can be prepared either by nature or function of the items shown thereto. The following is an illustration of both methods of preparation of financial statements. Statement of comprehensive income classified by function provides more relevant information to users of financial statements. The choice between the two methods depends on many factors, which includes the following, among others

- history of the entity
- nature of the expenses
- nature of the industry

Classification by function - Statement of Comprehensive Income for the year ended………..

Revenue	xxx
Cost of sales	(xxx)
Gross profit	xxx
Other income	xxx
Distribution costs	(xxx)
Administration expenses	(xxx)
Other expenses	(xxx)
Finance costs	(xxx)
Profit before taxation	xxx
Income tax expense	(xxx)
Profit for the period	xxx

Classification by nature

Revenue		xxx
Other income		xxx
Change in inventory of finished goods and WIP	xxx	
Raw materials and consumables used	xxx	
Employee benefit expenses	xxx	
Depreciation and amortization expenses	xxx	
Finance costs	xxx	
Other expenses	xxx	
Total expenses		(xxx)
Profit before taxation		xxx
Income tax expense		(xxx)
Profit for the period		xxx

Statement of Financial Position as at ………………..

ASSETS

PROPERTY, PLANT AND EQUIPMENT

Property, Plant and Equipment		
Land and buildings		xxx
Plant and machinery		xxx
Motor vehicles		xxx
xxx		
Intangible – Goodwill		xxx
Total Property, plant and equipment		xxx
CURRENT ASSETS		
Inventory	xxx	
Trade and other receivables	xxx	
Cash and cash equivalents	xxx	xxx
TOTAL ASSETS		xxx

EQUITY AND LIABILITIES

EQUITY		
Share capital		xxx
Other reserves		xxx
Retained earnings		xxx
Total equity		xxx
LIABILITIES		
Non-current liabilities		
Long-term loans	xxx	
Long-term provision	xxx	
Other long-term liabilities	xxx	
Total non-current liabilities		xxx

Current liabilities

Trade and other payables	xxx	
Short-term borrowings	xxx	
Current portion of long-term borrowings	xxx	
Short-term provisions	xxx	
Total current liabilities		xxx
Total non-current liabilities		xxx
Current tax payable		

Statement of changes in equity

	Share capital	**Retained profits**	**Other reserves *(Specify)***	**Total**
Opening balance	Xxx	xxx	xxx	xxx
Profit after tax		xxx		xxx
Issue of shares	Xxx			xxx
Dividend paid and proposed		(xxx)		(xxx)
Transfer to other reserves	-	(xxx)	xxx	-
Closing balance	Xxx	xxx	xxx	xxx

The closing balance from the statement of changes in equity is disclosed on the face of the Statement of Financial Position.

2.9 Accounting bases and Policies

Accounting policies are the specific accounting bases judged by business enterprise to be most appropriate to their circumstances and adopted by them for the purpose of preparing their final accounts. . Accounting bases are methods developed for applying fundamental accounting concepts to financial transactions, e.g. method of depreciation i.e. straight-line method, reducing method & sum of digits methods etc. First In First Out (FIFO) etc. while policies are the best bases chosen by a business at the best in preparing its financial statements.

Example 5

The following is a trial balance of C. Mlambo as at 31 December 2001.

	Debit	Credit
Capital		98 900
Sales		220 000
Purchases	140 000	
Opening inventory	30 000	
Wages & Salaries	23 000	
Rent & Rates	9 100	
Machinery	40 000	
Stationery	3 200	
Debtors	20 000	
Creditors		26 000
Commission receivable		5 800
Carriage outwards	13 200	
Bank	20 000	
Light & Heat	32 000	
Drawings	20 200	
	350 700	**350 700**

Additional Information

On 31 December 2001 the following was discovered

(a) Light and heat accruing amounted to $800.
(b) Inventory at 31 December 2001 was valued at $31 600.
(c) During the year Mr. Mlambo took goods cost $1 500 from the business for his own use.
(d) Rent & Rates prepaid $900.
(e) Commission receivable due but not paid $1 000.

You are required to:-

a) Prepare Statement of comprehensive income for C Mlambo for the year ended 31 December 2001 and
b) Prepare a Statement of Financial Position as at that date.

Solution

Statement of comprehensive income for C. Mlambo for the year ended 31 December 2001.

	$	$
Sales		220 000
Less Cost of sales		
Opening inventory	30 000	
Add Purchases	140 000	
	170 000	
Less drawings in goods	1 500	
	168 500	
Less closing inventory	31 600	136 900
Gross profit		83 100
Commission receivable (500 +1 000)		6 800
		89 900
Less Expenses		
Wages & Salaries	23 000	
Rent & Rates (9 100 – 900)	8 200	
Light & heat (32 000 + 800)	32 800	
Carriage outwards	13 200	
Stationery	3 200	80 400
Net Profit		9 500

Statement of Financial Position for C. Mlambo as at 31 December 2001

	$	$
Non-current assets		
Machinery		40 000
Current assets		
Inventory	31 600	
Debtors	20 000	
Bank	20 000	
Prepayment Rent & Rates	900	
Commission receivable owing	1 000	73500
		113 500
Equity and liabilities		
Capital		86 700
Current Liabilities		
Creditors	26 000	
Accrual -Light & Heat	800	15 100
		113 500

Statement of changes in equity for the period ending 31 December 2001

	Capital
Balance at 1 January 2001	98 900
Add net profit	9 500
	108 400
Less drawings *(20 200 + 1 500)*	(21 700)
Balance at 31 December 2001	86 700

Please note that an alternative, the ledger accounts explained above can be prepared as workings for amounts accrued or prepaid.

2.10 Examination type questions

2.11 Multiple choice questions

1. An accounting period is
   A. An twelve – month period
   B. Any period for which an entity chooses to prepare its accounts.
   C. A calendar year
   D. The duration in which the business has been trading.

2. A company's financial year ends on 31 December. At 31 December Year 1, the company carried forward a debit balance of $18 100 on the Rent account. During year 2 payments made for 12 months' rent, to 31 March year 3 were $78 600.

What is the amount of rent to be charged against profit in the year ended 31 December year 2?

A. $60 500
B. $96 700
C. $80 100
D. $77 050

3. B Ltd rents its building to C Ltd owed $4 500 for rent, but at 31 December 2002 had paid $3 200 in advance. During the year B Ltd had received $17 100 in rental from Y Ltd. What is the rental income to be shown in B Ltd's Profit and Less Account for the year ended 31 December 2002?

A. $18 400
B. $24 800
C. $9 400
D. $15 800

4. Which item is revenue expenditure?

A. Cost of painting new office premises during construction
B. Cost of repairs to factory plant and machinery
C. Legal fees for the purchase of new factory premises
D. Wages of a company's own workmen for building an office extension.

5. Which item should be treated as capital expenditure?

A. Cost of carriage on the purchase assets
B. Cost of replacement of part of a property, plant and equipment
C. Depreciation of a property, plant and equipment
D. Repairs to a property, plant and equipment

6. The rationale for making a provision in respect of doubtful debts is that the provision…

A. Is an estimate of future debts.
B. Records the expense of bad debts as they are incurred.
C. Matches the estimated cost of future bad debts against the revenue earned in giving rise to the potential bad debts.
D. Records bad debts without taking them out of the *'books'* of an entity; thus showing the full amount owed by debtors as a current asset.

7. A company does not include the value of skills gained by its employees from training programmes in its financial statements. Which accounting principle is being applied?

A. Consistency
B. Materiality
C. Money measurement
D. Substance over farm

8. What does a credit balance on an expense account represent

   A. A debtor for expenses owing
   B. An overdrawn expense account
   C. A prepaid amount paid for the expense
   D. An accrued amount owing for the expense

9. A Statement of Financial Position is

   A. A ledger account proving that the accounting records 'balance'
   B. A Statement showing the market value of a business.
   C. A listing in a special format, of the balances brought down remaining in the double – entry accounts after the profit and loss account has been prepared.
   D. A statement showing the market value of assets and liabilities.

10. "Payments and accruals have to be adjusted for in the preparation of final accounts."

    On what accounting convention is this statement based.

    A. Going concern
    B. Matching
    C. Prudence
    D. Consistency

11. Expenditure on a mining plant during a year has included the following.

	$
Insurance costs	24 000
New engine – plant will increase productivity	220 000
Installation cost of new engine	3 000
Cleaning costs	72 000

    How much of this expenditure should be treated as capital expenditure?

    A. None
    B. $223 000
    C. $247 000
    D. $319 000

12. Executive Link (Pvt) Ltd, whose financial year ended on 30 September 2006, sent goods costing $12 000 to A. Smith on a sale or return basis. None of these goods were sold by A. Smith until late October 2006. However, in preparing the draft accounts for the year ended 30 September 2006, closing inventory was recorded as $124 000 after having made the assumption that the goods sent to A. Smith had been sold. The company obtains a gross profit of 25% on all sales. What is the correct amount of closing inventory to be recorded in the books of the company

A. $112 000
B. $124 000
C. $136 000
D. $140 000

13. The inventory at 31 March 2007 in the books of Alice Apple includes goods received in February 2007 from Betty Bee Ltd on a sale or rerun basis. These goods, which remained unsold at 31 March 2007 had been recorded as purchased from Betty Bee Ltd at the pro- forma invoice price of $3 000. The adjusting entries necessary to amend the closing figure are:

A. $Debit inventory $3 000 and credit trade creditors with $3 000
B. $ Credit inventory $3 000, and debit trade creditors $3 000
C. $Debit inventory $6 000, credit trade creditors $3 000
D. $ Credit inventory $3 000, Debit trade creditors $6 000

2.12 Structured questions

Question 1

What do you understand by each of the following accounting concepts and how they are applied in the preparation of Financial Statements?

A. Prudence
B. Accrual
C. Going concern
D. Consistency
E. Entity

Question 2

The following trial balance was extracted from the books of J. Banda for the year ended 30 June 2003

	Dr **$**	**Cr** **$**
Capital		500 000
Purchase and sales	156 000	354 000
Rent	35 000	
Discount allowed	12 000	
Discount received		3 500
Sales returns	14 000	
Carriage inwards	23 000	
Motor vehicles	100 000	
Computers	80 000	
Machinery	375 000	
Debtors and creditors	56 000	45 000
Salaries and wages	50 000	
Inventory	16 000	
Sundry expenses	1 500	
Carriage outwards	6 000	
General repairs	12 000	
Bank overdraft		23 000
Cash	14 000	

Drawings	15 000	
Loan		40 000
	965 500	965 500

Additional information

(a) Inventory on 30 June 2003 was valued at $26 500.
(b) The following balances were available on 1 July 2002
Rent (Dr) $1 200
Rent (Cr.) $ 800
Sundry $1 000
(c) $2 000 of the general repairs balance relate to an amount that was paid as the cost of installing the computers.
(d) Salaries and wages of $4 000 relate to managers' salary for July 2003, which was paid in advance at the year-end.

You are required to:
(a) Prepare a Statement of comprehensive income for the year ended 30 June 2003 and
(b) A Statement of Financial Position as at that date.

Question 3

Benjamin Blue commenced business on 1 January 2004 and prepares his financial statements to 31 December every year. For the year ended 31 December 2004, bad debts written off amounted to $28 000. It was found necessary to create a Provisition for credit loses of $4 800. Debtors on that date stood at $182 000 after the adjustments for bad debts written had been made.

In 2005, debts amounting to $24 000 proved to be bad and were written off. In addition, a report was received that S. Phiri, a debtor who owed $5 300 has been declared insolvent and can only pay $0.30 every dollar he owes. In addition, the provision – for doubtful debts was to be increased to 5% of remaining debtors. Furthermore, Benjamin decided to create a provision for discounts allowable of $1 400 on debts which could be settled within one month. Total debts, before any adjustments were made in the year ended 31 December 2005 stood at 4202 500.

In 2006 a debtor J. White, whose debt of $1 200 was written off as bad in December 2005, settled his account in full on 30 November 2006 recoveries of $780 was made in respect of debts written off in 2004. As at 31 December 2006, bad debts written off totaled $7 250 but no adjustments have yet been made to the accounts. Total debtors for the year were $225 000 and a reduction in Provisition for credit loses of $2 450 was considered reasonable. The provision for discounts was to be adjusted to 2% of debts less than 30 days of totaling $32 000. Furthermore a specific Provisition for credit loses of $3 100 was to be incorporated into the accounts for a debtor who had left the country.

REQUIRED:

Prepare

a) The bad debts account
b) Provision for credit loses account
c) Provision for discount allowable a/c
d) S. Phiri's account
e) Bad debts recovered a/c
f) Profit and loss account extracts for the years 2004, 2005 and 2006.

Statement of Financial Position extracts for the years 2004, 2005 and 2006.

Question 4

The following trial balance was extracted from the books of L. Nixon at 28 February 2007.

	$	$
Capital account 1 March 2006		60 720
Freehold premises at cost	40 000	
Fixtures and fittings at cost	9 000	
Provision for depreciation on fixtures & fittings		900
Inventory on 1 March 2006	11 368	
Purchases and sales	22 526	45 482
Returns inwards and outwards	382	246
Debtors and creditors	6 760	3 388
Salaries	4 780	
Lighting and heating	1 024	
Rent, rates and insurance	3 240	
Bad debts	420	
Sundry expenses	408	
Discounts allowed and received	720	560
Cash at Bank	5 228	
Cash in hand	240	
Drawings	5 200	
	111 368	111 368

Additional Information:

1. Inventory at 28 February 2007 $9 344
2. Prepaid rates $600
3. Rent accrued due $800
4. L. Nixon sold some goods on behalf of a friend as earned a commission of $3 000. No record of this transaction has been made in the books.
5. Freehold premises are to be depreciated at the rate of 5% per annum on cost.
6. Depreciation of 10% is to be charged on fixtures and fittings on their written value.
7. It has been discovered that debts amounting to $600 e not recoverable.
8. Create a Provision for credit loses of $360 and a provision for discount allowable of 2½ of remaining debtors.

REQUIRED:

Prepare a Statement of comprehensive income for the year ended 28 February 2007 and a Statement of Financial Position at that date.

Question 5

The following trial balance relates of to the business of Joseph Benjamin as at 31 December 2003, extracted after his first year of trading.

	Dr	**Cr**
	$	**$**
Capital		127 600
Drawings	5 000	
Sales		324 000
Purchases	213 000	
Heating & lighting	9 600	
Stationery	4 000	
Rent	15 000	
Motor vehicles	40 000	
Buildings	60 000	
Repairs	12 000	
Cash on hand	2 000	
Insurance	7 000	
Bicycle	84 000	
	451 600	451 600

Additional information

a) Inventory on hand was valued at $13 000 on cost.
b) During the year Benjamin's ware house was broken into and inventory worth $10 000 was stolen. The insurance company agreed to pay $9 000 as compensation for inventory loss. No entry has been made in the books of accounts.
c) Mr. Benjamin bought a bicycle shown in the trial balance for his son's use.
d) Included in the repairs is an amount of $2 000 spent on the extension of the building.
e) Non – current assets are depreciated at the following rates using the straight line method:
   i. Motor vehicle 20%
   ii. Buildings 2%
   iii. Furniture and Fittings 10 %

f) Heating and lighting owing $400
g) Rent prepaid $ 1000
h) Mr. Joseph Benjamin brought an office desk valued at $5000 on 31 May 2003 for office use no entry has been made in the books

Required

a) Prepare a Statement of comprehensive income for the year ended 31 December 2003
b) Prepare a Statement of changes in equity
c) Prepare a Statement of Financial Position as at that date

CHAPTER 3

BANK RECONCILIATION

3.1 Chapter objectives

After studying this chapter *the student should* be able to:

1. *Explain why bank reconciliations are prepared.*
2. *Outline likely causes of differences between the bank statement and the cash book*
3. *Reconcile the cashbook balance with the bank statement balance*
4. *Update the cashbook and prepare a bank reconciliation statement*

3.2 Introduction

When a business opens a bank account, the bank becomes the custodian of the company's funds and treats the account as a creditor. On the other hand, the money deposited in the bank is an asset to the business. The business keeps its own record of its bank account and so does the bank keep the same record. Often, however, the two balances i.e. the one shown on the bank statement and the one shown by the cash book, do not agree. This is not necessary because errors have been made by either party, but it's because of transactions that have not been reflected by either party e.g. Cheques written by the business which have not been presented to the bank for payments or bank charges which have not been communicated to the business so that the cash bank is updated. Their differences, therefore, often arise because of the timing, factor and rarely errors.

To reconcile means to bring to an agreement

The purpose of bank reconciliation is to explain the differences at a given date between the balance of the bank account as shown in the firm's cash book and the balance of the bank account as shown in the bank statement, and get the bank statement and cash book balances to agree.

3.3 Reasons why the bank balance shown by the bank statement and cash book do not agree.

1. Transactions made by the bank on behalf of the business have not been recorded in the firm's cash book namely.
   i) Bank charges
   ii) Interest on overdraft
   iii) Standing orders, i.e. a regular amount paid through the bank on a regular basis, e.g. 24th of every month. This is an automatic deduction.
- (iv) Direct debits- a creditor is given permission by the account holder, e.g. rates electricity and any other bills, to obtain the money directly from the firm's bank account direct debits apply where the amount of money to be paid varies from time to time.

2. Amounts received directly by the bank and have not been recorded in the firm's cash book e.g. when the firm received payments in the form of standing orders and direct debits, such as dividends received.
3. Cheques drawn by the firm in favour of its creditors which have been presented to the bank for payment. These are known as unpresented cheques
4. Cheques or cash paid into the bank by the business and recorded as such in the firm's cash book, but not yet entered on the bank statement

5. Charges levied by the bank which have not yet been entered in the cashbook, such as bank charges, bank service fees, interests charged on an overdrawn bank account.
6. Dishonoured cheques not yet entered in the cash book. In this case, the bank indicates a credit entry when a cheque is deposited and when it subsequently dishonored, the account is debited on the bank statement to cancel the cheque. The cash book therefore needs to be updated by making a credit entry showing the dishonoured cheque.
7. Sometimes an error is made by the bank on the bank statement and this rarely occurs but an examination question may be presented with this type of problem.

Whenever the bank balance as per the cash book and bank statement do not agree a bank reconciliation needs to be done. It is important to note, however, that the bank reconciliation is not part of double entry. Its function is to reassure owners of the business and auditors that the difference between the bank statement and cashbook is due to genuine reasons and is clearly verified.

3.4 Reconciling the cashbook with the bank statement

A detailed examination of the cashbook (bank columns) and the bank statement is necessary to identify each individual cause of a difference. The debit side of the bank column of the bank statement and the credit side of the bank column of the bank account (cash book) is compared with the debit column of the bank statement.

Step 1
When doing the above mentioned comparison, tick similar items in both the cash book and bank statements.

Step 2
Update the cash book by entering any items remaining unticked in the bank statement. What is unticked on the debit column will be updated on the credit side of the cashbook and what remains unticked n the credit column on the credit column of the bank statement will be updated on the debit side of the cashbook.

Step 3
Once the cashbook has been updated, balance it

Step 4
Prepare a bank reconciliation statement using items remaining unticked in the cash book. If you start with the balance as per updated cash book, add unpresented cheques, i.e. items unticked on the credit side of the cash book and deduct uncleared deposit, i.e. items remaining unticked on the debit side of the cash book, in order to arrive at the balance as per bank statement.

Note
When the bank erroneously debits firm's bank account, in practice when a query is raised it is confirmed with the bank manager and a correcting entry on the bank statement would be made to reverse the transaction. For the purpose of this syllabus, it will simply be recorded in
bank reconciliation statement.

An extract of both the cash book and bank statement is not always provided n the examination particularly at this level. Often information indicating that the cashbook and bank balances do not agree will be given, and the question may not purely be on bank reconciliation but it may be incorporated in another question, say incomplete records.

Example
Billy Joseph's cash book showed a balance at the bank of $1710 in hand on 30 August 2011. At the same date, his bank statement balance was $1356, overdrawn.
The following discoveries were made.

i) Cheques paid to creditors amounting to $4665 on 29 August were not paid by the bank until 8 September
ii) Cheques amounting to $7 560 paid into the bank were not credited by the bank until 2 September
iii) A standing order for rent payment of $180 had been paid by the bank on 28 August but no entry had been made in the cash book.
iv) A cheque paid by Billy Joseph for electricity $45 had been entered in the cash book as $54.

Required

Update the cashbook and prepare a bank reconciliation Statement

Solution

Up-dated cash book

		$			$
Aug 30	Balance b/d	1710	August 28	Stop Order-rent	180
	Correct of error (iv)	9	30	Balance c/d	1 539
		1 719			1 719
Sept 1	Balance b/d	1 539			

Bank Reconciliation Statement	**$**
Balance as per updated cash book	1539
Add unpresented cheques	4 665
	6 204
Less uncleared deposits	7 560
Overdraft as per bank statement	1 356

3.5 Exercises

Ntando Dube, a sole trader discovers that her bank statement balance and cashbook balance do not agree on 30 June. The cashbook balance is $1 843 on that date and the bank statement shows an overdraft. Upon investigation, she ascertains the following.

i) The following cheques issued by Ntando have not yet been presented to the bank for payment.

Cheques No. 87	$328
Cheque No. 96	$403
Cheque No. 97	$192

ii) Cash and cheques amounting to $3 650 had been entered in the cash book but not yet credited by the bank
iii) A cheque for $143 received from a debtor, has been returned by the bank marked R/D
iv) Regina, debtor paid $78 direct to Ntando's bank and this appears on the statement
v) A cheque for $200 drawn by Ntando for drawings has been correctly entered in the cash book but debited twice in the bank statement
vi) A standing order of $80 for business rates has not been entered in the cash book
vii) Ntando received dividends form her investment of $52 which were credited directly to the bank account. No centuries were made in the book.

Required

i) A statement showing the adjusted cash books balance
ii) A bank reconciliation statement showing the overdraft appearing n the bank statement.

Suggested Solution

Updated Cash book

Balance b/d	1843	(iii) Dishonoured cheques	143
Regina-debtor	78	(v) Drawings duplicated	200
vii) Dividends red	52	(vi) Standing Order- Rates	80
		Balance c/d	1 550
	1 973		1 973
Balance b/d	1 550		

Bank Reconciliation Statement

		$	$
Balance as per cash book			1 550
Add unpresented cheque cheq no.	87	328	
	96	403	
	97	192	923
			2473
Less uncleared deposits			3650
Overdraft as per bank statement			1177

Correction of Errors

The bank reconciliation statement can be used in the correction of errors. The nature and extend of such errors affect the bank entries, such as in the example below.

Example:

The summary of the bank column in the cash book of Chandipa Ltd for the year ending 30 June 2001 is as follows:

Opening balance	1654	
Receipts	332 478	
		334 132
Payments		316 735
Closing Balance	**17 397**	

Your investigation of the accounting records for this period reveals the following information.

a) Cheques paid to suppliers of $1 435 have not yet been presented at the bank, and cheques paid into the bank $1 620 on 30 June 2001 have not yet been payable to the company's account.

b) Standing orders entered in the bank statement have been omitted from the cash book in respect of lease payments on company car, 12 months at $96 per month, and annual insurance of $150.

c) Bank Charges of $452 shown in the bank statement have not been entered in the cash book.

d) A cheque drawn for $127 has been entered in the cash book as $172, and a cash book page on the receipts side has been under added by $200.

e) A cheque for $238 has been receivable to the company's bank account in error by the bank.

f) The bank statement shows a favourable balance as at 30 June 2001 of $15 465.

Required:-

Bank reconciliation statement as at 30 June 2001, together with a corrected cash book position.

Solution

Corrected Cash Book

Uncorrected balance b/d	17 397		Standing order		
			Lease Payments (12x96)	1 152	
Overstated Cheque (172 – 127)	45		Insurance	150	
Undercast Total	200		Bank Charges	452	
			Balance c/d	15 888	
		17 642		**17 642**	

Chandipa Ltd Bank Reconciliation statement as at 30 June 2001

Balance as per corrected cash book		15 888		
Add Unpresented cheques		1435		
			17 323	
Less Deposits not yet cleared by the bank	1620			
Cheque receivable in error by bank	238	1858		
Balance as per bank statement			**15 465**	CR

3.6 *Examination type questions*

CHAPTER 4

PROPERTY PLANT AND EQUIPMENT (IAS 16)

4.1 Chapter objectives

After studying this chapter *the student should* be able to:

By the end of this chapter you should be able to:

1. *State the meaning of historical cost of assets as well as the depreciation of property, plant and equipment.*
2. *Explain the fundamental principles which are applied when depreciating property, plant and equipment.*
3. *To what extent, if at all, does proving depreciation ensure that a business can afford to replace its property, plant and equipment.*
4. *State what is meant by the terms, 'residual value' and 'useful life' of property, plant and equipment.*
5. *Describe the methods which are used in the depreciation of property, plant and equipment.*
6. *Draw up the journal entries to record the disposal of property, plant and equipment.*
7. *Prepare the following accounts as they would appear in the general ledger: property, plant and equipment account, its provision for depreciation and its disposal account*
8. *Describe the disclosure requirements for property, plant and equipment in the financial statements.*

This standard superseded IAS 4.

Acquisition cost / cost of an asset

Cost means historical cost, which includes the purchase price less trade discount and all directly attributable costs involved in bringing the asset into use. This includes non-recurring costs (capital expenditures) e.g. transport cost, railage cost/carriage inwards cost, import duty, site preparation cost Installation cost and professional fees like architects and engineers.

4.2 Depreciation

Which is the subject of this chapter is also covered

It defines it as the allocation of depreciable amount of property, plant and equipment over its useful life. Depreciable amount is equal to historic cost or revalued amount less scrap value (residual value). The depreciation charge allocated to a period should be recognised as an expense in the Statement of comprehensive income.

It requires all assets with a finite life to be depreciated even if the market price is more than the CA. It also requires that when an asset is revalued, depreciation should be based on the revalued amount over the remaining useful life.

All property, plant and equipment with a finite life must be depreciated. The only exception is land, which is not depreciated. Depreciation must be charged even if the market price of the asset is more than the carrying amount (net book value).

Property, plant and equipment are used in business for a number of years to produce goods or services because of this reason, their cost cannot be charged to the Statement of comprehensive income in one year but should be charged over their useful life in order to match the cost (depreciation) and income generated by the assets in line with the accrual concept (matching concept) and going on concept. From this point of view, the standard treats property, plant and equipment as deferred expenses and the depreciation process is simply a method of allocating the deferred expenses to the relevant accounting periods.

The purpose of depreciation is to match the cost (depreciation) with the income generated by the asset. It is not a way of valuing assets. Depreciation does not provide cash for the replacement of assets. It is a non-cash expense. The other purpose is to reduce profits and Statement of Financial Position values.

4.3 Fundamental principles

As noted in Chapter 1, financial statements are prepared under 4 fundamental assumptions, all are explained in that chapter. The allocation of depreciation expense is therefore in accordance with the following fundamental principles:

- **Going concern concept**

When depreciation is charged, it is assumed that the organization will continue operating in the future. If the organization is not a going concern, depreciation should not be charged in the Statement of comprehensive income.

- **Matching concept**

Depreciation expense is matched with revenue generated by the assets being depreciated.

Example 1

Mr. T Chiroora, a photographer bought a motor vehicle on 1 March 2006. The following are the cost incurred on the purchases of the motor vehicle.

i.	Invoice price	$600 000
ii.	Petrol (Full tank)	$ 20 000
iii.	License fees for 1 year paid to the City Council	$ 5 000
iv.	Sign writing on the sides of the motor vehicle	$ 21 000
v.	Insurance for 1 year, up to 28 February 2007	$ 18 000
vi.	Cost of number plates	$ 7 500

You are required to calculate the amount to be capitalized as the cost of the motor vehicle as at 1 March 2006, assume Mr. T Chiroora’s year end is 31 December.

Solution

Invoice price	$600 000
Sign writing on the sides of the motor vehicle	$ 21 000
Cost of number plates	$ 7 500
Total cost of the motor vehicle	$628 500

Notes

- *The remaining costs will the expensed in the Statement of comprehensive income, as follows, since they are not of capital. License fees and insurance premium must however be apportioned between the 2006 and the 2007 financial years, in the ratio 10: 2 because there are 10 months up to year end in 2006 and there are 2 months in 2007.*
- *Depreciation should be based on the cost of the motor vehicle, of $628 500. if the motor vehicle has a useful life of 5 years depreciation for the year ended 2006 can be calculated as follows, assume the method of depreciation is the straight line method:*

$$\frac{628\ 500}{5} \times \frac{10}{12} = \$104\ 750$$

Example 2
To what extent, and in what way, if at all, does providing depreciation ensure that a business can afford to replace its property, plant and equipment?

- There is a no direct connection between depreciation and providing funds for replacement.
- Depreciation is the allocation of the cost of an asset over its useful life/ the charge for the wear and tear of using a property, plant and equipment.
- As such, there will be an expense charged in the profit and loss a/c which will not require a cash outflow.
- If an amount equal to the depreciation charged were to be set aside as a cash reserve, it is unlikely that the amount provided would enable the asset to be replaced, given inflation.
- In any case, technological changes mean that the asset would be replaced by something fundamentally different from the original.

If an asset is bought part way through the year e.g. 1 July for a Company whose year end is 31 December each year, it should not be charged a full year depreciation but a 6 months' depreciation i.e. annual depreciation x 6/12 the same principle applies to assets sold part way through the year. This means depreciation on asset acquired or sold partway through the year should be time apportioned. However, in an examination you may be given an accounting policy, which provides that a full year's depreciation is charged in the year of purchase and none in the year of sale, follow this policy.

Useful life

This is the expected useful life / economic life and not technical life (maintained to keep on working). It is then that period expected to be useful in the profit earning operations of the firm. If revised, allocate the balance of cost over, the remaining useful life. s:

a) Residual value
Residual value is the expected/estimated realisable value of the asset at the end of its useful life. It depends on the manner and length of time that the asset is to be used, as well as its physical condition and market prices for periods; it is then likely to be difficult.

4.4 Methods of providing for depreciation

Depreciation to be allocated over the period expected to benefit from the use of the asset. Thus, managers should select method regarded as the most appropriate to the type of asset and its use in the business. There are several methods of providing for depreciation but the most common are: -

a) Straight-line method
b) Reducing balance method
c) Sum of digits method
d) The production (usage method)

The first two methods have been illustrated fully in our ordinary level in this book we look the remaining method in detail

Sum of digits Method

It is an alternative to the reducing balance method which involves a less rapid pattern of depreciation allocations but retains the principle of higher depreciation charges in early years than in later years. Thus very high depreciation is charged in the first two years but declining rapidly.

Procedure

1. Each year of an asset is assigned a number or digit in reverse orders to the year of life e.g. if the economic life is five years, this can be shown below.

Years of life	No. Assigned
1	5
2	4
3	3
4	2
5	1
	15

Sum of digits $= \frac{n(n+1)}{2}$

Where n = 5

2. Depreciation cost is then divided by the sum of the digits to obtain a depreciable cost for each digit.
3. Annual depreciation is then calculated by multiplying the digit assigned to that year by the depreciable cost per digit.

Thus, depreciation Provision $= \frac{\text{Number Assigned x depreciable cost}}{\text{sum of digits}}$.

Or Depreciation charged $= \left[\frac{t(c-s)}{n(n+1)\frac{1}{2}} \right]$

Where
t - number assigned
n - economic life
c - Cost
s - residual value

4.5 Sum of digits method of depreciation

Example 3

Extra Investments Pvt. Ltd. acquired assets at a cost of $5 000 with an estimated residual value of $500 after its economic life of 5 years. Calculate depreciation charge for each year.

No. of years of economic life	**Digit Assigned**
1	5
2	4
3	3
4	2
5	1
	15 (sum of digits)

Depreciation per digit $= \frac{(5\,000 - 500)}{15}$

$$\frac{4500}{15} = 300$$

Depreciation in years

		$
1	= 300 x 5 =	1 500
2	= 300 x 4 =	1 200
3	= 300 x 3 =	900
4	= 300 x 2 =	600
5	= 300 x 1 =	300

The provision for depreciation account must now be entered using these amounts. Using this method, the written down value of an asset declines at a much less rapid rate than calculated using the reducing balance method.

4.6 The Production (usage) Method.

Depreciation is calculated on estimated usage of the asset e.g. units produced, hours worked or mileage in case of motor vehicles. Depreciation given assumes the benefit obtained is the same for each unit usage. For example if total output expected during five years of the asset is 30 000 units and output occurred as follows:

Year	**Output**
1	6000
2	7000
3	8000
4	5000
5	4000

Depreciation expense per unit $= \frac{(5000 - 500)}{30\,000 \text{ units}}$

= 15 cents/ unit

→Thus depreciation in : year 1 6000 x 15c = $900

: Year 2 7000 x 15 c = $1050.

: e.t.c.

Again the provision for depreciation account must be entered with these values.

The accounting procedure required to generate information for inclusion in the Statement of Financial Position is to debit, under any method, the acquisition account, or valuation as the case may be, in the asset account and to accumulate depreciation yearly in provision for depreciation account. The annual provision for the depreciation must be charged to the profit and loss account for that period.

Change from any one method to another is only allowed/permissible where the new method will give a fair presentation of the result and financial position. The effect of such change must be disclosed in the year of change if material. The un-depreciated cost should, however be written off over the remaining useful life on the new basis commencing with the period in which the change is made. Where assets are revalued depreciation must be based on the revalued amount and current estimate of remaining useful life with the effect, if material,

Note: Depreciation policy is such that it accumulates evenly during the year. It must then be allocated for acquisition part – way through the year. If full depreciation is charged irrespective of when the asset was brought then full depreciation must be charged. If no depreciation is charged in the year of disposal, it must also be observed.

Example 4

The following is a Statement of Financial Position extract of E. Madory Ltd.

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2000

	Cost	Acc. Dep	CA
Plant & Equipment	30 000	5 000	25 000

Notes:
The plant and equipment was revalued upwards to $32 000 on 1 March 2001. The company uses the straight-line method of depreciation at a rate of 10% assuming a residual value of zero.

Required:-
Calculate the annual depreciation for year 2001.

Solution

10% x 32 000 = $3 200

Also state that when a business changes from one method to the other, the unamortised cost should be depreciated over the remaining useful life using the new method.

Example 5

Assuming the facts are the same as above, the company changes from straight-line to reducing balance method at 15% in year 2001 but there is no revaluation.

Required

Calculate **depreciation for annual depreciation** assuming it is independent of the illustration above.

Solution

15% (30 000-5 000) = $3 750

It is also stated that when the useful life of the assets is revised, the remaining book value should be depreciated over the revised useful stated with the year of charged.

Example 6

The trial balance of Mutero is shown at 31 December 2000 (Extract)

	DR	CR
Plant & machinery	60 000	
Accumulated Depreciation		18 000

Notes:

The useful life of the Plant and Machinery was reviewed on 31 December 2001 and it was established that it still had a life of only 5 years instead of 8 years. The company uses the straight-line method of depreciation assuming a zero residual value.

Required:-

Calculate depreciation for the years ending, 31 December 2000 and 2001.

Solution

To get this correct, you should always add 1 year to the remaining useful life.

Depreciation $= \frac{60\,000 - 18\,000}{6} = \$7\,000$

Example 7

Equipment Suppliers is a well-established company specializing in the distribution of agricultural buildings, equipment and fertilizers, commenced a machinery repair service on 1 January 2002. From the beginning of the new venture, the repair service used a building which the company had bought with the intention of selling it. In fact, the building was included in trading inventory at cost 31 December 2001, at $500 000 and was then displayed for retail sale at $650 000. In preparing the building for use as a workshop on 1 January 200, the following expenditure was incurred:

	$
Foundation and erection costs	50 000
Interior and exterior painting	3 000
Heating and lighting systems	150 000

On 1 January 2003, further work was undertaken the repair service buildings' heating system at a total cost of $70 000 half of which related to repairs and the rest concerned the installation of additional thermostatic controls. On 30 June 2003, the following work was complete on the workshop building:

	$
Installation of partition walls	80 000
Renewal of wooden window frames	50 000

Early in 2004, following the closure of the machinery repair service the workshop building including the heating and lighting systems, was sold $400 00. it is company policy to provide depreciation annually on buildings at the rate of 10% of cost on assets held at the end of each financial year (31 December).

Prepare the following ledger accounts as they would appear in the books of Farm Suppliers Equipment for each of the financial years ended 31 December 2002, 2003 and 2004.

(i) Repair service workshop building.
(ii) Repair service workshop building – provision for depreciation.
(iii) Repair service workshop building disposal a/c

Repair service workshop building a/c

2002			**2002**	
Jan 1	Bank	500 000	Dec 31 Balance c/d 703 000	
	Foundation &			
	Erection	50 000		
	Painting	3 000		
	Heating &			
	Lighting systems	150 000		
		703 000		703 000

2003			**2003**	
Jan 1	Balance b/d	703 000	Dec 31 balance c/d	818 000
	Thermostat Controls	35 000		
June 30	Partition wall	80 000		
		818 000		818 000
2004			2004	
Jan 1	Balance b/d	818 000	Dec 31 Disposal	818 000

4.7 Disposal of fixed assets

The cost of the benefit derived from the use of assets cannot be ascertained until the assets have completed their useful life and have been sold or otherwise disposed of. The standard provides that when an asset is disposed of, the difference between the net sales proceeds and the carrying amount (net book value) should be recognised as income or expenses in the Statement of comprehensive income

The method is to open the asset realization (disposal account) and to reverse the existing entries in the asset and provision for depreciation accounts in respect of the asset disposed of. e.g. On 31 December 2001, plant and machinery acquired at cost $120 000 in 1992 was sold for $40 000. The accumulated depreciation to date was $70 000.

The journal and ledger entries will be as follows:

	DR.	CR.
1. Realisation (Disposal account)	$ 120 000	
Assets – plant & Machinery Account		$ 120 000
To close the asset account at cost.		
2. Provision for depreciation account	$70 000	
Disposal / Realisation account		$70 000
To close the provision for depreciation account.		
3. Cash account	$40 000	
Disposal account		$40 000
To recognize received at disposal.		
4.a) DR Statement of comprehensive income(SCI)	$10 000	
CR. Disposal		$10 000
Being loss on disposal		
b) DR Disposal account		
CR. Statement of comprehensive income(SCI)		

If a profit has been made at disposal

Pro-forma Disposal A/c

Historical Cost	xxx	Accumulated Depreciation	xxx
		Bank / Cash/ Trade-in Value/Insurance proceeds	xxx
Profit (Balancing Figure)	xxx	Loss (Balancing Figure)	xxx

LEDGER ACCOUNTS

Plant & Machinery account

	$		$
1 Jan Bal. b/d	120 000	Dec 31 Disposal Account	120 000

Provision for Depreciation account

	$		$
31 Dec Disposal account	70 000	Jan 1 Bal. b/d	70 000

Cash account

	$		
Assets Disposal	40 000		

Asset Disposal account

	$		$
Plant & Machinery	120 000	Sales proceeds	40 000
		Depreciation	40 000
		SCI	10 000
	120 000		**120 000**

Comprehensive income account (extract) for the year ended 31 Dec 1993

	$	
Loss on disposal	10 000	

Example 8

Mulambo (Pvt) Ltd. is company registered in Zimbabwe on 1 January 1998. The company's records revealed that motor vehicles were purchased as follows: -

1 January 1998	No. 30	50 000	Cash
1 January 1999	No. 31	60 000	"
1 March	No. 32	65 000	"
1 September 1999	No. 33	70 000	"
30 June 2000	No. 34	80 000	Note 3

Additional information

1. Vehicle No. 30 was sold for $60 000 on January 1999.
2. Vehicle No. 33 was involved in an accident on 30 April 2000 and the insurance company agreed to pay $42 000
3. Vehicle number 34 was purchased on 30 June 2000 for $80 000. The amount was settled by trading in Vehicle 31 at an agreed value of $52 000 the balance being paid for in cash.
4. The company depreciates vehicles using the straight-line method at the rate of 20% per annum on cost. The policy of the company is to provide for a full year's depreciation in the year of purchase and none in the year of sale. Its financial year-end is 31 December.

Required

Prepare the following accounts as they would appear in the general ledger of Mulambo (Pvt) Ltd. for the years ending 31 December 1998, 1999, 2000

(i) Vehicles at Cost
(ii) Provision for depreciation of motor vehicles
(iii) Vehicle disposal account

Solution

(a) **Motor Vehicle account *(at cost)***

1998			**1998**	
Jan 1 Bank	50 000		Bal. c/d	50 000
1999			**1999**	
Jan. 1 Bal b/d	50 000		Jan 1 Disposal	50 000
Jan 1 Bank	60 000			
Mar 1 Bank	65 000			
Sep 1 Bank	70 000		Bal. c/d	195 000
	245 000			245 000
2000			**2000**	
Jan 1 Bal. b/d	195 000		Apr. 30 Disposal	70 000
			Sep 1 Disposal	60 000
June 30 Bank	28 000		Bal. c/d	145 000
Disposal A/c	52 000			
	275 000			275 000
2001				
January 1 Bal. b/d	145 000			

(b) Provision for Depreciation account

1998		**1998**	
Bal. c/d	10 000	profit and loss	10 000
1999		**1999**	
Disposal	10 000	Bal. b/d	10 000
Bal. c/d	39 000	Dec. 31 SCI	39 000
	49 000		49 000
2000		**2000**	
Disposal *33*	140 000	Jan 1 Bal. b/d	39 000
Disposal *31*	12 000	Dec 31 b/d	29 000
Bal. c/d	42 000		
	68 000		68 000
		2001	
		Jan 1 Bal. b/d	42 000

c) Disposal Account –Vehicle No. 30

Vehicle A	50 000	Disposal	10 000
SCI	20 000	Bank	60 000
	70 000		70 000

Disposal Account – Vehicle No. 31

Vehicle	60 000	Depreciation	12 000
SCI	4 000	Trade in value	52 000
	64 000		64 000

Disposal account - Vehicle No. 33

Vehicle	70 000	Depreciation		14 000
		Insurance		42 000
		SCI	14 000	
	70 000			70 000

The entry to be made in the Asset account when an asset is traded in , it often gives a problem to students . Two sets of entries are required. These are:

1. DR Asset account
   CR. Disposal Account

   With the trade in value

2. DR Asset account
   CR. Bank

   With the difference between the total purchase price and trade in value

4.8 Disclosure of property, plant and equipment in the financial statements

The term Property, plant and equipment refer to all tangible, long-term assets held by organizations. Before the adoption of the IFRSs, Property, plant and equipment would be referring to property, plant and equipment. This section is focusing on the disclosure of Property, plant and equipment in the published financial statements of public limited company. Students should note that a Property, plant and equipment disclosure note is one of the requirements of the A level syllabus. If the note is required in a question, the total net amount should be disclosed in the Statement of Financial Position. The following example will illustrate this disclosure requirement.

Example 9
Chiwara Tours (Pvt) ltd is a Zimbabwean registered company, whose operations are based in the Masvingo province of the country. The following is a summary of the tangible assets owned by the company as at 31 December, the financial year end of the company.

	2006	2005
Asset, at cost		
Land	150 000	150 000
Buildings	200 000	150 000
Motor vehicles	90 000	140 000
Computer equipment	25 000	25 000
Accumulated depreciation		
Land	-	-
Buildings	65 000	50 000
Motor vehicles	55 000	60 000
Computer equipment	10 000	5 000

Other information

- Land is not depreciated
- Additional buildings were erected during the year at a cost of $50 000
- During the year, a motor vehicle which was bought for $50 000 was sold for $49 000. The accumulated depreciation at the time of disposal was $30 000

Required

Prepare the property, plant and equipment note, as it would appear in the financial statements of the company as at 31 December 2006.

Solution

Notes to the financial statements as at 31 December 2006

Property, plant and equipment

	Land	Buildings	Motor vehicles	Computer equipment	Total
	$	$	$	$	$
Balance at 1/01/06 *(Cost)*	150 000	150 000	140 000	25 000	465 000
Balance at 1/01/06 *(acc. depcn)*	-	(50 000)	(60 000)	(5 000)	(115 000)
Balance at 1/01/06 *(Net)*	150 000	100 000	80 000	20 000	350 000
Additions	-	50 000	-	-	50 000
Current year depreciation charge	-	(15 000)	(25 000)	(5 000)	(45 000)
Disposal *(cost)*	-	-	(50 000)	-	(50 000)
Disposal *(acc. depcn)*	-	-	30 000	-	30 000
Balance at 31/12/06 *(Net)*	150 000	135 000	35 000	15 000	335 000
Balance at 31/12/06 *(Cost)*	150 000	200 000	90 000	25 000	465 000
Balance at 31/12/06 *(acc. depcn)*	-	(65 000)	(55 000)	(10 000)	130 000

Note

*The total amount that should be disclosed on the face of the Statement of Financial Position is the net a carrying amount of **$335 000**. It is not necessary to show the detailed movement of property, plant and equipment, if the above note is shown as part of the notes to the financial statements.*

4.9 Examination type questions

4.10 Multiple choice questions

1. Depreciation is

   A. A way of setting aside money to provide for the eventual replacement of property, plant and equipment.

B. A way of writing off the cost of property, plant and equipment over their estimated revenue generating period.
C. The writing off of the cost of property, plant and equipment evenly over their estimated useful economic life.
D. The writing off of the cost of property, plant and equipment over their estimated useful economic lives in ever decreasing amounts.

2. During the year a business sells a property, plant and equipment. The following information is known

Original Cost	\$500 000
Accumulated depreciation at the date of sale	\$240 000
Profit on sale	\$70 000

What were the proceeds from the sale of the property, plant and equipment?

A. \$170 000
B. \$190 000
C. \$310 000
D. \$330 000

3. A Company acquired a new computer system for \$500 000 on 1 November 2001. The computers' estimated useful life is five years, at the end of which it is expected to have a scrap value of \$45 500. If the company's financial year ends on 31 March, and straight line depreciation is applied on a time-apportioned basis, what is the depreciation charge on the computer in the profit and loss account for the year to 31 March 2002?

A. \$37 880
B. \$41 670
C. \$90 900
D. \$100 000

4. Which asset does not normally need to be depreciated?

A. land
B. an oil well
C. a quarry
D. A revalued property.

4.11 Structured questions

Question 1

Plant & Equipment which cost \$16 000 has an estimated useful life of four years and a salvage value of \$10 000 at the end of that time. Calculate the annual depreciation expense, Statement of Financial Position value at the end of each year of useful life using the following methods.

1. Straight – line
2. Reducing balance (or double declining balance).
3. Sum of the digits

Question 2

At the beginning of the financial year commencing on 1 April 1995, a company had a balance on plant account of $744 000 and on provision for depreciation of plant account of $410 800. The company's policy is to provide depreciation using the reducing-balance method applied to the property, plant and equipment held at the end of the financial year at the rate of 20% per annum.

On 1 September 1995 the company sold for $27 400 some plant which it had acquired on 1 31 October 1991 at a cost of $72 000. Additionally, installation costs totaled $8 000. During 1993, major repairs costing $12 600 had been carried out on this plant and, in order to increase the capacity of the plant, a new motor had been fitted in December 1993 at a cost of $8 800. A further overhaul costing $5 400 had been carried out during 1994.

The company acquired new replacement plant on 30 November 1995 at a cost of $192 000, inclusive of installation charges of $14 000.

<u>Calculate:</u>

a) The balance of plant at cost at 31 March 1996.
b) Calculate the provision for depreciation of plant at 31 March 1996.
c) Calculate the profit or loss on disposal of plant.

Question 3

Zola is in the luxury car line business for safari tours in the holiday resort area of Victoria Falls and Kariba. His property, plant and equipment register on 1 June 2004 shows the following information.

Toyota Landcruiser No	Cost Price	Date of Purchase
AAA 142 Q	$156 250	1 June 2000
AAB 369 B	$125 000	23 March 2001
330-787 A	$137 000	26 August 2001
ABB 111 Z	$150 000	23 January 2003

On 18 May 2005, a new Landcruiser, number MVD 346 J, was purchased on credit from Bulawayo Cars Ltd for $175 000. Bulawayo Cars Ltd agreed a trade-in price of $6 000 for AAA369B, which the new Landcruiser replaced. All the vehicles are depreciated at 40% per annum using the reducing balance method. A full year's depreciation is charged in the year of purchase and none in the year of disposal, regardless of the date of purchase or sale.

<u>You are required to:</u>

a) Prepare the Toyota Landcruiser Account for the year ended 31 May 2005. [4]
b) Draw up the Provision for Depreciation of Toyota Landcruiser Account for the year ended 31 May 2005. [12]
c) Draw up the Disposal of Toyota Landcruiser Account for the period ended 31 May 2005. [4]

CHAPTER 5

ERRORS AND SUSPENSE ACCOUNTS

5.1 Chapter objectives

After studying this chapter *the student should* be able to:

1. Explain the purpose of suspense accounts
2. *Prepare the journal entries necessary to record the adjustments for the correction of errors*
3. *Write up the suspense account to eliminate the difference on a trial balance*
4. *Draw up the trial balance after the correction of errors.*
5. *Prepare a statement showing the effect of these adjustments on the gross or net profit for the year.*
6. *Prepare a Statement of Financial Position after the correction of the errors.*

5.2 Introduction

A suspense account is a temporary account which is opened when the causes of differences on the trial balance cannot be established and corrected immediately. Where a transaction cannot be identified or classified at the time of entry the amount causing a difference in the trial balance is recorded in this nominal account as the suspense account, pending investigation which will then determine the final and proper destination of the transaction or transactions in question.

There are two main reasons why a suspense account could be opened

1) A book-keeper is not sure where to post an item and enters it in the suspense account pending clarification on the transaction. Once the correct account to be posted has been properly identified and classified, correct posting how to be undertaken and the suspense account is then closed.
2) There is a difference in the Trial Balance and attempts to find the causes of the difference have been unsuccessful so a suspense account is opened with the amount of the difference so that the Trial Balance agrees pending investigation into the Trial Balance difference. Once the errors causing the Trial Balance difference have been discovered, they are corrected and the suspense account is subsequently eliminated.
   Under examination conditions, it should be noted that some errors discovered may not necessarily affect the suspense account. There may be corresponding errors which affect two already existing accounts and such errors will not affect the suspense account.

5.3 Correction of error

Errors which affect the trial balance are errors which are corrected through the suspense account. The suspense account is opened as a temporary measure to balance a trial balance. There are some errors; however which may be discovered during the cause of the year before a trial balance is extended. Such errors may be corrected by simply altering the relevant accounts. Where the error affects more than one account, the correction will usually be made through a journal entry.

5.4 Types of errors

1) Errors not affecting trial balance agreement

When a trial balance is in correct balance, it is not evidence of absence of errors. A trial is not evidence of absence of errors. A trial balance only tests the arithmetical accuracy of double entry and in addition, is used as a worksheet for preparing final accounts. This means that there are some errors that could be present in the books of account but may not be detected by a trial balance. Such errors which may not create an imbalance in the trial balance are classified as:

a) Error of omission – This is where a transaction is completely left out or is not recorded at all in the books of account
b) Error of principle – this is where an item is posted to the correct side of the wrong class of account e.g. cash paid for machinery repairs is debited to machinery account.
c) Error of commission- an item is entered on the correct side but a wrong account of the same class e.g. sale of goods to E Watanga debited in error to E.F. Watonga's account.
d) Error of original entry- an incorrect figure is entered in the records and double entry is completed using the same incorrect figure e.g. cash sales of $ 910 recorded in both accounts as $190.00
   NB: if double entry is completed using the same wrong amount, it is not an error of transposition.
e) Complete reversal of entries- This is where double entry is completed using the correct amount but entries are made on the wrong side of each of the two accounts e.g. Wage of $ 900 cash paid recorded as
   Dr. Cash a/c $900
   Cr Wages a/c $900
f) **Compensating errors –** two equal and opposite errors have been made in the books and these errors are not related e.g. a debtors account has been under-cast by $70 and a rent receivable a/c has been under-cast by $70.
   NB: this type in practice is rare and will not be revealed by a trial balance. Sometimes this type or error can be because a deliberate second error has been made to force the balancing of the records to conceal fraud.

2 Errors which affect the trial balance agreement

a) **Addition / casting errors :** figures are incorrectly added in the books resulting in the total / balance being overcast or under-cast.
b) **Failure to complete double entry/ single entry errors** : the dual aspects of a transaction is not revealed in the books. Only one side of the transaction is recorded and double entry is not completed
c) **Completing double entry using different amounts / error of transposition:** Double entry can be completed using different figures where an error of transposition has taken place e.g. goods worth $127 sold to A. Andrews recorded as
   Dr A. Andrews $172.00
   Cr Sales $127.00
d) Double entry completed on the same side e.g. 2 debits or 2 credits
e) A balance wrongly brought forward
f) Trial balance errors; a balance is omitted, or incorrectly extracted in preparing the trial balance. This type error which is only found in the trial balance is corrected by a single sided journal entry to simply amend the trial balance itself as there is no error in the ledger.

The examiner can ask candidates to correct these errors in one of the following ways: -

a) Correcting of errors during the accounting period
b) Correcting errors after the preparation of trial balance.

In this situation the examiner requires candidates *to:*

i) Write journal entries to correct the errors
ii) Prepare the suspense account clearly showing how the trial balance difference is cleared
iii) Draw up the corrected trial balance.

c) Correction of errors after the preparation of final accounts.

In this situation the examiner requires students to: -

i) Write journal entries correcting the errors
ii) Prepare the suspense account and how it is cleared.
iii) Prepare a statement of revised gross profit and / or Net profit
iv) Prepare a corrected Statement of Financial Position(Statement of Financial Position)

5.5 How to correct errors

Type 1 errors are corrected by means of a journal entry between the accounts affected and no entry is made in the suspense account. **It is important to note that errors which are not reflected by the trial balance will not be corrected through the suspense account.**

Type 2 errors also require journal entries to correct them.

One side of the journal entry will be to the suspense account and the other to the account affected by the error. Generally type 2 errors are those which affect 1 of the 2 accounts in the double entry except errors in the trial balance itself.

One has to decide how to correct an error by seeking answers to the following questions:

1 How the transaction has been recorded?
2 How the transaction should have been correctly recorded?
3 What adjustments are required to be made in order to correct the error?

5.6 Helpful hints in the correction of errors which affect the trial balance

1 When an error is made to an item written on the wrong side of an account with the amount being correct, double the amount on the correct side.

The first half cancels the error and the second half records the correct answer.

2 When an error is made to an item written on the wrong side of an account with an incorrect amount, make an entry of the same wrong amount on the correct side to cancel the error and then make another entry on the correct side with the correct amount to record the correct thing.
3 When a wrong amount has been recorded on the correct side, if the amount is less than the correct amount record the difference on the same side. If the recorded amount is more than the correct amount, record the difference on the opposite side so that it reflects the correct amount which should have been recorded in the first place.
4 There are some errors which if corrected will necessitated the correction of other accounts e.g. correction of debtors' figure will result in the correction of Provision for credit loses, correction of error on depreciable non-current will cause the provision for depreciation to adjusted.

Example 2: ***correction of errors and the suspense a/c***

The trial balance of Tamboedza Limited was unable to balance on 30 September 2011 and the totals where: debit $3 592 200

Credit $3 705 634

On the same day, draft accounts were prepared having included the trial balance difference as suspense account balance. The draft Statement of comprehensive income showed a profit of $282560 for the ended 30 September 2011.

Consequently, the following errors were discovered:

1. $1 160 Electricity prepaid at 30 September 2010 had not been brought down as an opening balance.

2. Discount allowed $1 672 and discount received $1 838 for the month of September 2011 had not been posted from the cash book to the general ledger.

3. $19 200 paid upon the acquisition of some item of office furniture on 1 April 2011 had been debited in error to office furniture repairs accounts. It is company policy to depreciate office furniture using the straight line method at 20% on a pro rata basis.

4. Returns inwards totalling $17 960 had been credited in error to the returns outwards accounts.

5. the balance of $76 520 for motor expenses had been omitted from the trial balance.

6. A motor Vehicle with a net book value of $8 000 had been sold during the year for $9600. The proceeds of the sale had been entered in the cash book and to complete double entry, a credit was made in the sales account in the general ledger. Motor vehicles are depreciated at 25% per annum with proportionate depreciation in the year of acquisition and none in the year of sale.

Required:

a) Journal entries to correct the errors (Narratives are not required)
b) A suspense account showing how the initial balance has been eliminated

Suggested solution:

	Dr	Cr
a) i) Electricity	1160	
Suspense		1160
ii) Discount allowed	1672	
Suspense		1 672
iii) Suspense	1 838	
Discount Received		1 838
iv) Office furniture	19 200	
Office furniture repairs		19 200

Statement of comprehensive income (depreciation)	1 920	
Provision for depreciation office furniture		1 920
v) Returns Inwards	17 960	
Returns outwards	17 960	
Suspense		35 920
vi) Suspense		76 520
vii) Sales	9 600	
Motor Vehicle Disposal		9 600
Motor vehicle disposal	8 000	
Motor vehicle @ CA a/c		8 000
Motor vehicle disposal	1600	
Statement of comprehensive income (Profit on disposal)		1600

Suspense A/c

Error in trial balance	113 434	Electricity	1160
Discount received	1 838	Discount allowed	1 672
		Returns Outwards	17 960
		Returns Inwards	17 960
		Balance omitted	76 520
	115272		115 272

Example 2

Mr. Tafara extracted the following trial balance as at 31 December 1999

	$	$
Discount allowed	9 500	
Discount received		11 000
Creditors		32 000
Debtors	26 500	
Inventory	19 400	

Wages and salaries	28 600	
Stationery	5 600	
Plant and equipment	40 000	
Provision for depreciation		4 000
Sales		316 000
Purchases	178 000	
Drawings	16 000	
Insurance	18 200	
Balance at bank	96 000	
Rent and rates	24 000	
Capital		105 800
Commission paid	9 000	
Commission received		6 000
Suspense account	4 000	
	474 800	474 800

On checking the books of accounts to eliminate the suspense account, you discover the following errors:

a) Discount received of $1 500 was posted to the debit of the discount allowed account.
b) Credit purchases of $1 700 had been correctly debited to a purchases account but had been credited to the supplier's account as $7 100.
c) The total of one page of the sales daybook had been carried forward as $6 800 whereas the correct amount was $8 600.
d) An amount of $200 paid for stationery had been entered in the insurance account in error.
e) A cheque of $2 500 received from a debtor was debited to the customer's account and credited to the bank account.
f) The debit side of stationery account was overcast by $600.
g) A cheque payment for rent of $2 000 was correctly entered in the cash book but not posted to the rent account.

Required

a) Prepare journal entries to correct the above entries (narratives are not required). [7]
b) A suspense account [8]
c) Prepare a corrected trial balance. [6]

Solution

<u>Journal entries</u>

		Dr	Cr
		$	**$**
a)	Suspense	1 000	
	Discount received		500
	Discount allowed		500
b)	Creditors	5 400	
	Suspense		5 400
c)	Suspense	1 800	
	Sales		1 800
d)	Stationery	200	
	Insurance		200
e)	Bank *($2 500 x 2)*	5 000	
	Debtors *($2 500 x 2)*		5 000
f)	Suspense	600	
	Stationery		600
g)	Rent	2 000	
	Suspense		2 000

Suspense account

	$		$
Balance as per trial balance	4 000	Creditors	5 400
Discount received	500	Rent	2 000
Discount allowed	500		
Sales	1 800		
Stationery	600		
	7 400		7 400

Corrected trial balance as at 31 December 1999

	$	$
Discount allowed *(9 500 – 500)*	9 000	
Discount received *(11 000 + 500)*		11 500
Creditors *(32 000 – 5 400)*		26 600
Debtors *(26 500 – 5 000)*	21 500	
Inventory	19 400	
Wages and salaries	28 600	
Stationery *(5 600 + 200 - 600)*	5 200	
Plant and equipment	40 000	
Provision for depreciation		4 000
Sales *(316 000 + 1 800)*		317 800
Purchases	178 000	
Drawings	16 000	
Insurance *(18 200 – 200)*	18 000	
Balance at bank *(96 000 + 5 000)*	101 000	
Rent and rates *(24 000 + 2 000)*	26 000	
Capital		105 800
Commission paid	9 000	

Commission received		6 000
	471 700	471 700

Correction of net profit in the draft final accounts

If errors are found and corrected after the daft income has been prepared, it goes without mentioning that the draft net profit has to be amended. All items which affect the trading account and the Statement of comprehensive income in general will have to be used in the correction of the net profit. Only items of revenue income and items of revenue expenditure are considered in the correction of net profit. The rule to help you correct net profit is:

Debit entries to nominal accounts in the journal to decrease profit and must therefore be deducted from the draft net profit.

Credit entries to nominal accounts in the journal to increase profit and must therefore be added to the draft net profit.

It therefore goes without mention at this stage that you should have a thorough understanding of the division of the ledger at this level for you to master particularly this topic and the chapter on control accounts.

Example 2 – correction of draft net profit/loss

Using information in example 1, draw up a statement showing the revised profit after the errors in Example 1 have been corrected.

Suggested solution

Statement of amended net profit for the year ended 30 September 2011

	Decrease (Dr)	Increase (Cr)
	$	$
Net Profit per draft Final a/c		282 560
Electricity opening balance omitted	1160	
Discount allowed	1172	
Discount received		1 838
Office furniture reduction in repairs		19 200
Depreciation -6/12 x 20% 19200	1920	
Returns inwards	17 960	
Returns outwards	17960	
Cash on disposal of F- a (reduction in sales)	9 600	
Profit on disposal		1600
	126 792	305 198
		(126 792)
Revised net profit		178 406

At this level, errors involving opening inventory and closing inventory and their effects on profit give students a challenge. Students need to understand the relationship between profit and inventory.

Opening inventory and profit

The relationship is indirect that is if opening inventory is overstated profit will be understated or (vice-versa).

Closing Inventory and profit

The relationship is direct i.e. if closing inventory is overstated profit will be overstated.

Example 2

The accounts of M K Moyo showed a profit of $98 000. The auditor discovered the following errors:

a) The correct valuation of opening inventory was $13 000 whereas the figure used in the accounts was $9 000.

b) The closing inventory figure used was $19 000, the correct figure which should have been used was $29 000.

Required
Calculate the revised profit

SOLUTION

	$
Profit as per draft	98 000
Add closing inventory understated	10 000
	108 000
Less opening inventory understated	4 000
Revised profit	104 000

Exercise 1

Android Ltd's trial balance for the year ended 31 October 2010 has failed to balance. An examination of the company books has revealed the following errors.

i) An invoice amounting to $600 for goods purchased has not been recorded in the purchases day book but has been posted directly to the purchases account and the creditor's account. The creditor's figure in the trial balance is derived from the control account.
ii) The sales day book has been under-cast by $1440
iii) Discount allowed for the month of October $2934 has not been posted to the nominal ledger
iv) Goods totaling $14 460 have been received from a supplier and included in stock, but the invoice has not yet been received.
v) A cheque of $1152 received from Andrew, a debtor has been posted direct to the sales account
vi) The sales account has been credited with $1 500, a credit note for trade- in allowance given on a company van. This amount has already been correctly dealt with when dealing with the replacement of the motor van.

Required

a) Journal entries to correct the above errors
b) A statement showing the effect of the corrections on the company's profit for the year.

Correction of a draft (Statement of Financial Position) .

The correction of profit ultimately affects statement of financial position as profit is included in the statement of financial position. In addition, the correction will affect balances of assets and liabilities such as Trade receivable and trade payables among other balances should also be corrected in the Statement of financial position.

Example 3

Agatha's trial balance failed to agree on 31 December 2010, the difference being entered in a suspense account. A Draft Statement of comprehensive income was then prepared and it showed a net profit of $10 000 upon investigation, the following errors were discovered.

i) The balance of opening inventory of $76 000 had been entered in the trial balance as $67 000
ii) Closing inventory at 31 December 2010 had been overstated by $3200
iii) Motor expenses of $4800 had been posted to Motor van account in the sales account
iv) Goods worth $2 300 invoiced to Kasandra have been correctly posted to her account but have not been entered in the sales account.

v) A credit balance of $47 in the sales ledger has been extracted as a debit balance in the trial balance.

Required

a) Prepare journal entries to correct the above errors
b) Prepare a suspense account showing the trial balance different and the subsequent correction of the errors
c) Show A Statement of Financial Position extract sheet containing the amended balances.

Suggested Solution

			Dr	Cr
A	i)	Suspense		9 000
	ii)	Capital	3200	
		Closing inventory		3200
	iii)	Motor expenses	4800	
		Suspense		4800
	iv)	Suspense	8400	
		Motor vans		8400
	v)	Suspense	2300	
		Sales		2300
	vi)	Suspense		94

B

Suspense a/c

Error in trial balance	3006	Adjustment to opening inventories	9 000
Motor Vans	8400	Motor expense	4800
Sales	2300		
Sales ledger	94		..
	13 800		13 800

Exercise 1

Suggested Solution	$	$
a. i) Suspense a/c	600	
Purchases ledger control a/c creditors		600
ii) Debtors control a/c	1440	
sales		1440
iii) Discount allowed	2934	
Suspense		2934
iv) Purchases	14460	
Purchases ledger control a/c debtors		14460
v) Sales	1152	
Sales Ledger control account (debtors)		1152
vi) Sales	1500	
Motor Van disposal account		1500

b.	Profit adjustment	Decrease	increase
i)	Sales day book under cast		1440
ii)	Discount allowed not posted	2934	
iii)	Purchases invoice from supplier	14460	
iv)	Sales incorrectly credited	1152	
v)	Sales incorrectly credited	<u>1500 20046</u>	
			(20046)
	Net decrease in profit		<u>(18606)</u>

5.7 Worked example with solutions

Example 1

<u>The following is a draft Statement of Financial Position for Smith a retailer as at 31 December 2000</u>

	$	**$**
Property, plant and equipment		194 000
<u>Current Assets</u>		
Inventory	50 000	
Debtors	29 000	
Cash	<u>18 000</u>	<u>97 000</u>
Total Assets		<u>291 000</u>
Equity and liabilities		
Capital		190 000
Add Net Profit		<u>30 000</u>

		220 000
Less drawings		20 000
		200 000
Current liabilities		
Creditors	25 000	
Bank overdraft	52 000	
Suspense	14 000	91 000
		291 000

Further investigation of the suspense account balance revealed the following errors: -

i. Bank charges of $400 had been omitted from the cash book.
ii. Cash sales of $3000 made on 31 December 2000 were debited to sales and credited to Debtors account.
iii. The total of discount allowed was under cast by $2 000.
iv. An amount of $86 paid for transport was debited to stationery account.
v. An inventory sheet totaling $1 200 was omitted from the closing inventory
vi. A Provision for credit loses of 5% of the Debtors is to be created.
vii. Returns outwards was debited to returns inwards account of $8 000.

Required:

a) Journal entries (Narratives are not required)
b) Write up suspense account
c) A statement of corrected Net Profit
d) A corrected Statement of Financial Position

Solution

			Dr.	**Cr.**
			$	$
a)	Bank charges		400	
	Bank			400
b)	Cash on hand		3000	
	Debtors		3000	
	Sales			6 000
c)	Discount allowed		2 000	
	Suspense			2 000
d)	Transport		86	
	Stationery			86
e)	Debit: Inventory		1 200	
	Credit:			-
	Correction of a single sided error			
f)	Statement of comprehensive income	(29 000+3000) x5%	1 600	
	Provision for credit loses			1 600
g)	Suspense		16 000	
	Returns outwards			8 000
	Returns inwards			8 000

Suspense A/C

Returns inwards	8 000	Difference per trial balance	1 4000
Returns outwards	8 000	Discount allowed	2 000
	16 000		16 000

Statement of correct Net Profit

		$	$
Profit as per draft accounts			30 000
Add:	Inventory omitted	1 200	
	Sales	6 000	
	Returns outwards	8 000	
	Returns inwards	8 000	23 200
			53 200
Less:	Provision for credit loses	1 600	
	Bank charges omitted	400	
	Discount allowed	2 000	4 000
Correct Net Profit			**49 200**

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2000

	$		$	
Property, plant and equipment			194 000	
Current Assets				
Inventory (1 200 + 50 000)		51 200		
Debtors (29 000+3 000)	32 000			
Less Provision for doubtful debts	1 600		30 400	
Cash (18 000+3 000)			21 000	102 600
Total assets				296 600

Equity and liabilities

Equity			219 200
Add Current Liabilities			
Creditors		25 000	
Bank	(52 000+400)	52 400	77 400
Total equity and liabilities			296 600

STATEMENT OF CHANGES IN EQUITY FOR THE PERIOD ENDING 31 DECEMBER 2000

	Capital
Balance at 1 January 2000	190 000
Add net profit	49 200
	239 200
Less drawings	(20 000)
Balance at 30 September 1998	219 200

5.8 Examination type questions

5.9 Multiple choice questions

1. A trial balance will fail to agree if :

   A. A sales invoice is omitted from the Sales Journal
   B. A sales invoice for $978 is entered in the sales Journal as $987.
   C. A sales invoice for $770 entered in the sales journal but not included in the monthly total
   D. A credit note has been entered in the sales journal.

2. A business discovers that two errors have been made after the draft final accounts had been prepared
   - Office expenses, $420 were debited in the office equipment account.
   - Purchase of a machine $3 400 was debited in the purchases account.

   How do these errors affect the net profit and the total property, plant and equipment shown in the Statement of Financial Position?

	Net profit	Property, plant and equipment in the Statement of Financial Position
A.	Reduce by $2 980	increase by $3 820
B.	Reduce by $3 820	reduce by $3 820
C.	Increase by $2 980	increase by $3 820
D.	Increase by $3 820	increase by $3 820

3. A trial balance failed to agree and the difference was entered in a Suspense Account. A credit balance of $10 710 in the Sales Ledger had been wrongly extracted as a debit balance. Which journal entry will correct this error?

Debit	**Credit**
A. Suspense \$21 420	-
B. Suspense \$10 710	Sales \$10 710
C. Suspense \$21 420	Sales \$21 420
D. Sales \$21 420	Suspense \$21 420

4. A trial balance has failed to agree. An investigation has revealed three errors.

- A cheque of \$300 paid to L. Lewis had been correctly entered in the Cash Book but had not been entered in L. Lewis account.
- The purchases account had been under cast by \$40
- A cheque of \$186 received from K. Keith had been correctly entered in the Cash Book but had not been entered in K. Keith's account.

What was the suspense account balance before the error were corrected.

A. \$154 credit
B. \$154 debit
C. \$446 credit
D. \$226 debit

5. After a trial balance had been prepared, four errors were discovered.

- Sales overcast by \$210
- Insurance under cast by \$120
- Cash received from a debtor entered in the cash book only 150
- A purchase of 59 is entered in the books, debit and credit as \$95

Which of the above errors does not affect trial balance agreement.

A. 1 and 4
B. 1, 2 and 3
C. 1, 2 and 4
D. 4 only

6. The following errors in the accounting records have been found and corrected:

- A purchase invoice for \$250 was omitted from the books of account.
- A credit sale for \$120 to X was debited to the account of Y.
- The sales day book was over- added by \$100

7. The gross profit for the year before correcting the errors was \$60 200. What is the correct gross profit for the year?

A. $59 850
B. $59 970
C. $60 350
D. $60 550

8. The directors of a company are completing the accounts for the year ended 30 April 2004. They discover that the inventory at 1 May 2003 was over- valued by $150 000. What is the effect of correcting the error in the accounts?

	Net profit for year – end 30 April 2004	Reserves brought forward at 1 May 2003
A.	Decrease	Decrease
B.	Decrease	Increase
C.	Increase	Decrease
D.	Increase	Increase

5.10 Structured questions

Question 1

When preparing a trial a balance, the bookkeeper found that it disagreed. The difference was entered in a suspense account prior to the discovery of the following errors:

1. The purchases daybook had been under cast by $4 000.
2. A payment of $8 100 to Moyo, a supplier has been correctly entered in the cash book but was not posted to his account.
3. The total of discount allowed had been overcast by $980.
4. A balance in the rent account of $9 600 was brought down as $6 900.
5. A payment of $6 000 for the purchase of stationery was entered in the cash book and credited to the stationery account.
6. Mr. Moyo, the proprietor advised his accountant that rent paid includes a payment of $600 for his private residents.

You are required to:

a) Prepare journal entries to correct the above entries.
b) Prepare a suspense account, showing clearly the original balance as per trial balance.

Question 2

The following trial balance at 31 September 2004 has been drawn up for a business after preparation of draft final accounts:

	$	$
Land and buildings at cost	234 000	
Equipment at cost	150 200	

Provision for depreciation: Land and buildings		40 600
Equipment		61 720
Inventory at 30 September 2004	32 600	
Bank	10 700	
Creditors		44 280
Loan		50 000
Debtors	51 000	
Provisition for credit loses		1 020
Capital		251 580
Profit for the year to 30 September 2004		77 400
Drawings	44 000	
Suspense account	4 100	
	526 600	526 600

Additional information

i. Purchases for $2 940 from a supplier had been received on 30 September 2004 and included in inventory figures on that date but the invoice had not been entered in the purchases day book.
ii. A photocopier costing $8 000 which had been bought for the business has been debited to the purchases account.
iii. Provision for depreciation had not been made for the new photocopier referred to above in (b). The depreciation is to be 20%.
iv. The photocopier in (b) above replaced an existing piece of equipment costing $6 000 which was sold for $1 800, and the proceeds of sale debited to the bank account and credited to the equipment account. No other entries have been passed. At the date of sale, the accumulated provision for depreciation for this item was $4 800.
v. A credit note for $250 received from a supplier, was entered in the returns outward daybook and credited to the suppliers' account.
vi. The proprietor's electricity bill of $1 120 for his private house has been paid by the business and debited to the business' electricity account.
vii. The creditors' figure in the trial balance includes a balance of $15 000, which should have been listed as $11 400.
viii. A long overdue debt of $4 000 should have been written off.
ix. It is the policy of the business to provide for doubtful debts at the rate of 2% of total debtors.

<u>You are required to:</u>

Prepare the journal entries necessary to record the adjustments for the above items. Narratives are not required. [12]
Write up the suspense account to eliminate the difference. [2]
Prepare a statement showing the effect of these adjustments on the profit for the year ended 30 September 2004. [7]
Prepare a Statement of Financial Position after the correction of the errors as at 30 September 2004. [6]

Question 3

Bangani Ltd is preparing its year end accounts. The accountant is on sick leave, there are numerous minor discrepancies to be dealt with before the accounts can be finalised. You are initially given the following balances:

	$
Debtors	254 700
Creditors	169 500
Inventory	183 900
Profit for the year	151 410
Bank overdraft	89 100
Ordinary share capital (50c shares)	150 000
Retained profits (beginning of year)	156 000
Investments	132 600
Provisition for credit loses	5 940
Plant and machinery at cost	420 000
Provision for depreciation – Plant and machinery	189 000
Suspense account (credit balance)	5 250

You discover the following errors

i) An inventory sheet had been under cast by $3 000 and two different inventory sheets had been overcast by $300 each.
ii) A sale of $180 000 had been correctly recorded in sales but not posted to the account of the debtor concerned. Sales returns of $5 250 had not been recorded at all. A contra item of $4 350 between a debtor and a creditor had been recorded in the debtors' ledger but not in the creditors' ledger.
iii) The sales included the sale of some plant and machinery for $9 600. This plant and machinery had been bought for $19 800 some years ago and had a written down value of $7 200.
iv) No entries have been made in the accounts for:

- An electricity bill for $1 800 which has been paid.
- A bill for audit services for $16 800 which has not yet been paid
- An entry on the bank statement for an overdraft interest of $22 200
- An overpayment to a creditor of $2 250.

v) The debit side of the cash book has been overcast by $6 600.

vi) During the year investments which had cost $51 600 were sold for $63 000. The cash receipt had been recorded in the cash book but not posted.

vii) The following balances were omitted from the list of balances given above:

Delivery vehicle at cost	$96 000
Provision for depreciation – vehicles	$54 000

viii) Provisition for credit loses is to be adjusted to be 2% of debtors' balances at the year-end.

ix) Depreciation at the rate of 10% on cost is to be provided on all property, plant and equipment at the end of the year.

x) A dividend of 6 cents per share is to be provided.

You are required to:

a) Prepare a suspense account, after making the relevant corrections. [15]

b) Calculate the revised net profit for the year [10]

CHAPTER 6

CONTROL ACCOUNTS

6.1 Chapter objectives

After studying this chapter *the student should* be able to:

1 *Define a control account*
2 *State the uses of control accounts*
3 *Draw up a sales and purchases ledger control account*
4 *Identify the sources of information for control accounts*
5 *Prepare an amended sales ledger control account and purchases ledger control account.*
5 *Draw up a statement reconciling the amended sales ledger control account balance with the total of the sales ledger.*
6 *Explain the purpose of control accounts.*
7 *Outline the benefits that accrue from maintaining a control account system.*

6.2 Introduction

A control account, also known as a total account, is a summary of all the individual accounts in the ledgers they control, namely the Trade receivables/debtors ledger which keeps records of all credit sales to trade debtors, and Trade Payables/creditors ledger which keeps records of all credit purchases from trade suppliers. A control account is therefore a summary account in the general ledger of all transactions pertaining to trade receivables (debtors) and trade payables (creditors)

6.3 Purpose of Control accounts.

The purpose of the control account is to keep the general ledger free of details, thus it summarises information in the subsidiary ledgers (debtors' and creditors' ledgers) although it uses a different source to compile that information. This enables the control account to act as an independent check of the arithmetical accuracy of the ledgers it controls. Where a trial balance fails to agree, a control account makes the localisation of errors easy. In addition, control accounts provide instant totals for trade debtors and creditor balances, which are useful and enable the statement of financial position (Statement of Financial Position) to be prepared quickly. The use of control accounts may also reduce the incidence of fraud as control accounts provide an internal check on the sales/purchases ledger.

6.4 Sources of information for control accounts

The information for constructing each control account is taken from both the personal accounts of trade debtors and creditors, as well as from the main daybooks/books of original entry. The table below summarises, information for the construction of a debtors control a/c.

Trade receivables/debtors control a/c

Information	**Source**
Opening debtors balances	Trial balance and Debtors account in the sales ledger
Credit Sales	Sales day book
Returns Inwards	Returns inwards day book
Money received from customers	Cash book
Discounts allowed	Cash book
Refunds to debtors	Cash book
Bad debts written off	General journal
Interest charged on overdue a/c	General journal
Discount disallowed/withdrawn	General journal
Other charges	General journal
Closing balance of debtors	Debtors accounts in the ledger

Trade Payable/Creditors control a/c

Information	**Source**
Opening balance of creditors	Trial balance and creditor accounts in the ledger
Credit purchases	Purchases day book
Returns outwards	Returns outwards day book
Money received from customers	Cashbook
Discounts received	Cashbook
Refunds from creditors	Cashbook
Interests charged on overdue a/cs	General journal
Other charges	General journal
Closing balance of creditors	Creditors accounts in the ledger

Layout of control Accounts

A control account takes the appearance and form of the personal accounts it controls with the amount relating to purchases and sales, returns discounts and payments made and received, among other things being recorded in the control account on the same sides as the personal accounts, as shown below.

Sales Ledger Control account

Debtors balances b/d	xxx	Cash and Cheques received from debtors	xxx
Credit Sales	xxx	Returns Inwards	xxx
Interest charged on		Discount allowed	xxx
Overdue accounts	xx	bad debts written off	xxx
Dishonoured cheques	xxx	Set offs/contra entries	xxx
		Cash/bank recovered from bad debts	
		Balances owed by debtors c/d	xxx
Bad debts recovered	xxx		
Refunds to customers	xxx		
Balance owed to debtors c/d	xx		
	xxx		xxx
Debtors balances owing b/d	xxx	Balances owed to debtors b/d	xxx

6.5 What not to include in the sales ledger control account

1. Cash Sales- the control account only controls the accounts of debtors who buy on credit. Cash sales are therefore not recorded in the debtors account but are posted from the cashbook to the general ledger, sales account and not the debtors account.

2. Provisions for bad and doubtful debts as well as provisions for discounts allowed- provisions do not affect the control account as they are posted from the general journal to the general ledger
3. Trade discounts- these are never recorded in any books of accounts as the total sales recorded are net of the trade discount calculated on the sales invoice.

NB: The sales ledger control account only controls the debtors ledger, therefore balances which are posted to the general ledger and not the sales ledger will not affect the sales ledger control account. This understanding of this concept is necessary to enable you to correct errors affecting the control account and the reconciliation of the ledger it controls.

Purchase ledger control a/c

Cash & Bank payments		Balances owed to creditors b/d		xxx
Made to creditors	xxx	Credit Purchases		xxx
Returns outwards	xx	refunds from creditors		xxx
Discounts received	xx	Interest charged by		
Sets offs/ contra entries	xxx	Suppliers on overdue a/cs		xxx
Balances owed by us		Dishonoured cheques		xxx
To creditors c/d		Balances owed to us by		
		creditors	c/d	xx
	xxx			xxx
Creditors balances owed to		Creditor balances owed		
Us b/d		xx to them b/d		xxx

NB: Cash purchases are not recorded in the creditors control account as they do not pass through the purchases ledger but go through the general ledger. The creditors control account only controls that section of the ledger- the purchases ledger.

Set offs or contra Entries

Sometimes in business it happens that some firms have customers who are also suppliers e.g. where the electricity company ZESA is a customer of the local authority which supplies it with water. There is inter-trading between these two companies and at the end of each month the local authority owes ZESA money for electricity and ZESA owes the local authority money for water supplies. In such an instance, it makes more sense to offset these accounts against each other, and the company owing the other more money then gets to write a cheque for the difference owed, rather than have both companies sending cheques to each other. If ZESA owes the local authority $30 and the local authority owes ZESA $50, it is sensible for the local authority to offset the $30 owed by ZESA and only write out a cheque to ZESA for $20. This offsetting is in full settlement of both debts by ZESA to the local authority and local authority debts to ZESA.

NB: Set offs appear in both control accounts as follows:

- In the sales ledger control account- on the credit side
- In the purchase ledger control account- on the debit side and the amount in both accounts are the same.

6.6 Control accounts with balances on either side.

Sometimes a control account may have both a debtor and credit balance either at the beginning of a period end of a period, or in both instances. It is important to note that in each case, the debtor balance always represents debtor balances i.e. those balances owed by outsiders to the business, even if its in a purchases ledger control account as anything owed by creditors constitutes debtors. On the other hand, the credit balances in either control account will represent monies owed by the business to the outside world i.e. creditors, including a credit balance on the debtors control account.

6.7 Reasons for a credit balance in a debtors control account.

A debtors control account will usually carry a debit balance at the end of a given accounting period, which represents amounts owed by debtors. However it can happen that the debtors control account will have both a debit and credit balance, usually the credit balance being smaller. The credit balance in a debtors control account may arise because of any of the following reasons:

i) A customer could have over paid his account and this over payment cannot be offset against other customers' outstanding balances.
ii) A customer may have not been refunded for goods returned to the business after he had paid for them in full.
iii) Customer paid for the goods in advance.
iv) Error of commission where a payment posted is made to a wrong debtor
v) Discount allowed was not taken into account when the account was settled.

Reasons for a debit balance in a creditors control account

A creditors/purchases control account generally carries a credit balance but may sometimes carry a debit balance due to the following reasons.

i) Goods are returned to a supplier after the account has been settled, thus the supplier owes the business to the value of goods returned.
ii) The account of the creditor has been overpaid
iii) Discount received was not taken into account when the account was settled.

Example in the preparation of simple control accounts

The following relates to the books of Ann Brooks

	$
Total Creditors on 1 April 2003	7 241
Total debtors on 1 April 2003	12 437
Credit Sales	16 483
Cash Sales	5 122
Credit purchases	11 312
Cash purchases	1 219
Cash paid to creditors	14 120
Cash received from debtors	13 166
Discounts received	896
Discounts allowed	649
Returns Inwards	543
Returns outwards	714

Required

Prepare

i) The debtors control account for the month of April 2003
ii) The creditors control account for the same month

Debtors Control a/c

	$		$
April 1 Balance b/d	12 437	April 30 Bank	13 166
30 sales	16 483	Discount allowed	649
		Returns inwards	543
		Balance c/d	14 562
	28 920		28 920
May 1 Balance b/d	14 562		

Creditors Control a/c

	$		$
Apr 30 Cash	14 120	April 1 Balance b/d	7 241
Discount received	896	30 Purchases	11 312
Returns outwards	714		
Balance c/d	2 823		
	18 553		18 553
		May 1 Balance b/d	2 823

NB: The debit balance on the debtors control account generally reflects amounts owed by debtors to the business i.e. an asset and the credit balance on the creditors control account reflects amounts by the business to trade creditors i.e. a liability.

Exercise 1

The following information has been obtained from the books of Claudia fashions Ltd for the month of October 2011.

		$
Sales ledger balances on 1 October	6 483	
Purchases ledger balance on 1 October	3 241	
Receipts from customers	27 486	
Payments to suppliers		22 107
Sales		29 212
Purchases		25 243
Returns Inwards	1 420	
Returns Outwards		1 324
Bad debts written off		528
Discounts allowed		888
Discounts received		783
Sales ledger balances on 31 October		?
Purchases ledger balances on 31 October		?

Required

i) Prepare the sales ledger Control account and

ii) The Purchases Ledger control account for the month of October 2011 from the above information.

iii) Explain the meaning and use of the sales ledger balance and purchases ledger balance on 31 October.

6.8 Control accounts as memorandum records

Where the control account is not kept as part of double entry, it is used as a check on the arithmetical accuracy of the sales and purchases ledger. In this case, the control accounts would be known as memoranda records as they are simply there as a back up to the normal double entry system and the users derive the benefits emphasised below. However, where the sales and purchases ledgers are not maintained and the control account is used to complete double entry, the control account is not regarded as a memoranda record but the sales and purchases ledgers would be as they would not be used for the completion of double entry. Examination questions often assume that the sales and purchases ledgers are maintained as part of the double entry system and the control accounts are only kept as memoranda records.

Exercise 2

The following information has been extracted from the books of Tight Controls Ltd for the month of September 2011.

$		$
1 September 2011: Sales ledger balances- debit		32 600
-Credit		840
1 September 2011: Purchases ledger balances- debit		987
	Credit	18 416
Transactions during the month of September:		
Purchases day book total		86 000
Sales day book total	107 500	

Returns inwards day book total	2 400
Returns outwards day book total	5 720
Cash book receipts from customers	99 150
Cash book payments to suppliers	73 212
Discounts received	1 800
Discounts allowed	3 400
Dishonoured cheques from debtors	4 200
General journal: Bad debts written off September	2 600
Bad debts (2010) recovered in 2011)	1 650
Sales ledger balances set off against	
Purchases ledger balances	5 500
On 30 September debit balances in the purchases ledger	6 120
Credit balances in the sales ledger	4 400

Note:
Bad debts recovered in September 2011 have been included in cash receipts form customers.

Required:
Prepare the Purchases Ledger and Sales Ledger control accounts of Tight controls Ltd for the month ended 30 September 2011.

6.9 Advantages and Uses of Control accounts

1. Control accounts make the detection and correction of errors easier as they help to identify the ledgers in which errors may have been made.
2. They are used to check the reliability and accuracy of all postings made to the personal ledgers, thus control accounts provide an independent check on the entries in the sales and purchases ledger as the balance on control account must equal the total of balances in the ledgers they control.
3. Control accounts can be kept by a person who is not the same person who maintains personal accounts of debtors and creditors. This segregation of duties helps in the prevention of fraud and increases the likelihood of errors being discovered
4. Control accounts allow the quick calculation of debtors and creditors totals enabling a trial balance and data for final accounts to be prepared quickly.

6.10 Limitations of Control Accounts.

1. Not all errors in the ledgers will be revealed by the preparation of a control account as control accounts do not guarantee the accuracy of individual ledger accounts where errors such as compensating errors, errors of omission, commission, original entry will not be revealed.
2. Control accounts may themselves contain errors thus compromising their reliability.

6.11 Control accounts and errors

It sometimes happens that the control account balance does not agree with the list of balances extracted from the ledger it controls. In such a case, the reasons for the non-agreement must be found and the necessary corrections made. This is known as reconciling the control accounts.

Reasons for non-agreement between the control account and the list of balances.

	Error	Correction Required
i)	Item correctly recorded in book of original entry and correctly posted to the personal account but no entry made in the control account	amend the control a/c
ii)	Item correctly recorded in book of of prime entry, correctly posted to the personal account but incorrectly recorded in the control a/c.	amend the control a/c
iii)	Item correctly recorded in book of prime entry and correctly entered in the control account but not posed to the personal account.	amend list of balances
iv)	Item correctly recorded in book of Prime entry, correctly entered in control Account but incorrectly posted to the Personal account.	
v)	Item correctly posted to a personal Account but not entered in the book of prime entry.	amend control account
vi)	Item correctly posted to a personal Account but entered incorrectly in Book of prime entry.	amend the control a/c
vii)	A book of prime entry is incorrectly Cast i.e. under cast or overcast	amend the control a/c
viii)	A personal account balance is incorrectly Cast	amend list of balances
ix)	A correct personal account balance is listed incorrectly	amend list of balances
x)	A personal account balance is omitted from the list of balances.	amend list of balances

Summary points to remember on the correction of errors and reconciliation of the control account and the list of balances.

1. Because a control account is prepared from books of original entry, if a total in the book of original entry is incorrect, the control account will also be incorrect as totals are posted from the books of original entry to the control account. However the sales or purchases ledgers will not be affected as individual entries are posted there thus a casting error in a book of original entry will not affect the personal ledgers
2. If an item is posted incorrectly from the book of original entry to the personal ledger, the list of balances will be incorrect and therefore will need amending but the control account will be correct.
3. If an item is incorrectly entered in the book of original entry, the error will be reflected in the personal ledger and the control account. Both records will be equally wrong and the control

account will not reveal the error. However, once the error is discovered, both the personal ledger and the control account will need to be corrected.

If an item is omitted form the book of original entry (error of omission), it will not appear in both the personal ledger and control account and so the control account cannot reveal the error. Once discovered however, the control account and the personal ledger will have to be amended.

An example on the correction of errors and reconciliation of the control account to the ledger below.

At the end of the month of January 2011, a routine comparison showed that the trade receivables (debtors ledger) control account balance amounted to $7 795 and the schedule of debtors in the ledger totaled $7 591. An examination of the books revealed the followed errors.

1) Discounts allowed $103 had been entered correctly in all other accounts except the control account where the balance had been omitted.
2) The returns inwards day book had been overcast by $97
3) A credit customer A Rinamonzi, had been credited with goods returned valued at $172 but no entry had been made in the returns inwards day book
4) Janice's account had been overcast in the ledger by $127 whist that of Tonderai had been under-cast by $153.

Required

i) Prepare a statement amending the trade receivables (debtors) balance.
ii) Prepare an amended sales ledger control account.

Solution

i) Statement amending schedule of debtors

	$
Original balance in the sales ledger	7 591
Less Janice overcast	127
	7 464
Add Tonderai undercast	153
Amended Sales ledger balance	7 617

ii) **Amended sales ledger control a/c**

	$			$
Balance b/d	7 795	Discounts allowed omitted		103
Sales returns	97	Returns inwards		
		Omitted		172
		Balance	c/d	7 617
	7 892			7 892
Balance b/d	7 617			

Exercise 3

The following has been extracted from the books of Howard Ltd at 31 December 2012

	$
Total purchases ledger balances	640 (dr)
	72 170 (cr)
Purchases ledger control account	78 470 cr)

The following errors have been discovered.

1. An invoice for $1 000 has been entered twice in the purchases day book.
2. A total of $840 has been omitted from both the discount received account and the purchases ledger control account.

3. A debits balance of $500 has been entered in the list of purchase ledger balances as a credit balance.
4. An amount of $7 100 owing to Thandiwe, a supplier has been offset against her account in the sales ledger but no entry has been made in the creditors control account.

Required

a) Prepare a statement correcting the purchase ledger balances
b) Prepare a corrected purchases ledger control account
c) Show how the balances pertaining to creditors would be reported in the Statement of Financial Position (Statement of Financial Position).

Note: **Where the ledger has both a debit and a credit balance, these balances are corrected independently. The smaller balance is not offset against the bigger one.**

Solutions to exercises

Exercise 1

Sales Ledger Control a/c

i)	Oct 1 Balance b/d	6 483	Oct 31 Cash & Bank	27 486
	31 Sales	29 212	Ret. Inwards	1 420
			Bad debts	528
			Disc allowed	888
			Balance c/d	5 373
		35 695		35 695
	Nov Balance b/d	5 373		

Purchase Ledger Control a/c

		$		**$**
ii)	Oct 31 Cash & Bank	22 107	Oct 1 Balance b/d	3 241
	Ret. Outwards	1 324	Purchases	25 243
	Discount reed	783		
	Balance c/d	4 270		
		28 484		**28 484**
			Nov 1 Balance b/d	4 270

iii) The sales and purchases ledger balances at the end of the month represent amount owed by debtors and amounts owing to creditors respectively. These figures are used in the extraction of a trial balance as well as in the preparation of a Statement of financial Position (Statement of Financial Position) at the end of a trading period as Trade receivables (debtors) from the sales ledger control account and as Trade Payables (creditors) from the Purchases Ledger control account.

Exercises 2

Purchases Ledger Control

2011	$	2011	$
Sept 1 Balance b/d	987	Sept 1 Balance b/d	18 416
30 Returns Outwards	5 720	30 Purchases	86 000
Cash + Bank	73 212	Balance c/d	6 120
Disc recieved	1 800		
Set-off	5 500		
Balance c/d	23 317		
	110 536		110 536
Oct 1 Balance b/d	6 120	Oct 1 Balance b/d	23 317

Sales Ledger Control a/c

2011	$	2011	$
Sept 1 Balance b/d	32 600	Sept Balance b/d	840
30 Sales	107 500	30 Returns Inwards	2 400
Dishonoured cheques	4 200	Cash & Bank	99 150
Bad debts recovered	1 650	Discount-allowed	3 400
Balance c/d	4 400	Bad debts	2 600
		Set off	5 500
		Balance c/d	36 460
	150 350		150 350
Oct 1 Balance b/d	36 460	Oct 1 Balance b/d	4 400

Exercise 3

a) **Statement correcting the Purchases Ledger balances**

		Dr $	Cr $
Original balances		640	72 170
Less (1)	Duplicated invoice		(1 000)
(3)	Dr Balance incorrectly listed as credit	500	(500)
Corrected purchases ledger balances		140	70 670

b) **Amended Purchases Ledger Control a/c**

Dec 31 1 duplicated invoice cancelled	1 000	Dec 31 Balance b/d	78 470
Discounts received	840	Balance c/d	1 140
Set-off	71 00		
Balance c/d	70 670		
	79 610		79 610
Jan 1 Balance b/d	1 140	Jan 1 Balance b/d	70 670

c) Statement of financial Position extract Current assets)

Current assets

Debtors-Purchases ledger		1 140

Current liabilities

Trade Creditors- purchases ledger	70 670	

6.12 Examination type questions

6.13 Multiple choice questions

1. A business provides the following information:

	$
Opening creditors	20 000
Cash paid to creditors	110 000
Purchases on credit	120 000
Balances set – off against sales ledger	2 000
Discount received	3 000

What is the closing creditors balance?

A. $31 000
B. $30 000
C. $29 000
D. $25 000

2. A credit balance on Sibanda's account in a firm's debtor's ledger means that…

A. The amount owed by Sibanda is a bad debt.
B. One or more of Sibanda's cheque has *'bounced'.*
C. The firm owes Sibanda some money.
D. A provision should be made specifically against Sibanda's account.

3. A trial balance at 30 April 2003, before making end of year adjustments, showed:

	Debit	**Credit**
Trade debtors	35 600	
Provision for credit loses		1 160

At 30 April 2003 it was decided to write off a bad debt of $1 600 and to make a Provision for credit loses of 2% of trade debtors. During the year an amount of $400 was received from a customer relating to a debt that was written off in the year ended 30 April 2002. What was the total bad and doubtful debts expense for the year ended 30 April 2003?

A. $720
B. $1220
C. $1880
D. $2280

6.14 Structured questions

Question 1

The following information relates to the books of Martin Moyo in the month of August 2005. He maintains total accounts as part of his double – entry system.

	$
Balances on debtors accounts as at	
1 August 2005 : Debit	124 740
Credit	1 800
Balances on creditors' accounts as at 1 August 2005	81 060
Credit sales invoiced during the month	140 850
Invoices for goods purchased during the year	79 140
Contra settlements between customers' and suppliers accounts	2 250
Cash sales during the month	42 250
Cash paid to suppliers for credit transactions	75 780
Cash discounts deducted from payments to suppliers	1 770
Provision for credit loses at 1 August 2005	2 850
Customers' balances written off as bad during August	1 350
Goods returned to suppliers	1 860
Credit notes issued to customers for goods returned	3 660
Cash received from credit customers in full settlement of debts totaling $126 690	124 890
Cash at bank on 31 August	15 300
Debit balances on suppliers accounts at 31 August 2005	690
Credit balances on customers' accounts at 31 August 2005	360

a) Using much of the above data as is relevant, prepare debtors total account and a creditors total account, both for the month of August 2005. [18]

b) Explain the ways in which control accounts can be of use to the management of the business. [7]

Question 2

A company maintains control accounts as a way of improving their internal control system. The following information is available from the books of the company for the year ended 30 June 2004.

	$
Sales ledger balances at 1 July 2003	211 120
Credit sales for the year	6 595 680
Credit sales returns	79 240
Cash and cheques received from credit customers	5 970 160
Cash sales	59 780
Interest charged on customers' overdue accounts	46 760
Bad debts recovered during the year	16 940
Debit balances transferred to the purchases ledger	52 920
Bad debts written off	32 340
Discounts allowed to credit customers	39 480

(a) From the data given above, prepare the Sales Ledger Control Account for the year ended 30 June 2004.

(b) The total of the balances in the Sales Ledger at 30 June 2004 amounted to $654 300 which does not agree with the closing balance on the control account.

<u>Investigations revealed the following errors:</u>

1. A credit sale of $45 600 had been recorded in the sales journal as $46 500.
2. The total of the discounts allowed column in the cash book had been under cast by $14 000.
3. A sales ledger account had been overstated by $16 800.
4. A debit balance of $2 940 had been set off against a balance in the purchases ledger but no entry had been made in the control account for this item.
5. A debit balance of $44 940 had been omitted from the schedule of debtors.
6. The total of a page in the sales journal had been carried forward as $35 000 when the correct amount was $53 000.
7. A receipt of $8 680 had been recorded in the bank account but omitted from the customers' account.
8. A debtor owing $6 720 had been declared bankrupt. The customer's account was closed but this debt had not been written off in the control account.

You are required to:

(i) Starting with the balance brought down in your answer to (a), prepare an amended sales ledger control account and balance it off.

(ii) Draw up a statement reconciling the amended sales ledger control account balance with the total of the sales ledger.

(iii) Explain the purpose of control accounts and outline the benefits that accrue from maintaining a control account system.

Question 3

The following figures appeared in the purchase ledger control account of XY Ltd Co. on 30 April 2006.

	$
Creditor balances 1 May 2005	73 692
Debtor balances 1 May 2005	2 296
Discount received	13 699
Purchases	1 933 540
Payments to Creditors	1 812 804
Purchases returns	21 812
Cash refunded from creditors	1 834
Bills payable	7 826
Debtors balances 30 April 2006	2 933
Contras: Sales Ledger	5 488

The control account creditor balance at 30 April 2006 failed to agree with the total of the list of balances of creditors extracted from the purchase ledger. Subsequent examination revealed the following errors.

i) Goods returned to a supplier valued at $574 had been correctly entered in the creditor's account but entered in the purchase returns account as $1 274.

ii) Discount received for the month of $959 had been posted to the debit instead of the credit side of the discount received account.

iii) An item of $1 302 in the purchases day book had been posted to the creditor's account as $1 176.

iv) The purchase day book had been under cast by $1 400.
v) Discount received of $196 had been entered in the cash book and discount received account but not in the creditor's account in the ledger.
vi) A credit balance of $1 232 on the account of a creditor had been omitted from the list of creditor's balances.

REQUIRED

a) Show how the control account would appear in the ledger before making any corrections.
b) Prepare a statement showing the adjustment of the balances in the control account in (a) above to the correct balance, giving details of the errors.
c) Prepare a statement reconciling the corrected balance with the totals as shown by the list of balances before the errors were found, giving details of the relevant errors.

CHAPTER 7

INCOMPLETE RECORDS

7.1 Chapter objectives

1. Define incomplete records.
2. Outline the features of incomplete records.
3. Distinguish between a statement of financial position (Balance sheet) and a statement of affairs .
4. Calculate profit or loss using a statement of affairs.
5. Prepare a Statement of comprehensive income and a statement of financial position from incomplete records.
6. Find the missing figures and information by preparing relevant accounts.
7. Outline the limitations of incomplete records.

7.2 Introduction

Dr. Edward Chamisa in his Book Principle of accounts define incomplete records as a situation where the transactions of a business have not been recorded using the concept of double entry system.

This can also be defined as any system that falls short of the complete double entry method of accounting is called single entry system.
In practice businesses are forced to prepare financial statements when required to do so for tax purposes or when required by the bank when seeking a loan or an overdraft facility.
It is a defective double entry system which is commonly found among many small size business enterprises This may be due to an entire lack of records or if the records are there, they are insufficient to facilitate the preparation of final accounts. Single entry is therefore a mechanism of maintaining records whereby some transactions are either one – sided or no entry is made at all. As a general rule, under the single entry practice only the personal aspects of transactions are recorded, i.e. the personal accounts of debts and creditors are maintained and the nominal and real aspects, i.e. information relating to expenses and revenues, assets and liabilities are partially recorded or omitted altogether.

7.3 Features of Incomplete records

Incomplete records may be due to partial recording of transactions prevalent among small –scale enterprises such as vendors , grocers etc. In the case of large organisation, incomplete records could be a result of natural disasters such as earthquakes and floods as well as unfortunate occurrences such as theft or fire. The features outlined below characters incomplete records.

i) It is an unsystematic and unscientific method of recording transactions.
The single entry system is unsystematic and unscientific. It does not have any set of fixed rules and principles for recording and reporting financial transactions.

ii) It is an incomplete system of keeping records. Generally records of cash transactions and personal accounts are kept and maintained properly but there is no information regarding revenue and gains, expenses and losses as well as assets and liabilities.

iii) It violates the business entity concept
Personal transactions of the business owners may also be recorded in the cash book.

iv) Lack of arithmetical accuracy

Single entry is not based on the principles of double entry and it therefore fails to prove the arithmetical accuracy achieved through the extraction of a trial balance.

v) It does not reflect true profit or loss.
The true amount of profit or loss cannot be ascertained in single entry accounting as the system generally does not maintain nominal accounts. To ascertain profit or any other information one has to depend on source documents.

vi) It does not reflect the true financial position. The single entry generally does not maintain real accounts and therefore it cannot reveal the true financial position of an entity which is achieved through the preparation of a statement of financial position.

vii) Frauds and errors cannot be easily be detected. As the single entry system of book –keeping is incomplete, inaccurate and unscientific, it does not help to check the arithmetical accuracy of the books of accounts and it also makes it difficult to detect fraud.

viii) Single entry is unacceptable for tax purposes because the single entry method of book-keeping has incomplete records of business transactions; it is not acceptable for a tax assessment to be made based on such records.

7.4 Reasons for Incomplete records.

i) Lack of knowledge, skill and expertise on the preparation and maintenance of accounting records using double entry and other accounting principles.

ii) It may not be economical for the business to maintain accounting records using double entry due to the volume and nature of transactions. The cost of maintaining accounting records in single entry is low as specialist accountants are not appointed.

iii) Deliberate omission to maintain records to evade tax or conceal fraud.

iv) Inability to maintain proper business records because of the time, effort and cost involved.

v) Convenience of the business owner who may only wish to record only the important transactions according to the nature of business.

vi) Loss of records through fire, theft, natural disasters or where records have been misplaced.

7.5 Limitations of Incomplete Records

Incompleteness of accounting records on its own is a disadvantage. Other disadvantages are:

i) As double entry is not followed, a trial balance cannot be prepared and therefore the arithmetical accuracy of transactions recorded in the books cannot be checked.

ii) Internal checks cannot be enforced and this increases the chances of cheating and fraud.

iii) The results of business operations cannot be ascertained and evaluated thus making it difficult for future decisions concerning the business to be made.

iv) Analysis of profitability, liquidity and solvency of the business cannot be done. This may make it difficult to borrow from outside who are interested in assessing the said aspects of the business.

v) Problems may arise with tax authorities who may not be convinced about the reliability of the computed income.

7.6 Purpose of preparing Final accounts

It is necessary and important **to know the results of trading** in order **to evaluate the efficiency, failure or success of an entity.** This is achieved when final accounts are prepared. Final accounts disclose.

a) The profit or losses made by the firm during a given period and this is evaluated in the Statement of comprehensive income.
b) The amount of assets and liabilities as at the end of the financial period as shown by the Statement of financial position.

All business organisations need to evaluate this important information, even those organisations with incomplete records. Problems faced by entities which have incomplete records are those of ascertaining the profit or loss for an accounting period as well as that of determining the financial position of the entity. This problem can be solved by

i) Preparing a statement of Affairs at the beginning and at the end of an accounting period and then using the Balance sheet equation to ascertain the profit or loss, called the net worth method.
ii) Putting the records in order so as to prepare a full set of final accounts, called the conversion method.

7.7 Ascertaining profit or loss through the use of a statement of Affairs.

A statement of affairs is a statement of financial Position prepared from Incomplete records. In order to ascertain profit or loss using this method, statements of the financial period are prepared to ascertain the change in owner's equity at the end of the accounting period. The difference between the total assets and liabilities is the capital or owner's equity. The difference between owner's equity at the opening and closing dates represents the increase (profit) or decrease (loss) made in the financial period. The problem with incomplete records is that of missing information which varies from question to question. As a result, it is not possible to prescribe the specific accounting technique to use in every situation.

The following steps are to be taken to ascertain profit or loss.

Step 1

Calculate owner's equity at the beginning and at the end of period by using the balance sheet equation:
Capital =Assets – liabilities

Step 2

Subtract the opening balance of owner's equity from the closing balance of owner's equity and the difference may be positive or negative.

Step 3

i) Where the owner has put in additional capital, subtract the amount of capital introduce during the period from the amount calculate in step 2.
ii) Where the owner has made withdrawals and the amount of the withdrawals made by the owner during the period to the amount calculated in step 2.

Step 4

If the net result is positive, it represents profit and if it is negative, it represents a net loss.

Once the amount of capital, both at the beginning and at the end is computed with the help of a statement of affairs profit or loss is prepared to ascertain the exact amount of profit or loss made during the years, as illustrated below.

Proforma Statement of profit or loss for the year ended........

Capital as at year end (from Statement of Affairs in step 1)	xxx	
Add drawings during the year (Step 3)		xxx
Less additional capital introduced during the year step 3		xxx
Adjusted capital as at year end		
Less Capital as at the beginning of the year (step2)		
(from Statement of affairs at start of year step 1)	xxx	
Profit or loss made during the year	xxx	

The same computation can be done in the form of an equation as follows:

Profit or loss = Capital at end **less** Capital at the beginning plus drawing the year **less** Capital introduced during the year.

Example 1

The following information was extracted from the records of Getrude

	$
Capital at the beginning of the year 01.01.11	640 000
Capital at the end of the year 31.12.11	1 800 000
Capital brought in by Getrude during the year	120 000
Withdrawals by Getrude during the year	70 000

Required

Calculate the profit earned or loss incurred by Getrude during the year ended 31 December 2011

Solution

Statement of profit or loss for the year ended 31 Dec 2011

		$
Closing Capital		1 800 000
Add Drawings during the year		70 000
		1870 000
Less additional capital introduced	120 000	
Adjusted capital at year end		1750 000
Less Capital at beginning of the year		640 000
Profit made during the year		1110 000

Example 2

Andrew opened a carpentry shop on 1 July 2011 with a capital of $80 000. He did not maintain a full set of accounts using double entry.

During the year he injected further capital of $25 000 and withdrew $8 000 for personal use. On 30 June 2012 his assets and liabilities were as follows:

Trade payable $110 000, Trade receives $160 000. Inventories $42 850, Cash at Bank $36 127

Calculate the profit or loss made by Andrew in his first year of trading.

Suggested Solution

Step 1

Statement of Affairs as at 30 June 2012

Assets:	$
Trade Receivables	160 000
Inventories	42 850
Cash at bank	36 127
	238 977
Less liabilities	
Trade payables	110 000
Closing Capital	128 977

Step 2

Statement of Profit or Loss for the year ended 30 June 2012

Closing Capital		128 977
Add drawings		8 000
		136 977
Less Opening capital introduced	25 000	
Adjusted Capital as at 30 June 2012	111 977	
Less Opening Capital		80 000
Profit made during the year		31 977

Exercise 11

Belinda Kadriya runs a small secretarial services shop where she types prints and binds documents. She maintained basic records she thinks are sufficient for her business. On 1 April 2010 she had the following assets and liabilities:

Photocopiers $18 000, Building $12 000 inventory of printing material $4 000 Cash at bank $7 300, cash in hand $820, accrued wages $640. Belinda withdrew $150 every moth to meet her personal expenses .She had also introduced $5 800 during the year as additional capital On 31 March 2011, her position was as follows "

photocopiers $ 22 000, Buildings $12 000 inventory of printing material $7 000, Cash at bank $4 750, Cash in hand $2 145, Trade receivable $1120, Trade payables $832.

Using the statement of Affairs method, calculate the profit made by Belinda Kadriya during the year ended 31 March 2011.

Defence between statement of Affairs & Statement of financial Position

- A statement of Affairs is prepared from incomplete records where values for most assets and liabilities are based on estimates. A statement of financial Position (Balance Sheet) on the other hand is prepared from records maintained on the double entry principle and all assets and liabilities can be verified in the ledger accounts. A Statement of Financial position is therefore more reliable than a statement of affairs.
- The objective of preparing a statement of Affairs is to ascertain capital as at that date whereas the objective of preparing a statement of financial position is to determine the financial position of the entry as at that date.
- In a statement of affairs, an item of assets or liabilities may be omitted and this omission may remain unnoticed as the effect of the omission gets adjusted in the capital account balance which is derived as a balancing figure. In a statement of financial position, the possibility of omission of any item is remote because the statement of financial position will not agree thereby forcing the accountant to investigate the cause of the imbalance.

<u>The difference between a statement of Affairs and a Statement of Financial position</u> has been summarised

Basis of difference	Statement of affairs	Statement of financial position
Reliability	- Less reliable as it is prepared from incomplete records.	- More reliable as it is prepared from double entry from double entry records.
Objective	- To estimate the balance on the capital account at a given date.	- To show the true financial position of an entry at a given date.
Omission & error	- Omission of assets and liabilities as well as error in calculation cannot be discovered easily	- Omission + errors in recording assets and liabilities can be discovered easily and traced to accounting records

7.8 *Preparation of Financial Accounts from Incomplete Records.*

To prepare a proper Statement of comprehensive income and a statement of financial position, one needs complete information regarding expenses and incomes, assets and liabilities, where a system of double entry is in force, the information is obtained from a trial balance. In cases of incomplete records, certain balances have to be ascertained in an indirect manner as the records often do not contain such balances which among others include

Opening capital,

Credit purchases

Credit Sales

Payment to trade Creditors

Receipts from trade debtors cash drawings and any other cash / bank related items.

When dealing with incomplete records; there is a need to obtain as much information as possible about the assets and liabilities at the beginning and end of the financial period. The values of fixed assets may be ascertained from the purchase documents. A determined effort has to be made to obtain information from various source documents, together with the use of detailed information about the various business activities. If details of trade debtors and creditors, cash received, sales and cash summary of transaction are available, it may be possible to work out some of the missing figures by using the logic of double entry accounting.

7.9 Ascertaining credit purchases and Trade Creditors as well as credit sales and trade debtors

The credit purchases and credit sales are not usually available from the incomplete records. It is also quite possible that some other information relating to trade creditors and trade debtors may also be missing. Missing information pertaining to credit purchases and credit sales and any item relating to trade debtors and creditors can be obtained by preparing control accounts as the balancing figure. If the missing figure is credit sales or credit purchases, it is then ascertained using the control account. To get the total value of purchases one has to add the credit Purchases from the control account to the cash purchases in the cashbook, and do the same with credit and cash sales in order to get total sales.

Example 3

M. Myself did not keep proper books of accounts. The following information relating to debtors and creditors is available.

	$
Opening debtors	61 089
Opening creditors	46 146
Sales returns	369
Cash paid to suppliers	44 685
Discounts received	321
Discounts allowed	603
Cash received from customers	39 450
Returns outwards	201
Bad debts written off	69
Set offs	300
Closing debtors	58 158
Closing creditors	28 164

You are required to compute missing figures for credit sales and credit purchases.

Solution

Sales Ledger control a/c

Debtors b/d	61 089	Returns inwards	369
Credit sales (bal Fig)	37 860	Cash	39 450
		Discount allowed	603
		Bad debts	69
		Set off	300
		Debtors c/d	58 158
	98 949		98 949
Debtors b/d	58 158		

Purchase ledger Control A/c

Cash	44 685	Creditors b/d	46 146
Discounts received	321	Purchases (Bal Fig)	27 525
Returns outwards	201		
Set off	300		
Creditors	28 164		
	73 671		73 671
		Creditors b/d	28 164

Use of mark- up and margin to determine sales and purchases

At times the information provided is scanty and not adequate to prepare control accounts. The mark up – margin relationship can be used to determine sales and purchases. Mark- is simply profit expressed in terms of cost of sales e.g. x% of purchases found by the equation.

$$\frac{\text{Net profit}}{\text{Purchases}} \times \frac{100}{1}$$

Margin, on the other hand is profit expressed in terms of selling price i.e to say x% of sales and is found by the equation

$$\frac{\text{Net profit}}{\text{Sales}} \times \frac{100}{1}$$

At times the examiner can give you information relating to the selling price and may relate the profit to a mark up. You then have to be able to convert the mark up to a margin so that you can apply it to the sales. Conversely, you have to be able to convert the margin to a mark up as well.

Converting mark up to a margin and margin to mark up

In order to convert a mark-up to a margin, the numerator does not change but in order to get the margins denominator, add the value of the numerator to the value of the denominator to the value of the mark-ups denominator as shown below.

Mark up	**margin**
$20\% = \frac{20}{100} = \frac{1}{5}$	$\frac{1}{5+1} = \frac{1}{6}$

Margin	Mark up
$25\% = \frac{25}{100} = \frac{1}{4}$	$\frac{1}{4-1} = \frac{1}{3}$

In order to convert a margin to a mark – up, the numerator remains the same. To derive the denominator of the margin, subtract the numerator of the margin from the denominator as shown above.

Note it is important to realise that once mark up is mentioned, it needs to be applied to cost and once margin is oriented, it needs to be applied to sales.

Example 4

The following information is obtained from the books of a business

Purchases	\$285 000
Opening stock	\$15 000
Closing stock	\$12 000

Margin is 20%

Required: Find the sales

Solution	**$**
Opening stock	15 000
<u>Add</u> Purchases	285 000
	300 000
<u>Less</u> closing stock	<u>12 000</u>
Cost of sales	288 00

= Margin = 20% = 1/5

Mark up = $\frac{1}{5-1} = \frac{1}{4}$

Sales = Cost + Profit

= 288 000 + (1/4 x 288 00)

= 288 00 + 72 000

= 360 000

Proof (margin = 20% of sales

= 20% x 360 000

= 72 000

<u>Example 5</u>

Sales	$540 000
Opening stock	$ 80 000
Closing stock	$ 54 000

Mark up is 20%

Required: Find purchases.

<u>Solution</u>

Mark up margin

$$20\% = \frac{20}{100} = \frac{1}{5} \qquad \frac{1}{5+1} = \frac{1}{6}$$

Profit = 540 000 x 1/6

= 90 000

Purchases = Sales – Profit

= 540 000 – 90 000

= <u>450 000</u>

<u>Using the receipts and payments Accounting to determine missing information</u>

The receipts and payments account is essentially a summary of the cashbook.

All monies paid out and received are recorded here just like in the cash book.

It can be used to determine amounts stolen, cash drawings or any other cash related balance of which no record exists.

<u>Example 6</u>

Another, a general dealer has not kept proper books of accounts. He wishes to establish the amount of drawings he has from the business throughout the year. He supplies you with the following information:

		$
Cash at bank and in hand	31 Dec 2011	2 400
" " " "	1 Jan 2011	700
Cash sales		28 000
Receipts from debts wages		6 000
Purchases of fixed assets		4 000
Purchases of stocks		18 000
Rent		1 200

A. Another assures you that the above is a strict record of business transactions which he recorded accurately throughout the year.

Receipts and Payments a/c for the year ended 31 Dec

	$		$
Balance b/d	700	Wages	6 000
Cash sales	28 000	fixed assets	4 000
Receipts from debtors	3 500	Purchases	18 000
		Rent	1 200
		Drawings (bal fig)	600
		Balance c/d	2 400
	32 200		32 200

Exercise

Determining the value of inventory lost due to theft or by fire.

Sometimes incompleteness of records is due to some unfortunate events such as a burglary, where records may also go missing or due to some natural disaster. If records of stock movement have not been kept or they also go missing, it is important to be able to determine the value of stock to enable the business to claim if the stock is issued, or just to get the value of the loss to be written off against the profits.

Example 7

Alibaba sells imported household appliances and his premises suffered a burglary on the 16th of November 2009. Alibaba is not sure how much stock was stolen as he is also missing his stock control records. However, he ascertains that the value of stock is remaining is $6 452. He also provides you with the following information;

	1 Jan 2009	16 Nov 2009
	$	$
Stock	17 452	6452
Debtors as at	37 800	12 100
Creditors as at	20 000	23 000
Payments to suppliers to date		183 000
Receipts from debtors to date		202 000

Alibaba applies a margin of 20% on all sales

You are required to calculate the value of stolen stock

Solution

Step 1

Establish sales + purchases figures workings

i) Debtors Control a/c

Bal b/d	37 800	Cash + bank	202 000
Sales	176 300	Balance c/d	12 100
	214 100		214 100
Debtors b/d	12 100		

Creditors control a/c

Cash at bank	183 000	Creditors b/d	20 000
Creditors c/d	23 000	Purchases	186 000
	206 000		206 000
		Creditors b/d	23 000

Step 2

Establish of gross profit by preparing a simple Trading account.

		$	$
i)	Sales (WI)		176 300
	Less cost of sales		
ii)	Opening inventory	17 452	
iii)	Add purchases	186 000	
iv)		203 452	
v)	Less Closing stock (203 452 -141040)	62412	
vi)		147 492	
vii)			141 040
viii)	Gross profit (20% x 176 300)		35 260

Stock Stolen $ 62 412- $6 452= $55 960

Cost of good available for sale from cost of sale to get total closing stock

Subtract stock remaining from total closing stock to find stock stolen

When preparing the trading account it is advisable to do it in the order provided by the numbers (i)-(viii).

Note:

- First prepare the template / layout for doing the trading account.
- Fill in the values known at this point and leave out totals.
- Work out gross profit using mark-up and margin and record it.
- Subtract gross profit from sales to get cost of sales.
- Add cost of sales to gross profit to get total sales (viii)
- Subtract (viii) from (iv) to get the value for stolen stock.

Accounting for destroyed, stolen or last inventory

Once the value of stolen, lost or destroyed inventory has been established, the books have to be written accordingly to reflect the prevailing state of affairs.

7.10 Goods stolen or destroyed by fire

(i) When goods for resale are lost during the year, their treatment depends on whether they are insured or not. If they are insured the treatment is as follows:

DR Profit and loss account

CR. Cost of sales or purchases

When they are insured, the insurance can pay the full cost or part.

When the insurance pays the full cost, the entries are following

DR Insurance, by full cost *(if the amount has been received in, we debit the bank or cash account)*

CR. Cost of sales/ Purchases

To record the amount agreed by the insurance.

When it pays part only

DR Insurance *(amount agreed)*

DR Statement of comprehensive income*(shortfall)*

CR. Cost of sales / Purchases *(full loss)*

Example 7

The following information was extracted from the books of Ali Mohammed for the month of August 2000.

a) Sales $80 000.
b) Purchases $48 500.
c) Opening inventory $10 000.
d) Trading expenses $14 500.
e) The provisions of the insurance contract, when trading inventory is destroyed states that $1 200 will be paid for full cover and for partial cover it is $720.

All the entire inventory of Ali was destroyed by fire soon after the inventory taking had been done. According to the accounting records that were made available, the inventory balance as on that date amounted to $12 000.

You are required to prepare an Statement of comprehensive income under the following scenarios

Scenario 1 – Ali's inventory is not insured.
Scenario 2 – Ali's inventory is fully covered by insurance.
Scenario 3 – Ali's inventory is partially insured.

Before the Statement of comprehensive incomes are prepared let's see how much was going to be Ali's profit if the Inventory were not destroyed by fire.

	$	$
Sales		80 000
Less cost of sales		
Opening inventory		10 000
Add purchases	48 500	
	58 500	
Less closing inventory	12 000	46 500
Gross profit		33 500
Less expenses		
Trading expenses		14 500
Net profit		19 000

Scenario 1 – Ali's inventory is not insured
Making the above assumptions, the Statement of comprehensive income will be prepared as follows:

	$	$
Sales		80 000
Less cost of sales		
Opening inventory		10 000
Add purchases	48 500	
	58 500	
Less closing inventory	-	
	58 500	
Less inventory destroyed by fire	12 000	46 500
Gross profit		33 500
Less expenses		
Trading expenses	14 500	
Inventory destroyed by fire	12 000	26 500
Net profit		7 000

Scenario 2 - Ali's inventory is fully covered by insurance.

Assuming that Ali's inventory is fully covered, the Statement of comprehensive income is prepared as follows.

	$	$
Sales		80 000
Less cost of sales		
Opening inventory		10 000
Add purchases	48 500	
	58 500	
Less closing inventory	-	
	58 500	
Less inventory destroyed by fire	12 000	46 500
Gross profit		33 500
Less expenses		
Trading expenses	14 500	
Insurance expense	1 200	15 700
Net profit		17 800

Please take note that the double entry relating to the Inventory destroyed is effected by debiting the insurance account (this is a current asset in the Statement of Financial Position) and crediting the cost of sales by the cost price of the goods. When the insurance claim is finally received, bank account is debited and insurance account is credited.

Scenario 3 – Ali's inventory is partially covered

Basing on the fact that the inventory was partially covered, the Insurance Company agreed to pay Ali Mohammed $7 200 and the Statement of comprehensive income will be prepared as follows:

	$	$
Sales		80 000
Less cost of sales		
Opening inventory		10 000
Add purchases	48 500	
	58 500	
Less closing inventory	-	
	58 500	
Less inventory destroyed by fire	12 000	46 500
Gross profit		33 500
Less expenses		
Trading expenses	14 500	
Inventory destroyed, at cost		4 800
Insurance expense	720	20 020
Net profit		13 480

Notes

The cost of sales is credited with the full amount of Inventory destroyed by fire whereas the insurance and the profit and loss account is debited by $7 200 and $4 800 respectively, being the proportion of insured and uninsured goods respectively.

Accruals and prepayments

Normally the examiner will provide balance of any accruals and prepayments. Adjustments have to be made accordingly. Below are the formats used to determine the amount to be recorded in the Statement of comprehensive income for expense and income accounts.

Expense a/c

Prepaid b/d	xxx	Owing b/d	xxx
Cash at bank	xxx	Statement of comprehensive income	xxx
Owing c/d	xxx	Prepaid c/d	xxx
	xxx		xxx
Bal d/d			

Income a/c

Owing b/d	xxx	Prepaid b/d	xxx
Statement of comprehensive income	xxx	Cash at bank	xxx
Prepaid c/d	xxx	Owing c/d	xxx
	xxx		xxx

The figure to be recorded in the Statement of comprehensive income for expenses is found on the credit side of the account and for income on the debit side. It is derived as a balancing figure.

Drawing and additional capital

Drawing includes cash and any assets taken from the business for the owner's private use as well as money from the business used to pay for personal expenses. If the proprietor pays personal income into his business bank account e.g. dividends from investment in shares, this constitutes additional capital and is credited to the capital accounts.

Exercise 4

The following is the Statement of financial position of Mrs Unlucky as at 31 March 2008

	$	
Non current assets	580 000	
Cash	20 000	
Bank	40 000	
Inventory	160 000	
Trade receivable	200 000	
	420 000	
Less current liabilities		
Trade payables	200 000	
		220 000
		800 000
Financed by		
Capital		800 000

A fire occurred on the night of 31st March 2009 destroying the accounting records as well as the closing cash. However, the following information was available.

i) Trade debtors and trade creditors as at 31 March 2009 showed an increase of 20% as compared to the beginning of the year.
ii) Credit period
  Debtors 1 month
  Creditors 2 months
iii) Stock levels were maintained at a uniform level throughout the year.
iv) Cash sales constituted 20% of total sales.
v) All purchases were strictly on a credit basis.
vi) Current ratio on 31 March 2009 was exactly 2
vii) Total expenses excluding depreciation for the year amounted to 1 000 000.
viii) Depreciation was provided at 10% on the closing book value of non-current assets.
ix) An evaluation of the receipt and payments account revealed the following.
a) Payment to trade payable (creditors) included $200 000 which related to cash purchases.
b) $2 360 000 was received from trade receivable (debtors) by way of cheques.
c) Mr Unluck's personal drawings from the bank amounted to $ 200 000
d) $480 000 was deposited into the bank.
e) Non –current assets worth $900 000 were purchased and paid for by cheque.
f) The cash destroyed in the fire was not insured.

Required

i) Statement of comprehensive income of Mrs Unlucky for the year ended 31 March 2009.
ii) A statement of financial Position as at that date.

Example 8

Where you use more than one accounting techniques

Sharon a stationery retailer who does not keep proper books of accounts provided his accountant with following:

	31/03/1999	**31/03/2000**
	$	$
Premises	100 000	100 000
Plant & Equipment	60 000	59 200
Trade Debtors	42 000	64 000
Trade Creditors	21 000	32 000
Wages paid in advance	700	600
Telephone expenses owing	4 500	900
Inventory	24 000	36 000
Cash on hand	500	1 200

The only book kept by Sharon is a cash book, summary of which for the year ended 31/03/2000 is given below;

CASH BOOK (BANK COLUMN ONLY)

Bal. b/d	56 000	Drawings	12 000
Cash taking banked	34 000	Wages & salaries	50 000
Receipts from debtors	59 000	Payments to suppliers	50 000
Bal. c/d	5 000	Telephone expenses	9 000
		Rent	15 000
		Purchases	18 000
	154 000		**154 000**

Additional information

1. The following amounts have been paid from the cash takings before they were banked.

	$
Purchases	6 000
Drawings	13 000
Wages	1 500

2. She had also taken goods worth 7 500 for her own use.

3. There was no purchase or disposal of property, plant and equipment during the year.

Required:-

a) Prepare a Statement of comprehensive income for the year-ended 31/03/2000.
b) Statement of Financial Position as at 31/03/2000

Solution

In this question we are expected to use the following accounting techniques;
1. Accounting equation to determine opening capital.
2. Control accounts to determine credit sales and Purchases
3. Cash account to determine cash sales.
4. Knowledge of prepayment and accruals

Step 1 - Determine opening capital using the equation: **Assets less liabilities = Capital**

Assets

	$	$
Premises		100 000
Plant & Equipment		60 000
Trade Debtors		42 000
Inventory		24 000
Bank		56 000
Cash		500
Wages paid in advance		700
		283 200

Less Liabilities

Creditors	21 000	
Telephone owing	4 500	25 500
Opening Capital		257 700

The mistake is to forget to include bank because it is not listed with other assets

Step 2- Calculation of credit sales

Debtors Control A/C

	$		$
Bal. b/d	42 000	Bank	59 000
Credit sales	81 000	Bal. c/d	64 000
	123 000		123 000
Bal. b/d	64 000		

The mistake students make in the examination is to treat cash banked as cash sales which is wrong, Cash sales is included in cash banked plus any cash used to pay expenses before it was banked. Note that

Total Sales = Credit sales + Cash sales

= \$81 000 + \$55 200 = \$136 200

Note that sometimes the computations in a) and b) have to be combined. This is necessary when cash and cheque sales are not given separately from receipt from debtors. In this case the total cash and cheque received in respect of sales are credited to control account. The same principle would have to be used in cash of purchases when cash and / or cheque purchases are not given separately from cheque paid to creditors.

Step 3- calculation of credit purchases

Creditors control A/C

Bank	50 000	Bal. b/d	21 000
Bal. c/d	32 000	Credit purchases	61 000
	82 000		**82 000**

Total purchases $ 61 000 + $18 000 (from bank) + $ 6 000 (Cash) = $85 000.

Step 4 – calculation of cash sales

Cash book (Cash Column Only)

	$		$
Bal. b/d	500	Purchases	6 000
Cash sales *(difference)*	55 200	Drawings	13 000
		Wages	1 500
		Banked	34 000
		Bal. c/d	1 200
	55 700		**55 700**

Or

6 000 + 13 000 + 1 500 + 34 000 + 700 - 1200 – 500 = $55 200

Total drawings = 7 500 + 12 000 + 13 000 = $32 500 are made up of inventories, cheque payment and in cash.

Step 4

Compute the charges to profit and loss account for those expenses with accruals or prepayments by preparing relevant ledger accounts.

Telephone A/c

	$		$
Bank	9000	Bal. b/d	4 500
Bal. c/d	900	I/S	5 400
	9 900		**9 900**

Or

9 000 – 4 500 + 900 =$ 5 400

Wages & Salaries

	$		$
Bal. b/d	700	I/S	51 600
Bank	50 000	Bal. c/d	600
Cash	1 500		
	52 200		**52 200**

Or

50 000 + 700 + 1 500 - 600 = **51 600**

Sharon's Statement of comprehensive income for the year ended 31 March 2000

	$	$
Sales		136 200
Less Cost of Sales		
Opening Inventory	24 000	
Add Purchases	85 000	
	109 000	
Less Inventory drawings	7 500	
	101 500	
Less Closing inventory	36 000	65 500
Gross profit		70 700
Less Expenses		
Wages	51 600	
Telephone	5 400	
Rent	15 000	
Depreciation	800	72 800
Net Loss		2 100

Statement of Financial Position For Sharon As At 31 Mach 2000

			$
Property, plant and equipment			
Premises			100 000
Plant & Equipment			59 200
			159 200
Current Assets			
Inventory		36 000	
Receivables		64 000	
Wages paid in advance		600	
Cash		1 200	101 800
Total assets			261000
Equity and liabilities			
Capital			223 100
Payables	32 000		
Telephone	900		
Bank Overdraft	5 000		37 900
Total equity and liabilities			**261 000**

Statement of changes in equity for the period ending 31 March 2000

	Capital
Balance at 1 April 1999	257 700
Less net loss	(2 100)
	255 600
Less drawings (12 000 + 13 000 + 7 500)	(32 500)
Balance at 31 March 2000	223 500

The goods taken by the proprietor for his own use of $7 500 should be added to drawings and deducted from purchases. In the examination, watch out for bank because it can be overdrawn.

Example 9

Sibongile Moyo commenced trading on 1 September 1994 with capital of $40 000 that was all used to open a business bank account. Unfortunately, Sibongile has found it difficult to keep her business accounts properly. However the following information is available for the year ended 31 August 1995.

1. All business receipts and payments have been passed through the business bank account.

2. All business receipts are deemed to be from credit customers.

3. Bank payments have been summarised as follows: -

	$
Payments to suppliers	64 240
Fixtures and Fittings	20 000
Motor Vehicles	12 000
Rent & Rates	3 200
Heat & Light	900
Wages	5 600
Drawings	8 000

4. All property, plant and equipment were acquired on 1 September 1994.

5. Inventory in trade was valued at cost of $6 000 on 31 August 1995.

6. A 20% gross profit margin is achieved on all sales.

7. Depreciation is provided at the following annual rates on the cost of property, plant and equipment:

Motor vehicles	25%
Other property, plant and equipment	10%

8. Trade Creditors at 31 August 1995 amounted to $7 300 and trade Debtors were $6 900 at that date.

9. All purchases and sales are on credit.

You are required to:

(a) Prepare an Statement of comprehensive income for the year ended 31 August 1995 and

(b) The Statement of Financial Position as on that date.

<u>Solution</u>

Bank account

	$		**$**
Capital	40 000	Payments to suppliers	64 240
Receipts from debtors	75 025	Fixtures and fittings	20 000
		Motor vehicles	12 000
		Rent and rates	3 200
		Heat and light	900
		Wages	5 600
		Drawings	8 000
		Balance c/d	1 085
	115 025		115 025
Balance b/d	1 085		

Creditors control account

	$		$
Payments to creditors	64 240	Purchases	71 540
Balance c/d	7 300		
	71 540		71 540
		Balance b/d	7 300

Debtors control account

	$		$
Sales	81 925	Receipts from debtors	75 025
		Balance c/d	6 900
	81 925		81 925
Balance b/d	6 900		

Statement of comprehensive income for the year ended 31 August 1995

	$	$
Sales		81 925
Less cost of sales		
Purchases	71 540	
Less closing inventory	6 000	65 540
Gross profit		16 385
Less trading expenses		
Rent and rates	3 200	
Heat and light	900	
Wages	5 600	
Depreciation: *Motor vehicles*	3 000	
Fixtures and fittings	2 000	14 700
Net profit		1 685

Statement of Financial Position as at 31 August 1995

	$	$	$
Property, plant and equipment	Cost	Accumulated depreciation	N.B.V.
Fixtures and fittings	20 000	2 000	18 000
Motor vehicles	12 000	3 000	9 000
	32 000	5 000	27 000
Current assets			
Inventory		6 000	
Debtors		6 900	
Bank		1 085	13 985
			40 985
Equity and liabilities			
Capital			33 685
Add creditors			7 300
			40 985

<u>Statement of changes in equity for the period ending 31 August 1995</u>

	Capital
Balance at 1 September 1994	40 000
Add net profit	1 685
	41 685
Less drawings	8 000
Balance at 31 August 1995	33 685

Notes

a) The creditors control account is opened to calculate credit purchases.
b) The trading account is opened to calculate gross profit and sales.
c) The debtors control account is opened to calculate receipts from debtors.
d) The bank account is opened to calculate the closing bank account.

In examination, it is common to find a question where profit to be shared by the partnership was determined before a number of errors were discovered. In this situation, a student needs to first come out with a revised profit as before the profit and loss appropriation is prepared.

Example 5

Matapi is a general dealer who does not keep a proper set of books of accounts. The following was the position of the business for the previous 2 years.

	31 December 2000	**31 December 2001**
	$	$
Inventory	19 000	59 800
Accounts receivable	34 000	39 000
Accounts payable	26 000	49 150
Balance at bank	3 500	15 000
Non – current assets, at cost	40 000	69 000

The following additional information relates to the financial year ended 31 December 2001.

1. All payments were made by cheque. A summary of the payments is as follows:

	$
Rent	8 000
Non – current assets	29 000
Stationery	5 600
Creditors	76 000
Wages & salaries	21 000
Insurance	12 000

2. Discount allowed amounted to $1 800 and discount received $800.
3. Bad debts written off during the year amount to $2 300.
4. All sales are on credit.
5. Non – current assets shown on 31 December 2000 were purchased on 1.1.98 and all non – current assets are being depreciated using the straight – line method at 10% per year.
6. All cash banked is assumed to be from customers.

Required:

a) Prepare a Statement of comprehensive income for the year ended 31 December 2001
b) Statement of Financial Position as at 31 December 2001

Workings

Working 1 – calculation of purchases

Creditors control account

	$		$
Bank	76 000	Balance b/d	26 000
Discount received	800	Purchases *(difference)*	99 950
Balance c/d	49 150		
	125 950		125 950
		Balance b/d	49 150

Working 2 – calculation of cash received from debtors

Bank account

	$		$
Balance b/d	3 500	Rent	8 000
Debtors *(difference)*	163 100	Non – current assets	29 000
		Stationery	5 600
		Creditors	76 000
		Wages and salaries	21 000
		Insurance	12 000
		Balance c/d	15 000
	166 600		166 600
Balance b/d	15 000		

Working 3 – calculation of sales

Debtors control account

	$		$
Balance b/d	34 000	Bank	163 100
Sales *(difference)*	172 200	Discount allowed	1 800
		Bad debts	2 300
		Balance c/d	39 000
	206 200		206 200
Balance b/d	39 000		

<u>Working 4 – calculation of capital as at 1 January 2001</u>

Statement of affairs as at 1 January 2001

	$
<u>Assets</u>	
Inventory	19 000
Accounts receivable	34 000
Bank	3 500
Non – current assets *($40 000 – $40 000 x 10% x 3 years)*	<u>28 000</u>
	84 500
Less accounts payable	<u>26 000</u>
Capital *(1.1.2001)*	58 500

Solution

<u>Statement of comprehensive income for the year ended 31 December 2001</u>

	$	$
Sales *(Working 3)*		172 200
<u>Less cost of sales</u>		
Opening inventory	19 000	
Add purchases *(Working 1)*	<u>99 950</u>	
	118 950	
Less closing inventory	<u>59 800</u>	<u>59 150</u>
		113 050
Add discount received		<u>800</u>
Gross profit		113 850
<u>Less trading expenses</u>		
Discount allowed	1 800	
Rent	8 000	
Stationery	5 600	
Wages & salaries	21 000	
Insurance	12 000	
Bad debts	2 300	
Depreciation	<u>6 900</u>	<u>57 600</u>
Net profit		56 250

Statement of Financial Position
as at 31 December 2001

Assets	**$**	
Non – current assets		
Motor vehicle, at cost		69 000
Less accumulated depreciation		18 900
		50 100
Current assets		
Inventory	59 800	
Accounts receivable	39 000	
Cash at bank	15 000	113 800
		163 900
Equity & Liabilities		
Capital		114 750
Accounts payable		49 150
		163 900

Statement of changes in equity for the period ending 31 December 2001

	Capital
Balance at 1 January 2001(*Working 4)*	58 500
Add net profit	56 250
Balance at 31 December 2001	114 750

Example 10

Edward Manhenga does not use the double entry system of book – keeping. On 31 December 2002 the balance of inventory on hand was $6 000.

Sales for January 2003 totaled $80 000; in February 2003 they increased by 50% on the January figure. This was as a result of having a clearance sale in February 2003.

Edward usually has a mark–up of 25% on cost, but during the sale he reduced this for some items so that:

$17 600 of sales had a mark-up on cost of 10%;
40% of sales earned a gross profit ratio of 20%;
The remainder was sold at the normal mark up.

Closing inventory was:
January $6 600

February	$9 800

You are required to:
a) Prepare the trading account of Edward Manhenga for January and February 2003 respectively

Solution

Trading account for January 2003

	$	$
Sales		80 000
Less cost of sales		
Opening inventory	6 000	
Add purchases	64 600	
	70 600	
Less closing inventory	6 600	64 000
Gross profit: *$80 000 x 20%*		16 000

Trading account for February 2003

	$	$
Sales *(80 000 + 50%)*		120 000
Less cost of sales		
Opening inventory	6 600	
Add purchases	101 120	
	107 720	
Less closing inventory	9 800	97 920
Gross profit: *$17 600 x 10/110*	1 600	
$120 000 x 40% x 20%	9 600	
($120 000 - $17 600 – $48 000) x 20%	10 880	22 080

7.11 Examination type questions

7.12 Multiple choice questions

1. On 1 January 2004, Betty's business assets were valued at $324 000 and her liabilities amounted to $21 600. At 31 December 2004, her assets equaled $513 000. This figure included her private car, which she had brought into the business on 1 November 2004. It was valued at $81 000. Creditors at 31 December 2004 totaled $153 000 and her drawings during the year were $243 000. Betty's profit for the year to 31 December 2004 was:

   A. $57 600
   B. $219 600
   C. $300 000
   D. $522 000.

2. Ben's shop was broken into on 5 February 1987. The entire inventory was stolen. His inventory on 31 December 1986 was $161 000. From 1 January to 5 February, sales totaled $294 000 and purchases were $266 000. Ben's mark-up on goods is 33⅓% to arrive at the selling price. The cost of stolen inventory was:

   A. $196 000
   B. $206 500
   C. $231 000
   D. $280 000

3. A business owner suspects a loss of cash has occurred. He provides the data shown.

	$
Cash balance at the start of the month	450
Cash balance at the end of the month	750
Cash banked	900
Cash sales per till rolls	1 050

   How much cash has been lost?

   A. $600
   B. $750
   C. $900
   D. $1050

4. At the end of a financial year the following information is available:

	$
Sales	200 000
Opening inventory	15 000
Closing inventory	18 000

   If the business makes a standard mark up of 25%, what were the purchases?

   A. $147 000
   B. $153 000
   C. $157 000
   D. $163 000

7.13 Structured questions

Question 1

Samkeliso Luphahla is a retailer who makes all of her sales for cash. During the night of 9 February 1998 a fire destroyed all of her inventory in trade and her shop fittings. The fire also destroyed all of her inventory records except the unpaid invoices, which she kept at home. Samkeliso was insured against destruction of inventory by fire, up to its full amount and for her shop fittings, up to $50 000.

On 31 December 1997, her most recent accounting year-end, her Statement of Financial Position was as follows:

Property, plant and equipment	$	$	$
Shop Fittings at net book value			75 000
Current Assets			
Inventory in trade		245 000	
Cash at bank		23 000	
Cash in hand		1 000	
		269 000	
Less Current Liabilities			
Trade creditors	82 000		
Accrued expenses	14 000	96 000	173 000
			248 000
Financed by			
Capital			248 000

During the period 1 January 1998 to 11 February 1998 (6 weeks) all takings were banked except for $1 500 each week for wages to an assistant and $1 600 for his own living expenses which were taken from the cash till. On 11 February 1998 there was $1 000 in the till (not destroyed by the fire). Samkeliso paid all shop expenses, apart from wages, by cheque. An analysis of her bank statement for the period 1 January 1998 to 11 February 1998 showed the following:

Receipts		Payments	
Balance on 01.01.98	23 000	Trade creditors	179 400
Cash deposits	211 700	Shop expenses	24 500
		Balance on 11.02.98	30 800
	234 700		234 700

Selling prices are always based on cost plus 25%. All of Samukeliso's suppliers allowed her to deduct a 2½ % discount for prompt payment from the invoice price of her purchases of inventory. On 11 February 1998, there were accrued expenses of $9 500 outstanding and unpaid invoices for inventory purchases totaled $61 800.

You are required to:
a) Prepare a statement detailing the calculation of inventory lost in the fire.
b) Prepare a Statement of comprehensive income for the period 1 January 1998 to 11 February 1998.
c) Prepare a Statement of Financial Position, immediately following the fire, assuming that the insurance claims will be met.
d) Prepare a statement of changes in equity

Question 2

Farai is in business as a general dealer. Although he is a successful businessman, he has not kept proper accounting records. The taxation authorities required him to state the amount of profit he made in his accounting year ended 30 September 2005. He asks you to help him calculate the profit for that year. He provides you with the following information;

	30-09-2004	30-09-2005
	$	$
Premises at cost	200 000	200 000
Motor at cost	45 000	45 000
Inventory	20 000	28 750
Trade debtors	7 375	11 500
Trade creditors	4 625	4 250
Balance at bank	5 710	11 590
Cash in hand	500	250
Rent paid in advance	2 000	2 500
Electricity owing	1 040	575

Additional information

1. The premises have been revalued to $275 000 on 30 September 2005.
2. The second-hand value of the motor vehicle at 30 September 2004 was $42 500, and at 30 September 2005 was $35 000.
3. Inventory at 30 September 2005 included goods, which cost $3 000, but no invoice has been received.
4. On 30 September 2005, inventory costing $500 was sent on sale or return to a customer who has been invoiced with the selling price, $700. The customer has not indicated if he wants to purchase the goods.
5. Trade debtors represent the total of invoices sent to customers, but unpaid.
6. Trade creditors represent the total of invoices received from suppliers and awaiting payment.
7. Farai has drawn $750 per week from the business in cash. He has taken goods costing $3 500 from the business during the year ended 30 September 2005.
8. In addition to his other liabilities, Farai borrowed $10 000 from his aunt on 1 January 2005. The interest is payable in arrears on 1 January each year.

You are required to:
Calculate Farai's profit for the year ended 30 September 2005.

Question 3
Minky Pink owns a retail business dealing in bathroom essentials. He is extremely busy and has not given much attention to his accounting records. He has gathered his bank statements a rough cash book and a number of invoices. Minky recognizes that if the performance of the business must be measured effectively, then details of assets and liabilities are crucial. Details of all business assets and liabilities are as follows:

	At 31 May 2005	At 31 May 2006
Shop premises (at cost)	126 000	126 000
Fixtures and fittings original		
Cost $75 000	45 000	57 000
Cash at Bank	86 340	3 690
Trade creditors	48 120	47 280
Accrued rent	1 350	-
Prepaid rent	-	1 500
Prepaid insurance	720	-
Accrued insurance	-	480
Debtors	18 300	6 420
Inventory	77 430	78 690
Van (original cost $21 000)	3 600	-
Capital	307 920	?
New Van	-	27 000

A summary of the bank statement for the year produced the following details

Receipts	$	Payments	$
Cheques from debtors	95 100	Cheques to creditors	468 900
Proceeds from sale of old		Purchase of new van	27 000
Van	2400	Rent	16 800
Net cash takings banked	425 580	Advertising	2 190
		Insurance	1 620
		Light & Heat	4 890
		Business rates	5 700
		New Fixtures & equip	12 000
		Drawings	66 630
	523 080		605 730

It was found that prior to banking the cash taking the following items were paid:

	$
Staff wages	70 500
Purchase of goods for resale	21 300
Sundry shop expenses	14 850

Additional Information

1) Minky Pink took goods amount to $3 150 at cost for his own use.
2) The bank drawings figure includes $150 per week paid to Minky, wife for work done by her for the business (50 weeks).
3) Minky has been advised that the fixtures and equipment and vans should continue to be depreciated by 10% on cost at the end of each year.

REQUIRED:

a) A Statement of comprehensive income for the year ended 31 May 2006.
b) A Statement of Financial Position for the business as at 31 May 2006.
c) Prepare the statement of changes in equity

Question 4

Madzingira received $350 000 from his grandfather's will which he used to open a retail outlet. On 1 January 2003, he opened a business bank account with the full amount of the legacy. However, Madzingira was unable to operate a full accounting system. Only very basic records were kept.

On 1 January 2003 again, he rented premises at a rental of $5 250 per month payable quarterly in advance. The first payment was made on the same date.

A summary of the bank transactions for the year as at 31 December 2003 revealed the following

	$		$
Receipts		**Payments**	
Legacy	350 000	Rent	33 750
Cash banked	1 883 000	Fixtures/ equipment	151 690
		Rates	16 800
		Electricity	32 690
		Telephone	4 830
		Purchases	1 860 390
		Holiday in Mauritius	23 800

Additional Information:

1. All takings were banked after the following cash expenses were paid and personal drawings taken:

   Wages $2 870 per week (50 weeks)

   Sundry expenses $105 per week (50 weeks)

   Cash purchases $20 860 for the year

2. Madzingira always retained a cash float of $1750 in the till.

3. Madzingira went on a 30 day holiday from mid-September. For this reason there was an oversight on the last quarters rent due on 1 October 2003 and was not paid until January 2004.

4. A mark –up of 40% was added to cost of sales in order to arrive at the selling price.

5. Business rates of $7 000 had been paid on 3 October 2003 to cover the period 1 October 2003 until 31 March 2004.

6. At 31 December 2003, it was estimated that electricity accrued should be $12 600 and accounting fees due to be paid $1 540.

7. Fixtures and equipment to be depreciated by $46 690.

8. Trade creditors at 31 December 2003 were $43 750.

9. Trade debtors at 31 December 2003 amounted to $266 000 and a provision for a doubtful debt of 5% was to be established at that date.

10. Closing inventory was valued at $105 000.

After the final accounts for the year were prepared, Madzingira received Advise from his sister to convert his business to a private limited liability company.

REQUIRED:

a) A Statement of comprehensive income for the year ended 31 December 2003. [14]

b) A statement showing Madzingira's drawings. [4]

c) A Statement of Financial Position as at 31 December 2003. [14]

d) A statement of changes in equity [10]

e) A report from Madzingira's sister about the advice offered, citing the advantages and disadvantages of converting his business to a private limited liability company. [16]

CHAPTER 8

NON-PROFIT MAKING ORGANISATIONS

8.1 Chapter objectives

After studying this chapter *the student should* be able to:

1) Explain what non-trading organisations are
2) Outline the objectives of non-trading organisations
3) Explain the purpose of a Receipts and Payment account, and Income and Expenditure account.
4) Draw similarities between accounts of non-trading
5) Outline the various sources of income for non-trading organisations
6) Prepare a subscriptions account showing the subscription income for the year
7) Prepare a receipts and payments account, income and expenditure account as well as the (Statement of Financial Position)
   Statement of Financial Position.
8) Prepare a Trading account showing the profit or loss from ancillary activities.

8.2 Introduction

A business is formed to carry on some kind of an economic activity with the objective of making a profit and increasing the wealth of the owners of the business. On the contrary, a non- trading organisation is formed to fulfil a societal objective such as a charitable organisation, religious group (church) library, hospital, young people's football club etc. Non-trading organisations are formed for the welfare of the society and not for the benefit of an individual, a group of people, partners or shareholders, as in the case with trading organisations. The income of non-trading concerns, which is derived from the various donations, subscriptions, entrance fees etc. is used to pursue the objectives for which the non-trading concerns were set up to achieve.

8.3 Characteristic of non-trading organisations

1. They are formed to render services in the fulfillment of social objectives and not to earn a profit, although such organisations may run a trading activity such as the operation of a bar in order to make a profit.
2. The main source of income for a non-trading organisation is made up of, among other things, subscriptions, admission and entrance fees to functions, donations, membership fees, legacies grants etc.
3. The day- to-day management of non-trading organisations lies in the hands of people elected by members from among themselves, who are called the managing committee.
4. The accruals concept is used in the preparation of the final accounts of non-trading concerns.

8.4 Final accounts of non-Trading concerns.

Clubs, societies and other similar concerns which are not formed with the intention of making a profit will differs little in principle from aA Statement of comprehensive income (Statement of comprehensive income). The income and expenditure account shows either a surplus or a deficit instead of a gross profit or loss and a net profit or loss. Where the non-trading concern engages in a profit-making activity to raise income such as running a bar or conducting dances, it will often prepare a separate trading account for the bar or whatever activity it may be in which it intends to make a profit. The profit or loss on the bar or the particular activity will then be transferred to the main income and expenditure account.

In addition to the Income and Expenditure account, a receipts and payments account is often produced which is nothing more than a summary of the cash and bank transactions of the organisation in the receipts and payments account whether they belong to the current year or not. The receipts and payments account is not prepared on an accruals basis but on a cash basis. In Addition, all receipts and payments are recorded whether they are revenue or capital in nature.

Layout of a Receipts and payments a/c

	$		$
		Overdraft b/d	xxx
Cash in hand b/d	xxx	Purchases of fixed assets	xxx
Cash at bank b/d	xxx	Purchases of fixed assets	xxx
Donations-specific	xxx	Printing and stationary	xxx
Legacies	xxx	Audit fees	xxx
Life membership fees	xxx	Repairs and maintenance	xxx
Sale of investments	xxx	Honoranium	xxx
Endowment Fund receipts	xxx	Telephone expenses	xxx
Sale of fixed assets	xxx	Sundry expenses	xxx
Subscriptions	xxx	Rent payable	xxx
General donations	xxx	Cash and Bank c/d	xxx
Receipts from ancilliary Activities	xxx		
Interest received on Investments	xxx		
Overdraft c/d	xxx		
	xxxx		xxxx
Cash and Bank b/d	xxx	Overdraft b/d	xxx

8.5 Features of a Receipts and Payments account

i) It is an asset account
ii) Like a cash book it is opened with the opening bank and cash balance in hand or overdraft of the current years.
iii) It is closed showing the respective balance in hand or overdraft at the end of the financial period.
iv) All receipts whether capital or revenue in nature are recorded on the debit side and all payments whether capital or revenue in nature are recorded on the credit side.
v) All receipts and payments, whether belonging to the previous year, current year or next year are recorded
vi) The receipts and payments account is prepared on a cash basis, Accrued expenses and incomes are not recorded.

8.6 Explanation of some important items of receipts and payments account

1. **Life membership fees**
   This is where members have paid a lump sum in order to become members of an organisation for the whole of their lives. Once a member has paid life membership fees, he/she does not have to pay annual subscriptions. When received, the accounting entries are;

Dr Receipts and Payments a/c
Cr deferred Income a/c
On an annual basis, the matching concept is used by making the following entries.

Dr Deferred Income a/c
Cr. Income and Expenditure a/c
With the amount calculated on an annual equal instalment covering such a period as deemed fair by the management committee. The balance of the deferred income a/c will be reflected as a capital receipt together with the Accumulated fund on a yearly basis in the Statement of Financial Position.

2. **Donations**

These are gifts received by the non-trading organisation in order to finance various activities undertaken by the organisation. Donations can be categorised either as general or specific.

i) General donations- these are meant to help finance the day-to-day operations of the organisation and are debited in the receipts and payment account and credited to the income and expenditure.

ii) Specific donations- sometimes a gift is received to fund a specific activity, such as the financing of a team of footballers to train for specific games, such as the Africa Cup of Nations games in 5 years' time. Such a donation is capitalised by and the accounting entries will be:

Dr. Receipts and Payments a/c
Cr. Accumulated fund

In other words, in the Statement of financial Position (Statement of Financial Position) the specific donation is added to the Accumulated fund.

3. **Legacy**

This is an amount donated by a deceased person to the organisation and is found in the will of that deceased person. It is a capital receipt and is treated like a specific donation by debiting the receipts and payments account and crediting the Accumulated Fund.

4. **Payment of an Honorarium**

An honorarium is an amount paid to any person for the work done for the organisation but such person is not an employee of the organisation. It is recorded on the credit side of the Receipts and payments a/c and is recognised as an expense by debiting the Income and expenditure a/c.

5. **Members' Subscriptions**

These are periodic contributions made by the members of the organisation. It is the main source of income for non-trading concerns and is usually paid annually by members of the organisation, and is therefore an annual revenue receipt which appears on the debit side of the Receipts and Payment account. A ledger account often has to be prepared to determine the subscription income for the year like this:

Subscriptions a/c

	$		$
Owing b/d	xxx	Prepaid b/d	xxx
Income & Expenditure	xxx	Cash and Bank	xxx
Prepaid c/d	xxx	Owing c/d	xxx
	xxxx		xxxx
Owing b/d	xxx	Prepaid b/d	xxx

Comparison of a cash book and a receipts and Payments accounts

Cash Book	**Receipts and Payments a/c**
1. It is prepared on a day to-day basis as transaction occur	It is prepared at the end of the accounting year in summary form.
2. An item may appear a number of times during the year depending on how many times transactions involving that items took place.	Every item appears only once in summary form i.e as a total for the year
3. It is not presented as one of the end of year financial statements.	It is presented as part of the end of year financial Statements.
4. It does not reflect the activities of the organisation	It reflects the activities of the organisation
5. It is prepared by all types of organisations	It is prepared by non-Trading organisations only.

8.7 The Income and Expenditure account

The income and expenditure account contains a summary of incomes and expenditures of the current year. It can be compared to a Profit and loss account in trading organisations. Adjustments for prepaid incomes and expenses as well as accrued incomes and expenses have to be taken into account when preparing the Income and Expenditure account in order to determine the surplus or deficit which is equivalent to the net profit or net loss in a trading organisation. If the income is greater than the expenditure, that difference is a surplus and if the expenditure is greater than the income that difference is a deficit.

Ledger accounts may need to be prepared to help you determine the amount to be reported into the Income and expenditure account. This is how the ledger accounts are prepared.

Expense a/c

Prepaid b/d	xxx	Owing b/d	xxx
Cash and bank	xxx	Income and Expenditure	xxx
Owing c/d	xxx	Prepaid c/d	xx
	xxx		xxx
Prepaid b/d	xxx	Owing b/d	xxx

Income a/c

Owing b/d		xxx	Prepaid b/d	xxx
Income & Expenditure	xxx		Cash and bank	xxx
Prepaid c/d		xxx	Owing c/d	xxx
		xxx		xxx
Owing b/d		xxx	Prepaid b/d	xxx

Note: In the exam you may not have enough time to prepare ledger accounts. Unless the examiner has specifically asked for ledger accounts, you do not need to prepare any. Workings must however always be shown in brackets where ledger accounts have not been written.

8.8 Features of an Income and Expenditure account

1. Only items of revenue nature are recorded in it
2. It is prepared using the accruals basis just like the Statement of comprehensive income (Profit and Loss Account), adjusting for Prepayments and accruals.
3. The closing balance which is a either a surplus or deficit is transferred to the Accumulated fund in the Statement of financial Position (Statement of Financial Position)
4. It includes non- cash items such as depreciation for the year.

Statement of financial position

The Statement of Financial Position of non-trading entities is prepared in much the same way as that of trading entities. The major difference however is that instead of Capital, non-trading organisations report Accumulated fund in its place and adjust for the surplus or deficit from the Income and Expenditure account, instead of the net profit or loss found in trading organisations.

Fully worked examination question

The treasurer of Knickknacks club has produced the following Receipts and payments account for the year ended 31 December 2011.

Receipts		**Payments**	
Bank balance at 1 Jan 2011	1 672	Bar purchases	26 922
Subscriptions	7 336	Bar wages	2 198
Bar Takings	30 784	Salaries & wages	2 730
Hire of hall	292	Office expenses	848
Interest from investments	630	Lighting and heating	744
Sales of investments (see note iii)	656	Rates and Insurance	574
		Miscellaneous expenses	606
		Investments	2 800
		Office furniture (01/07/2011)	1 800
		Balance at bank (31/12/2011)	2 148
	41 370		41 370

Notes

i) The bank balance on 1 January 2011 represents the following:

$672- current account
$1 000- deposit account

ii) $702 is to be transferred to the deposit account from the current account on31 December 2011.

iii) Investments costing $526 were disposed for $656

iv) At 31 December 2010, the club owned the following assets whose details are shown below:

Asset	Cost $	expired economic life as at 31 December 210
Freehold Premises	12 000	12 years
Office furniture	2 000	12 years
Office furniture	1 600	5 years
Investments	6 000	4 years

v) The club uses the straight line method to depreciate its non-current assets as follows:

Freehold premises	2 ½ % per annum
Office furniture	10% per annum

vi) The following items were outstanding as at 31 December

	2010	2011
	$	$
Subscriptions in arrears	158	196
Salaries and wages accrued	66	82
Trade payables for bar supplies	2434	2 650
Stock of stationery	112	130
Subscriptions in advance	28	52
Telephone account owing	58	74
Electricity account owing	62	88

	2010	2011
	$	$
Trade receivables for bar sales	24	98
Repairs accrued	18	106
Bar wages outstanding	42	46
Stock of charcoal	80	114
Rates and insurance prepaid	124	146
Stock of bar supplies'	2 844	3 978

Required

i) Prepare an opening statement of affairs to determine the opening accumulated fund
ii) A bar trading account showing the profit or loss from trading
iii) An income and expenditure account for the year ended 31 December 2011
iv) A statement of financial position as at 31 December 2011.

Suggestion solution

Knicknacks Clubs

(i) Opening Statement of affairs as at 1 January 2011

Non- current assets	**Cost**		**Depr**		**CA**	
Freehold premises	12 000		3 600		8 400	
Office furniture		3 600		2 800		800
		15 600		**6 400**		9 200
Investments				6 000		
Deposit account				1 000		7 000
Current Assets						
Stocks: Stationery		112				
Bar supplies charcoal		2 844				
		80				
Subscriptions in arrears		158				
Bar Trade receivables		24				
Prepaid rates and insurance		124				
Bank current account		672				
		4 014				
Less Current Liabilities						
Trade payables		2 434				
Accrued salaries & wages		66				
Prepaid subscriptions		28				
Telephone accrued		58				
Electricity owing		62				
Repairs owing		18				
Bar wages outstanding		42		2708		1 306
Accumulated Fund					17 506	

Balance as at 1 January 2011	17 506	

ii) **Bar Trading Account for the year ended 31 December 2011**

		$	$
Sales (30784 + 98-24)		30 858	
Less Cost of Sales			
Opening inventory	2 844		
Add Purchases (26 922 +2 650- 2 434)	27 138		
	29 982		
Less Closing inventory	3 978	26004	
Gross Profit		4 854	
Less Bar wages (2 198 +46- 42)		2 202	
Net Profit		2 652	

iii) **Income and expenditure account for the year ended 31 December 2011**

	$	$
Income		
Subscriptions (w1)		7 350
Hire of hall		292
Profit from investments (656-526)		130
Interest from investments		630
Bar profit		2 652
		11 054
Expenditure		
Salaries & wages (2 730 + 82-66)	2 746	
Office expenses (w2)	846	
Heating and lighting (w3)	736	
Rates and insurance (124 +574-146)	552	
Repairs (106-18)	88	
Miscellaneous expenses	606	
Depreciation- Premises (2 000 x 2 ½ %)	300	
Furniture (w4)	250	6 124
Surplus of Income over expenditure to accumulated fund		**4 930**

v) Statement of financial Position as at 31 dec 2011

	Cost	Depr	CA
Non-Current Assets	$	$	$
Freehold premises	12 000	3 900	8 100
Office furniture	5 400	3 050	2 350
	17 400	6 950	10 450
Investments (6 000 + 2 800- 526)			8 274
Deposit account (1000 + 702)			1 702

Current Assets			
Bank current account	446		
Stocks: Stationery	130		
Bar supplies	3 978		
Charcoal	114		
Subscriptions in arrears	196		
Trade receivables- bar	98		
Prepaid rates and insurance	146	5108	
LessCurrent liabilities			
Salaries & Wages owing	82		
Trade payables- bar	2 650		
Subscriptions prepaid	52		
Telephone owing	74		
Electricity owing	88		
Repairs accrued	106		
Bar wages owing	46	3 098	2 010
			22 436
Financed by:			
Accumulated Fund as at 1/01/2011			17 506
Add Surplus of income over expenditure			4 930
			22 436

Workings

Subscriptions a/c

2011		2011		
Jan 1 Arrears b/d	158	Jan 1	Prepaid b/d	28
Dec 31 Income & Expenditure	7 350	Dec 31	Cash c/d	7 336
Prepaid c/d	52		Arrears c/d	196
	7 560			7 560
2012		2012		
Jan 1 Owing b/d	196	Jan 1 Prepaid b/d	56	

Office expenses a/c

Stock of stationery b/d	112	Accrued telephone b/d	58
Cash	848	Income & expenditure	846
Accrued telephone c/d	74	Stationery stock c/d	130
	1034		1 034
Stationery stock b/d	130	Accrued telephone b/d	74

Heating and Lighting a/c

Charcoal stock b/d	80	Electricity owing b/d	62
Cash	744	Income & expenditure	736
Electricity owing c/d	88	Charcoal stock c/d	114
	912		912
Charcoal stock b/d	114	Accrued electricity b/d	88

4) Depreciation- furniture:

Furniture b/d	\$1 600 x 10%	=	160
	\$1 800 x 10% x 6/12	=	90
			250

NB: Furniture b/d of \$2 000 is no longer subject to depreciation as its economic life is 10yrs (10% p.a for 10yrs) and it has elapsed.

Example 1

Mujinga Burial Society was formed in 1996 with 145 members. Up to now the number of members has remained the same and each member pays an annual subscription of \$1 000. On 1 January 1998, the books of the society showed the following balances:

Amounts owing for subscriptions	\$14 000
Subscriptions received in advance	\$12 000

During 1998, subscriptions received in cash were \$160 000. This amount includes subscriptions for year 1999 for 23 members.

On 31 December 1998, subscriptions owing amounted to \$10 000.

You are required to prepare a subscriptions account showing clearly the amount to be transferred to the income and expenditure account.

Solution

Subscriptions account

		$			$
1 January 1998	Balance b/d	14 000	1 January 1998	Balance b/d	12 000
31 December 1998	Income & Expenditure	∗145 000	31 December 1998	Bank	160 000
31 December 1998	Balance c/d	23 000	31 December 1998	Balance c/d	10 000
		182 000			182 000
1 January 1999	Balance b/d	10 000	1 January 1999	Balance b/d	23 000

∗$145 000 = 145 members X $1 000/member

Example 2

The treasurer of Tengwe Country Club has prepared the following receipts and payments a/c for the year ended 31 December 1999.

Receipts	$	**Payments**		$
Opening Bank balance	700	Payments to suppliers		
Members subscriptions	28 000	of bar inventory		4 200
Bar takings	8 000	Printing and stationery		1 500
Donation	50	Purchase of equipment		1 500
Dinner dance receipts	6 000	Rent		1 200
		Dinner dance expenses		2 500
		Electricity		5 400
		Cleaning & Laundry		1 900
		Bal. c/d	24 550	
	42 750			**42 750**
Bal. b/d	24 550			

You are also given the following additional information: -

1. The club depreciates equipment using the straight-line method at the rate of 10% on assets held at the end of the year.

2. The following is a list of the club's assets and liabilities

	1 Jan 1999	**31 Dec 1999**
	$	$
Bar inventory	200	900
Bar Creditors	1 000	7 00
Electricity accrued	150	400
Rent prepaid	90	130
Subscriptions prepaid	6 000	8 000
Subscriptions in arrears	3 500	4 700
Equipment	13 000	14 500

Required: -

(a) A Calculation of accumulated fund of Tengwe Country Club at 1 January 1999.
(b) Prepare the Bar Trading A/C
(c) The Income and Expenditure A/C for the year ended 31 December 1999 and a Statement of Financial Position as at that date.

Solution

Working 1 – A statement of affairs as at 1 January 1999

Assets		
Bar Inventory		200
Rent prepaid		90
Subscription in arrears		3 500
Equipment		13 000
Bank		700
		17 490
Less liabilities		
Bar Creditors	1000	
Electricity accrued	150	
Subscriptions	6000	7 150
Accumulated Fund		10 340

(W2) Bar Trading A/c

Sales		8 000
Less Opening inventory	200	
Add purchases (W1)	3 900	
	4100	
Less Closing inventory	900	3200
Gross Profit		4800

Creditors Control A/c

(iii)

Bank	4 200	Bal. b/d	1 000
		Purchases	3 900
Bal. c/d	700		
	4 900		4 900
		Bal B/d	700

(iv) **Subscription A/c**

	$		$
Bal. b/d	3 500	Bal. b/d	6 000
Income & expenditure	27 200	Bank	28 000
Bal. c/d	8 000	Bal. c/d	4 700
	38 700		38 700
		Bal. b/d	8 000

(v) **Rent**

	$		**$**
Bal. b/d	90	Income & Expenditure	1 160
Bank	1 200	Bal. c/d	130
	1 290		1 290
Bal b/d	130		

(vi) **Electricity**

	$		**$**
Bank	5 400	Bal. b/d	150
Bal. c/d	400	Inc. & Exp.	5 650
	5 800		5 800
		Bal d/d	**400**

Income and Expenditure Account for the year ended 31 December 1999

	$	$
Subscription (W1)		27 200
Profit from Bar (W2)		4 800
Donation		50
Dinner dance receipts	6 000	
Less Dinner dance expenses	(2 500)	3 500
		35 550
Less expenditure		
Printing and stationery	1 500	
Rent (W v)	1 160	
Electricity (W vi)	5 650	
Cleaning & Laundry	1 900	
Depreciation – equipment (10% x 14 500)	1 450	11 660
Surplus of income over expenditure		23 890

Statement of Financial Position as at 31 December 1999

ASSETS

Property, plant and equipment	**Cost**		**Deep**	**CA**
Equipment	14 500		1 450	13 050
Current Assets				
Inventory			900	
Bank			24 550	
Rent prepaid			130	
Subscription in arrears			4 700	
Total current assets				30 280
Total assets				43 330
EQUITY AND LIABILITIES				
Accumulated funds				34 230
Current Liabilities				
Creditors		700		
Subscription in advance		8 000		
Electricity accrued		400		9 100
Total equity and liabilities				43 330

Statement of changes in equity for the period ending 31 December 1999

	Accumulated funds
Balance at 1 January 1999	10 340
Surplus of income over expenditure	23 890
Balance at 31 December 1999	34 230

8.9 Examination type questions

8.10 Multiple choice questions

1. A club charges each of its 100 members an annual subscription of $120. At the end of a year four members had not paid their annual subscription. What will be the entries in the financial statements for subscriptions?

	Income and Expenditure account	Statement of Financial Position
A.	$11 520	Current asset $480
B.	$11 520	Current liability $480
C.	$12 000	Current asset $480
D.	$12 000	Current liability $480

2. A social club whose financial year ends on 31 December receives an annual donation from a company based on 50% of total membership fees due in that year. This donation is paid on 28 February the following year. The following is provided.

	$
Subscription received in year 1	2 940
Subscription received in year 2	3 180
Subscription outstanding in year 1	60
Subscription outstanding in year 2	70

How much should be recorded in the Income and Expenditure account in year 2?

A. $1 500
B. $1 625
C. $2 940
D. $3 180

3. The journal entry 'Debit Subscription account, Credit Creditors' was made in the accounting record of a club. What does this represent?

A. Subscription owed by members
B. Subscription received by cheque
C. Subscription received in advance
D. Subscription refunded to members

4. Life membership fees in club accounts are treated as:

A. Loans to the club
B. Additions to the accumulated fund
C. Deferred income
D. Income of the year in which they are received.

8.11 Structured questions

Question 1

The Senior Citizens Social Club was formed on 1 January 1999. On 31 December 2000, the treasurer presented a list of receipts and payments as follows.

<u>Receipts</u>

	$	$
Opening bank balance		15 000
Subscriptions		28 000
Net income from raffle draws		12 000
Donations		<u>10 000</u>
		75 000
<u>Payments</u>		
Rent of club house	10 000	
Printing and stationery	8 000	
Electricity and water	5 600	
Telephone and postage	4 100	
Insurance	3 200	
Net payment from dinner dance	<u>8 600</u>	<u>39 500</u>
Closing bank balance		35 500

The treasurer reported that:

(a) Stationery worth $1 000 was unused at the end of the period.
(b) Subscriptions in advance amounted to $200 whilst subscriptions in arrears amounted to $1 200 31 December 2000.
(c) Insurance was paid to cover the period from 1 January up to 31 October 2000.

You are required to prepare the club's income & expenditure account for the year ended 31 December 2000.

Question 2

The War Vets Football Association is a social club which makes up its accounts to 31 December each year. On 31 December 2004, the treasurer left the club premises and has not been seen since then. An examination of the records showed that the books it was decided to reconstruct the figures from 1 January 2004.

A summary of the bank account for the year showed the following:

	$		$
Balance as at 1 Jan 2004	1 664	Rent and rates	1 840
Bank deposits	170 440	Insurance	156
		Light & heat	624
		Bar purchases	140 268
		Telephone	236
		Balance at 31 Dec 2004	5 588
	172 104		172 104

The following information is also obtained:

1. The barman places the takings in the bank night safe on his way home for crediting to the club account. The duplicate paying – in slips total $162 448 for the year. The treasurer had no access to bar takings or inventory.
2. Receipt counterfoils for members subscriptions total $12 200.
3. Petty cash & wages were paid for as followed:

	$
Glasses, crockery & maintenance	5 240
Wages	10 632
Insurance	840
Sundry expenses	1 028

4. Outstanding amounts and prepayments at 31 December were:

	2003	**2004**
	$	**$**
Rates prepaid	104	112
Tent outstanding	164	328
Electricity outstanding	88	72

5. Bar Inventory ON 1 January 2004 was $14 428, and on 31 December 2004, $11 664.

REQUIRED:

a) Prepare a summary of the position for the year ended 31 December 2004 indicating the amount, if any, to be claimed under the club's Fidelity insurance Policy.
b) An income and expenditure account for the year.

Question 3

The Montrosian Young People's Social club had the following assets and liabilities as at 31 August 2004.

Assets	$	Liabilities	$
Premises at cost	360 000	Bar supplies	57 600
Snooker tables	27 000	Subscription in advance	3 600
Lawn mower	900		
10% Debentures	40 500		
Subscriptions due	4 500		
Bar inventory	64 800		
Bank	22 500		

The following is the Receipts and Payment statement for the year ended 31 August 2005.

Receipts		Payments	
Subscriptions	216 000	Dance expenses	22 500
Annual dance	27 000	Competition prizes	8 550
Competition entries	12 600	Bar inventory	238 000
Bar sales	528 300	Bar wages	153 000
Takings from snooker tables	5 850	Caretaker's wages	1 35 000
Donation	54 000	Maintenance	19 800
		Deposit Account	54 000
		Lawn mower	4 500

Their books revealed the following balances at 31 August 2005.

Bar inventory	$48 600
Subscriptions in advance	$5 850
Subscriptions in arrears	$6 300
Bar inventory unpaid	$28 800
Wages due to caretaker	$13 500

Snooker Tables were depreciated at 25% at 31 August 2005 on book value. A trade-in of $1 800 was allowed when the new lawn mower was purchased. This transaction took place on 1 September 2004 and a full year's depreciation at 25% was charged to the new mower in the final accounts in August 2005. No depreciation was charged to the old mower.

The Donation of $54 000 which was received at the end of August was placed in a bank deposit account. The interest is to be used in future years to pay for an annual prize called 'The Best Montrosian Prize'.

You are required to:

a) Prepare the club Bar Trading Account for the year ended 31 August 2005. [8]

b) Prepare the club Income and Expenditure Account for the year ended 31 August 2005. [15]
c) Prepare the club Statement of Financial Position as at 31 August 2005. [12]

Question 4

The treasurer of the Bulawayo Cultural and Ballroom Dancing club has prepared the following receipts and payments account for the year ended 31 December 1998.

Receipts		Payments	
	$		$
Balance b/d	7 040	Purchase of amplifier	
Subscriptions (note 1a)		(D1/07/98)	2 800
Cultural dancing	9 640	Cultural dancing	
Ballroom dancing	6 760	Musicians fees	3 600
Annual dinner-ticket Sales	1 360	Coaching fees	3 280
		Hall-rent	1 320
Sale of tent	2 680	Rates for the year to 31/12/98	3 200
Cultural dancing festival-admissions	3 760	Decorating	440
Sales-clothes	8 400	Cleaning	640
-refreshments	33 200	Ballroom dancing	
		Show	5 280
		Annual dinner-hotel	
		Annual catering	1 640
		Cultural dancing	
		Festival-prizes	680
		-judgment fees	360
		Purchases-clothes	7 200
		-refreshments	28 000
		Balance c/d	14 400
	72 840		72 840

Additional information

[a] Subscriptions

	Cultural dancing	Ballroom dancing
Received in 1997 for 1998	$520	$240
Received in 1998 for 1997	$ 40	$560
Received in 1998 for 1998	$9 200	$6 080
Received in 1998 for 1998	$ 400	$ 120
Received in 1998 for 1999	$9 640	$6 760

b] (i) It is not the policy of the society to take into account subscriptions in areas until they are paid.

(ii) The tent, which was sold during 1998, had been valued at $ 200 on 31 December 1997, and was used for the club's activities until sold on 30 June 1998.

(iii) Immediately after the sale of the tent, the club rented a new hall at $1 320 per annum.

(iv) The above receipts and payments account is a summary of the club's bank account for the year ended 31 December 1998, the opening and closing balances shown above were the balances shown in the bank statement on 31 December 1997 and 1998 respectively.

(v) All cash is banked immediately and all payments are made by cheque.

(vi) A cheque for $800 drawn by the club on 28 December 1998 for stationery was not paid by the bank until 4 January 1999.

(vii) The club's assets and liabilities at 31 December 1997 and 1998, in addition to those mentioned earlier, were as follows.

	1997	1998
	$	$
Inventory of goods for resale, at cost: Clothes	5 200	4 400
Refreshments	1 240	2 400
Sundry creditors-Annual dinner (catering)	-	280
Purchases-clothes	2 400	1 600
-Refreshments	1 200	2 000

The club has now instructed its treasurer to prepare an income and expenditure account for the year ended 31 December 1998, and a Statement of Financial Position at that date.
It is proposed to provide for depreciation on the amplifier at the rate of 20% per annum on cost, on a month-by-month basis of ownership.

<u>You are required to:</u>

Draw up the club's income and expenditure account for the year ended 31 December 1998, and a Statement of Financial Position as at that date.

CHAPTER 9

MANUFACTURING ACCOUNTS

9.1 Chapter objectives

After studying this chapter *the student should* be able to:

1. Explain why manufacturing accounts are prepared
2. Define Prime cost and calculate it.
3. Differentiate between prime cost and overhead
4. Identify the 3 types of inventory found in a Manufacturing account and differentiate them,
5. Prepare a manufacturing account showing the production cost of finished goods.
6. Adjust for work-in-progress correctly in a manufacturing account.
7. Determine manufacturing profit and correctly account for it in the books.
8. Explain what unrealised profit is and adjust closing of inventory of finished goods correctly with the unrealised profit.
9. Prepare the Statement of comprehensive income after the manufacturing account.
10. Prepare the Statement of Financial Position for a manufacturing enterprise.

9.2 Introduction

So far, we have looked at businesses which retail goods which they do not produce. Such firms generate profit by purchasing inventory and then selling it at a higher price thus earning profit on the other hand, there are some which manufacture and retail their own goods manufacturing concerns. These organisations have to calculate the cost of production which will then be transferred to the Trading account and be incorporated in the cost of sales so as to arrive at the profit. The calculation of cost of sales in a manufacturing business involves the identification and proper treatment of the different kinds of inventory (stocks) namely raw materials work-in progress and finished goods. It also includes the collection of all the other costs associated with production, namely prime costs and production overheads. Once the cost of production of finished goods has been established, it is then transferred to the Trading and is used to calculate the trading profit or loss.

9.3 Prime cost

The prime cost covers all the costs involved in physically making the products and other costs that are directly related to the level of output. Prime cost is also known as direct costs Prime costs includes,

i) Direct materials these are raw materials purchased for production and can be directly linked to unit of output. Direct material cost includes cost of transportation of the goods ie. Carriage inwards, import duty and any other costs incurred to bring the raw materials to the factory.
ii) Direct labour- these are wages paid to workmen for producing goods per unit. The wages paid have a direct relationship with output as they are paid per unit of output.
iii) Direct expenses- these are any other direct expenses related to production and are paid per unit of output, such as royalties patent and licence fees etc.

9.4 Overheads

This is a name given to indirect expenses, ie those expenses which cannot be linked to any particular unit of output but are recognised as production expenses. Overheads include among other things

i) Indirect materials- these are materials purchased for use in the factory but are not directly linked to any unit of output e.g. cleaning materials for the factory, grease for lubricating production machinery.

ii) Indirect wages-these are wages paid to factory employees which cannot be traced to any particular unit of output e.g. Foreman's wages, cleaners wages etc.
iii) General overheads-there are indirect expenses relating to the factory but cannot be traced to any unit of output, such as rent, heating and lighting, depreciation of factory equipment etc.

9.5 Allocation of overheads

Some expenses may be split between two areas of the financial statements e.g. the rent expense may be split between the factory and the administration and this will be indicated by the split in the relevant expense in the Manufacturing account and Statement of comprehensive income.

If there are adjustments to be made on the expenses to be allocated i.e adjustments for prepayments and accruals, the adjustments should be made first before the expense is split.

Work-in- Progress
Goods which are not finished and are still in the production process at the end of a financial year cannot be sold and are known as work-in-progress. They will be completed in the next financial period. The opening balance of work-in-progress is added on to the current year's production cost and the closing balance of work-in progress is deducted to arrive at the cost of goods completed at the end of the year.

9.6 Inventories (stocks) in manufacturing organisations

There are three types of stocks which are dealt within the manufacturing account and they are;
i) **Raw materials**- as is the practice in trading organisations purchases are adjusted with opening inventories and closing inventories to arrive at the raw materials consumed. Opening inventories is added and closing inventories is deducted from purchases. Raw materials stock form part of the prime cost calculation. If there are carriage inwards and returns outwards adjustment have to be made accordingly.
ii) **Work-in progress**- As stated earlier this is stock of goods that have not been competed in terms of production and are dealt with at the end of the manufacturing account.
iii) **Finished goods**- this is the end product derived from the manufacturing account and is transferred to the Trading account where it is sold to make a profit.

Note: All three types of stocks will appear as current assets in the statement of financial Position (Statement of Financial Position)

9.7 Factory cost of finished goods.

When all production costs have been accumulated, the end result is the factory cost of finished goods also known as the production cost of goods completed. The whole purpose of a manufacturing account is to determine the cost of production which is summary is derived as:

Cost of production=Prime cost + factory overheads + Opening work in progress-Closing work in progress.

Layout of final accounts of a manufacturing concern

XYZ Ltd
Manufacturing Account for the year ended.....................

		$		$
Raw Materials				
Opening inventory				xxx
Add Purchases		xxx		
Carriage Inwards		xx		
Customs duty on raw materials		xx		
		xxx		
Less Returns outwards		xx		xxx
Cost of raw materials available for production				xxx
Less Closing inventories of raw materials			(xx)	
Cost of Raw materials consumed			xxx	
Add Direct labour			xxx	
Direct expenses				xxx
PRIME COST				xxxx
Add Factory overheads				
Factory rent and rates	xxx			
Factory insurance	xxx			
Fuel and power	xxx			
Indirect wages	xxx			
Depreciation of factory non-current assets	xxx			xxx
				xxxx
WORK-IN- PROGRESS				
Add Opening work-in-progress		xxx		
Less Closing Work-in-progress		(xxx)		xxx
PRODUCTION COST OF GOODS COMPLETED				xxxx

<u>XYZ Ltd</u>

Statement of comprehensive income for the year ended....

	$	$	$
Sales			xxx
<u>Finished goods</u>			
Opening Inventory		xxx	
<u>Add</u> Production cost of goods completed		<u>xxx</u>	
		xxx	
<u>Less</u> closing inventory		<u>(xx)</u>	
			<u>xxx</u>
Gross Profit			xxx
<u>Less</u> Expenses			
<u>Administrative/Office expenses</u>			
e.g Office rent		xxx	
Administrative salaries		xxx	
General administrative exp		xxx	
Depreciation-office furniture		xxx	
-Office equipment		<u>xxx</u>	
Distribution		xxx	
<u>Selling and distribution expenses</u>			
e.g. Advertising expenses	xxx		
Sales commission	xxx		
Carriage outwards	<u>xxx</u>	xxx	
<u>Financial expenses</u>			
e.g. Discounts allowed	xxx		
Bad debts	xxx		
Provisions for Bad debts	<u>xxx</u>	<u>xxx</u>	<u>(xxx)</u>
Net Profit for the year			<u>xxx</u>

XYZ

Statement of Financial Position (Bal Sheet) as at...

	Cost		AccDepr	CA	
	$		$	$	
Plant and Equipment	xxxx		xx	xxx	
Office Equipment	xxx		xx	xxx	
	xxx		xxx	xxxx	
Current Assets					
Inventories: Raw Materials			xxx		
Work-in-Progress			xxx		
Finished goods			xxx		
Trade Receivables (debtors)		xxx			
Less Provision for credit loses		(xxx)	xxx		
Prepaid expenses			xx		
Bank			xxx		
Cash			xxx		
			xxxx		
Less Non-current Assets					
Trade Payables (creditors)		xxx			
Accrued expenses		xx	xxx		
Working capital					xxx
					xxxx
FINANCED BY:					
Capital on 1/01/20..					xxxx
Add Net profit					xxx
					xxxx
Less Drawings					(xxx)
					Xxxx

Example 1

Natalie Joseph manufactures a single product. Her trial balance at 28 February 2011 was as follows:

	$	$
Non- current assets at cost	360 000	
Depreciation on non-current assets		144 000
Inventories at 1 March 2010:		
Raw materials	24 000	
Work-in- progress	18 900	
Finished goods	129 000	
Trade Receivables	91 800	
Trade Payables		27 000
Provision for credit loses at 1 March 2010		3 750
Sales		660 000
Drawings		
Capital at 1 March 2010	30 000	315 000
Current account at March 2010		65 400
Purchases of raw materials	246 000	
Manufacturing wages	120 000	
Manufacturing expenses	62 400	
Administration expenses	41 850	
Selling and distribution expenses	64 200	
Cash at bank	27 000	
	1 215 150	**12 15150**

Additional information

1. Inventories as at 28 February 2011 were:

Raw materials	30 000
Work-in-progress	18 900
Finished goods	117 000

2. Depreciation is to be provided on non-current assets at the rate of 10% per annum on cost. The annual depreciation is to be apportioned as follows:

Administration	1/10
Factory	8/10
Selling and distribution	1/10

3. Bad debts of $1 800 are to be written off.
4. The Provision for credit loses is to be increased to $4 500.
5. Accruals and prepayments as at 28 February 2011 were as follows:

	Accruals	Prepayments
	$	$
Administration expenses	600	300
Selling and distribution expenses	2 100	300

Required:

a) Prepare a Statement of comprehensive income and Statement of financial Position of Natalie Joseph as at 28 February 2011.

b) State what is meant by the term "direct" in each of the elements of prime cost.

Suggested Solution

Natalie Joseph
Statement of Comprehensive income account for the year ended 28 February 2011.

		$		$
Raw Materials				
Opening Inventory	24 000			
Add Purchases	246 000			
		270 000		
Less Closing inventory	30 000		240 000	
Cost of raw materials consumed			240 000	
Add Manufacturing wages			120 000	
PRICE COST				360 000
Add factory overheads				
Manufacturing expenses	62 400			
Depreciation (360 x 10% x 8/10)	28 800	91 200		
			451 200	
Add Opening work in progress	18 900			
Less Closing work in progress	(18 900)	-		
PRODUCTION COST OF FINISHED GOODS			451 200	

Statement of comprehensive income for the year ended 28 February 2011

Sales				660 000	
Less Cost of Sales					
Opening inventory of finished goods		129 000			
Add Production cost of goods completed	451 200				
		580 200			
Less Closing inventory of finished goods	117 000	463 200			
Gross Profit				196 800	
Less Expenses					
Selling & district expenses					
Expenses		64 200			
Bad debts		1 800			
Increase in Provision for credit loses			750		
Depreciation (360 x 10% x 1/10)		3 600			
Accruals		2 100			
		72 450			
Less Prepaid selling & district expenses		300			
		72 150			
Administration expenses					
Administration expenses (41 850 + 600- 300)	42 150				
Depreciation (360 x 10% x 1/10)	3 600	45 750		117 900	
Net Profit					78 900

Statement of Financial Position as at 28 February 2011

Non- Current Asset	Cost		Depn		CA
	$		$		$
Non- Current Assets	360 000		180 000	180 000	
Current Assets					
Inventories: Raw materials			30 000		
Work-in-progress			18 900		
Finished goods			117 000		
Trade receivables			86 100		
Cash at Bank			27 000		
			279 000		
Less Current liabilities					
Accrued Selling & distribution expenses		2 100			
Administration expenses	600				
Trade payables		27 000	29 700		
Working capital					249 300
					429 300
Financed by:					
Capital					315 000
Add Current account					65 400
					380 400
Add Net Profit					78 900
					459 300
Less Drawings					30 000
					429 300

- The module is well presented as far as information from page 108 up to the end is concerned. Just leave out the introduction and take everything else as it is. Its excellent
- Change example 1 from the module to

Example 2

- Add this information before example 1

How to eliminate provision for unrealised profit from unsold stock

Step 1

Find out what the mark-up/margin is on the unsold stock of finished goods. This is done by finding the amount of factory profit from the manufacturing account like this.

Transfer price less production cost of finished foods (Optional x 100)
Transfer price of finished goods

This model will give you the margin.
Alternatively you can find the mark up by making the denominator the production cost of finished goods.

Step 2

Because the Closing inventories of finished goods already contains an element of profit you have to use the margin to determine the amount of unrealised profit like this.

Margin $\frac{x}{y}$ x closing inventory of finished goods

NB: If the margin cannot easily be determined, convert the mark-up to a margin by adding the numerator of the mark-up to the denominator in order to get to margin. The numerator of the margin remains the same as that of the margin e.g. If the mark up is 3/7, the margin will be derived like this.

Mark-up	Margin
3/7	(3/(7 + 3) = 3/10

Be sure then to deduct the unrealised profit from the inventory of finished goods in the statement of financial position (Statement of Financial Position) in line with the prudence concept. In the Statement of comprehensive income that inventory is reported as it is inclusive of the unrealised profit.

Unrealised profit in closing inventory has to be deducted from the manufacturing profit in the Statement of comprehensive income also in line with the prudence concept and this is done after the net trading profit has been reported.

9.8 Unrealised profit

When goods are manufactured at a price lower than the purchase price of the finished product the organisation assumes a manufacturing profit, it is the difference which is the manufacturing profit. The profit is however unrealised if goods are not sold since it is in fact not an actual profit but an assumed profit. The effect is that profits and inventory are overstated. An adjustment must be prudently made to the two, accordingly.

Example 1

The following was extracted from the books of Nhengu Enterprises for the year ended 31 December 2000.

	$
Purchases of raw material	258 000
Fuel and light	21 000
Administration salaries	17 000
Factory wages	59 000
Carriage outwards	4 000

Rent & rates	21 000
Discount received	500
Sales	492 000
Returns inwards	7 000
General office expenses	9 000
Repairs to plant machinery	9 000
Inventory at 1 January 2000: Raw materials	21 000
Work in progress	14 000
Finished goods	23 000
Trade creditors	47 000
Capital account	423500
Freehold premises	410 000
Plant and machinery	80 000
Provision for depreciation on plant & machinery	8 000
Trade debtors	20 000
Cash at bank	11 000

Additional information

a) Goods are transferred to the warehouse at cost plus 10%.
b) Inventory in hand as at 31 December 2000
   Raw materials $25 000
   Work in progress $11 000
   Finished goods $28 600
c) Depreciation on plant and machinery is provided at the rate of 10% using the straight-line method.
d) 80% of fuel and light and 75% of rent and rates to be charged to the factory.
e) Outstanding amount of $ 4 000 on fuel and light
f) Doubtful debts provision of 2.5 % of Debtors.
g) Rent and Rates paid in advance is $5 000.

Required
Prepare the Statement of comprehensive income for the year ended 31 December 2000 and a Statement of Financial Position as at that date

Solution
Nhengu Manufacturing account for the year ended 31 December 2000.

	$	$	
Opening inventory of raw materials		21 000	
Add purchases of raw materials		258 000	
		79 000	
Less closing inventory		25 000	
Cost of materials consumed		254 000	
Add Factory wages		59 000	
Prime cost		313 000	
Factory overheads			
Plant and machinery depreciation	8 000		
Fuel and lights	20 000		
Rent and rates	12 000		
Repairs – plant & machinery	9 000		49 000
			362 000
Add Opening work in progress	14 000		
Less Closing work in progress	(11000)		3 000
			365 000
Add manufacturing profit (10%)			36 500
Total cost of production			401 500

Statement of comprehensive income for the year ended 31 December 2000

Sales			492 000
Sales returns			7 000
			485 000
Less cost of sales			
Opening Inventory		23 000	
Add manufacturing cost		401 500	
		424 000	
Less Closing inventory		28 600	
Cost of Sales			395 900
Gross Profit			89 100
Add Discount received			3 500
			92 600
Less Operating expenses			
Fuel and light	5 000		
Administration Salaries	17 000		
Carriage outwards	4 000		
Rent & Rates	4 000		
General office expenses	9 000		
Provision for doubtful debt	5000		39 500
			53 100
Add Factory profit	36500		
Less unrealised profit in closing inventory	2 600		33900
Profit for the year			87 000

Statement of Financial Position as At 31 December 2000

ASSETS

Non Current Assets

		Cost	Acc. Depn.	Net
Freehold Premises				400 000
Plant & machinery		80 000	16 000	64 000
				464 000
Current Assets				
Inventories	Raw materials	25 000		
	Work-in-Progress	11 000		
	Finished goods 28600			
Less Provision for unrealised profit	2600	26 000		
Debtors (20 000 – 500)		19 500		
Rent prepaid		5 000		
Cash at Bank		11 000		
Total current assets				97 500
Total assets				561 500

EQUITY AND LIABILITIES

Capital		510 500
Less Current liabilities		
Creditors	47 000	
Fuel outstanding	4 000	51 000
Total assets		561 500

<u>Statement of changes in equity for the period ending 31 December 2000</u>

	Capital
Balance at 1 January 1999	460 000
Add net profit	50 500
Balance at 31 December 2000	510 500

Notes:

- Closing inventory must then be entered excluding the unrealised profit.

Mark up on cost is $^{1}/_{10}$

$\therefore$ Margin = $\left(\frac{1}{10+1}\right) = {}^{1}/_{11}$

Unrealised profit in closing inventory = $^{1}/_{11}$ x 28 600

= $2 600

This must be deducted from closing inventory in the Statement of Financial Position and from profit and loss account.

Provision for credit loses = 2,5% x 20 000 = $500

Factory Profit is debited to cost of production and credited to net profit. When it is a loss the opposite entries are made.

a) Unrealised Profit
DR Statement of comprehensive income
CR. Provision for unrealised profit

With full amount in first year of making a provision

b) DR Statement of comprehensive income
CR. Provision with increase
less margin % x closing inventory less opening provision in the Tri

With increase only

c) DR Provision
CR. Statement of comprehensive income
Opening Provision in the Trial Balance less margin % x closing inver

With decrease only

9.9 Examination type questions

9.10 Multiple – choice questions

1. Information about a business is given

	$
Production overheads	161 000
Opening inventory of raw materials	21 000
Purchases of raw materials	245 000
Closing inventory of raw materials	14 000
Production wages	231 000
Production supervisor's salary	14 000

What is the prime cost?

A. $483 000
B. $497 000
C. $644 00
D. $658 000

2. When preparing a manufacturing account, a distinction is made between direct costs and indirect costs. Categorise each of the following items as either direct or indirect costs and choose the option, B, C or D, which correctly categorise all four items.

Item 1 Royalties payable relating to the production process in use.

Item 2 The cost of acquiring raw materials

Item 3 Wages paid to production line operators in respect of the current accounting period

Item 4 Wages of a production supervisor

	Item 1	Item 2	Item 3	Item 4
A.	Direct	Direct	Direct	Direct
B.	Indirect	Direct	Direct	Direct
C.	Indirect	Direct	Direct	Indirect
D.	Direct	Direct	Direct	Indirect

3. Goods in a manufacturing company are charged out from the factory to the warehouse at production cost plus a mark-up of 25%. At 1 September 1998 the balance on the provision for unrealised profit account is $182 000. At 31 August 1999 the closing inventory of finished goods is $718 200. What is the effect of the entry in the Provision for unrealised Profit account on 31 August 1999?

A. A decrease in profit of $2 450
B. B decrease in profit of $38 360
C. C increase in profit of $2 450
D. D increase in profit of $38 360

4. A manufacturing company calculates factory profit at 20% of cost of production. The following information is available.

	Statement of Financial Position as at 31 December 2002	**Manufacturing a/c for the year ended 31 December 2002**	**Trading Account for the year ended 31 December 2002**
	$	$	$
Inventory of finished goods	200 000	-	-
Cost of goods produced	-	1 200 000	-
Closing inventory of finished goods	-	-	270 000

How much would be credited in the Profit & loss Account for the year ended 31 December 2002 as factory profit?

A. $195 000
B. $200 000
C. $235 000
D. $240 000

5. The following relate to a factory

Carriage inwards
Depreciation of factory machinery
Machine operators' wages
Insurance of machinery
Royalties on production

Which items make up factory overhead?

A. 1 and 2
B. 2 and 3
C. 2 and 4
D. 4 and 5

6. Goods in a manufacturing company are charged out from the factory to the warehouse at production cost plus a mark-up of 25%. At I September 1998 the balance on the Provision for Unrealised Profit account is $182 000. At 31 August 1999 the closing inventory of finished goods is $718 200. What is the effect of the entry in the Provision for Unrealised Profit account on 31 August 1999?

A. Decrease in profit of $2 450
B. Decrease in profit of $38 360
C. Increase in profit of $2 450
D. Increase in profit of $38 360

9.11 Structured questions

Question 1

D. Mustafa is a manufacturer of wedding and graduation gowns. On 31 December 1996, he provided you with the following information.

		$
Opening inventory, 1 Jan. 1996 –	Raw materials	13 600
	Work in progress	14 000
	Finished goods	23 000
Closing inventory, 31 Dec. 1996 –	Raw materials	12 500
	Work in progress	16 900
	Finished goods	19 800
Raw materials purchases		143 600
Manufacturing wages		21 300
Royalties and patent fees		6 000
Factory maintenance		10 000
Sales of finished goods		308 000
Repairs to plant and machinery		5 600
Administration expenses		14 000
Factory rent and rates		5 000
Selling expenses		12 000
Factory power		2 300
Carriage on purchases		1 300
Depreciation of plant and machinery		3 580
Bad debts written off		500

You are required to prepare for the year ended 31 December 1996.

(a) The manufacturing account, showing clearly the cost of raw materials consumed & prime cost and cost of production.
(b) The trading account.

Question 2

Prepare a Manufacturing Statement of comprehensive income of N. Esther Ltd for the year ended 30 September 2005 from the details below.

	$	$
Inventory at 30 September 2004:		
Raw materials	900 000	
Work in progress	750 000	
Finished goods	780 000	
Factory wages: direct	1 800 000	
Indirect	180 000	
Purchase: direct materials	4 500 000	

Indirect materials	90 000	
Carriage inwards	324 000	
Factory overheads	486 000	
Sales		12 150 000
Office salaries	786 000	
Other administration expenses	1 350 000	
Debentures interest paid	45 000	
Dividends paid: ordinary shares	30 000	
8% preference shares	48 000	
Provision for unrealised profit		156 000
Freehold premises at cost	3 900 000	
Provision for depreciation- freehold		
Premises		540 000
Manufacturing plant and machinery@		
Cost	2 400 000	
Provision for depreciation-manufacturing plant and machinery		1 200 000
Office equipment at cost	1 140 000	
Provision for depreciation-office		
Equipment		300 000
Trade debtors	1 182 000	
Trade creditors		552 000
Bank balance	915 000	
Issued share capital:		
Ordinary shares of $30 each		3 000 000
8% redeemable preference shares of $15 each		1 200 000
Share premium		750 000
10% debenture inventory (2012-2014)		900 000

General reserve	300 000
Retained profit b/d	558 000

Additional information

(i) Inventory at 30 September 2005 valued at lower of cost and net reliable value: Raw materials \$882 000; Work in progress \$1 125 000; finished goods \$1 188 000.
(ii) Carriage inwards relates wholly to the purchase of direct materials.
(iii) Finished goods are transferred from the factory to the warehouse at a mark-up of 20%.
(iv) The factory occupies 75% of the freehold premises and the administrative offices occupy the remainder.
(v) Depreciation policies:
Freehold premises 4% per annum on cost

Plant and machinery 30% per annum on net book value

Office equipment 15% per annum on net book value.

(vi) The freehold premises have been professionally revalued at 30 September 2005. This revaluation is to be incorporated in the accounts.
(vii) \$300 000 is to be transferred to the General Reserve.
(viii) The directors propose a final dividend of \$0.90 per share on the ordinary shares together with a further 6-month preference dividend, both dividends to be paid on 1 December 2005.

CHAPTER 10

INVENTORY VALUATION

10.1 End of chapter objectives

By the end of this chapter you should be able to:

1. State the basis in which inventory is value and the reason thereof.
2. Describe the International Accounting Statement applied when valuing inventory.
3. Calculate the value of inventory using FIFO, LIFO and AVCO.
4. State the advantages and disadvantages of FIFO, LIFO and AVCO.
5. Distinguish between adjusting and non-adjusting events.

10.2 IAS 2 - Inventory valuation

This deals with valuation of inventory. It requires inventory to be valued at the lower of cost and net realisable value. The term cost is included in any expense involved in bringing the goods to present location and condition e.g. these include the purchase price less any trade discounts plus carriage inwards, import duty, freight charges, handling costs etc. Net realisable value is the actual or expected selling price less any cost involved in selling the goods.

Example 1

From the following calculate the value of inventory

Product	**Cost**	**Net Realisable Value (NRV)**
	$	$
A	200	230
B	180	165
C	90	120

For us to choose the correct value, we compare the cost with the NRV and take the lower as the value of each class of inventory.

Solution

	$
A	200
B	165
C	90
Required Value	455

Example 2

The closing value of inventory for ABC LTD as on 31 December 2001 was $28 800. Included in this is an item of inventory that cost $800 and can only be sold for $900 after repairing it at a total cost of $250.

Required

Calculate value of inventory.

Solution

We first determine the Net realisable value of the item market price $900 less $250 = $650. Since this is lower than cost, the lower value should be taken as follows.
$28 800 – 800 + 650 = 28 650.

The value of manufactured goods is determined by adding, direct material, direct labour and proportion of overhead based on normal capacity.

Let's consider the following example

An item was bought for $2 000. The cost of carriage amounted to $140. The retailer's normal mark-up is 25% but due to a technical fault on the item, it needs some attention at a cost of $400 of which it can be sold at $1 700 after advertising it at a total cost of $200.

The value of inventory can be calculated as follows:

Cost	=	$2000 + $ 140	=	$2 140
Net Realisable value	=	$1 700 - $400 - $200	=	$1 100

The value of the item in inventory is $1 100 since it is the lower as compared to the cost of $2 140.

The above methods of inventory valuation should be used in conjunction with the following methods of inventory control to get the actual value of inventory at the end of the period.

10.3 Methods of inventory control

There are various methods of inventory control that have been put in place by various authors. The methods of inventory control that we are looking at here are; FIFO, LIFO & AVCO. Some authors refer them as inventory valuation methods. We would want the students to see this difference by the end of this chapter.

First In First Out (FIFO)

The first goods to be received are the first ones to go out. The method is commonly used by retailers of perishable goods like fruits, vegetables and bread. There is however a danger of them not maintaining the quality of the goods by issuing out shoddy products. The government's tax department has recommended this method of inventory control as it does not understate taxable income, thereby more revenue to be collected by the state in times of rising prices.

Example

The following information relate to the movement of Mr. R. Bingo's category Z of inventory during the month of February 2002. His selling price is maintained at $150 per unit.

IN			**OUT**	
1 Feb	Balance b/d 14 @ $100 each		5 Feb	Sold 6 @ $150
3 Feb	Bought 6 @ $125 each		9 Feb	Sold 5 @" "
9 Feb	Bought 10 @ $120 each		21 Feb	Sold 4 @ " "
28 Feb	Bought 7 @ $135 each		28 Feb	Sold 10 @ " "
Purchases	=	$2 895	Sales	= $3 750

Method A

The value of closing inventory will be calculated as follows using this FIFO method of inventory valuation, using the perpetual inventory approach.

Date	Inventory In	Inventory Out	Inventory Value
1 Feb	Bal b/d 14 @ $100		14 @ $100 $1400
3 Feb	6 @ $125		14 @ $ 100 $2 150 6 @ $125
5 Feb		6 @ $150	8@ $100 6 @ $125 $1 550
9 Feb	10 @ $120	5 @ $150	3 @ $100 6 @ $125 10 @ $120 $2 250
21 Feb		3 @ $150 1 @ $150	5 @ $125 10 @ $120 $1 825
28 Feb	7 @ $135	5 @ $150 5 @ $150	5 @ $120 7 @ $135 $1 545

The value of inventory at the end of Feb. 2002 under FIFO is $1 545.

Please note that the concept of cost and net realisable has been used. For valuing inventory, we were considering the lower of the two. In all cases, the cost was lower, therefore giving the value of the inventory. Suppose the cost of inventory bought on the 28th of Feb cost $155 each unit and the selling price remains the same. The value of goods was going to be calculated at $150 as follows:

Date	Inventory In	Inventory Out	Inventory Value	
28 Feb	7 @ $155	5 @ $150	5 @ $120	
		5 @ $150	7 @ $150	$1 650

The inventory value is now $1 650

Method B

Periodic inventory approach

opening balance (units)	14
Total bought	23
	37
Less Sales (Units)	25
Units in stock at end	12

These units in stock at end (12 units) should be the last or latest stock made up of 7 @ $135 and 5 @ $120 = $1 545.

Last In First Out (LIFO)

Each time when goods are sold or dispatched, they are said to be from the last lot of goods just received on or before that date. When there are no enough inventories on the last lot, the balance of goods is said to come from the previous lot still unsold. This method of inventory control is commonly used on the valuation of fashionable goods like clothes, radios, motor vehicles etc. The effect of this method is that the reported profit would be low in times of rising prices.

Let's look at our example of Mr. R. Bingo's category of inventory

Method A – Perpetual valuation approach

Date	Inventory In	Inventory Out	Inventory Value
1 Feb 2002	Bal b/d 14 @ $100		14 @ $100 $1400
3 Feb 2002	6 @ $125		14 @ $ 100 6 @ $125 Total = $2 150
5 Feb 2002		6 @ $150	14@ $100 Total = $1 400
9 Feb 2002	10 @ $120	5 @ $150	14 @ $100 5 @ $120 Total = $2 000
21 Feb 2002		4 @ $150	14 @ $100 1 @ $120 Total = $1 520
28 Feb 2002	7 @ $135	10 @ $150	12 @ $100 Total = $1 200

The value of closing inventory is $1 200

Method B – Periodic Inventory Approach

The Closing inventories (12 u nits) should be at the earliest / first to be bought.

12 @ $100 = $1 200

Average Cost (AVCO)
Upon the receipt of the goods, the average cost for each item of inventory is re-calculated. The new value would be the value of each item of inventory. This method is common to goods like spanners, bricks, petrol and paraffin. The method is suitable for business which do not have a policy on the issue of goods. Using this method, Mr. Bingo's Category Z product may be calculated as follows:

Method A – Perpetual valuation approach

Date	Inventory In	Inventory Out	Inventory Value
1 Feb 2002	Bal b/d 14 @ $100		14 @ $100 Total = **$1400**
3 Feb 2002	6 @ $125		14 @ $ 100 $1 400 6 @ $125 $750 AVCO = $107.50 Total = 20 x $107.50 **$2 150**
5 Feb 2002		6 @ $150	14@ $107.50 Total **=** **$1 505**
9 Feb 2002	10 @ $120	5 @ $150	14 @ $107.50 = $1 505 10 @ $120 = $1 200 AVCO = $112.71 Total = 19 x $112.71 **$2141.49**
21 Feb 2002		4 @ $150	15 @ $112.71 Total = **$1 690.65**
28 Feb 2002	7 @ $135	10 @ $150	15 @ $112.71 $1 690.65 7 @ $135 $945.00 AVCO = $119.80 Total = 12 @ $119.80 = **$1437.60**

The value of inventory under AVCO is $1 437.60.

The following is an illustration of the profit figures being reported by the three methods of inventory control

Method B – Periodic Inventory Approach

Calculate average purchase price

(14 x $100) + (6 x $125) + (10 x $120) + (7 x $135)

37

1 400 + 750 + 1 200 + 945

37

4 295

37

= $116. 08

Total value = 12 x $116.08 = $1 392.96

Trading account for the month of February 2002

	FIFO		LIFO		AVCO	
	$	$	$	$	$	$
Sales		3 740		3 750		3 750
Less cost of sales						
Opening inventory	1 400		1 400		1 400	
Add purchases	2 895		2 895		2 895	
	4 295		4 295		4 295	
Less closing inventory	1 5452 750		1 2003 095		1 437.62 857.4	
Gross profit		1 000		655		892.60

For all along, we have assumed that inventory taking is done on the last day of the accounting period. It is common in practice for organizations to take inventory either before or after the financial year end and reduce disruption of business activities. If stock-take is done this way, the Closing inventories figure is calculated as follows:

10.4 Inventory-take done before the financial year-end

Due to various reasons, stock-taking can be done before the financial year end. If inventory take is done before the end of the accounting period, you determine your correct inventory-take figure as follows:-

Illustration 1

Susan Ndlovu whose financial year ends on 31 December 2006 carried out her annual stock-taking on the 25th of December in order to proceed on holiday. On that day inventory in the factory at cost price was valued at $89 100.

Additional information

a) The average ratio of gross profit to sales was 25%
b) Purchases made during the period 25 to 31 December totaled $11 900
c) Purchases returns totaled $2000 on 29 December
d) Sales totaled $60 000 during the same period
e) Sales returns made on 28 Dec. totaled $12 000

It was discovered that some goods included in the above figure were damaged and had cost $900. They could be sold for $750. Goods on sale or return (not included the inventory take figure above) were valued at $10 000 at selling price were sent to a customer on 24 December.

Required

Calculate the value of closing inventory on 31 December.

Solution

	$
Inventory as at 25 December	89 100
Add purchases	11 900
Add sales returns 12 000 less 25%	9 000
Add goods on sale on return basis 10 000 less 25%	7 500
	117 500
Less	
Sales 60 000 less 25%	45 000
Purchase returns	2 000
Less inventory write down (900 – 750)	150
Inventory at 31 December	70 350

10.5 Inventory taking done after the financial year – end

When inventory take is taken after year end, the inventory take figure is determined as follows:

Sales as per account		x
Add:	Sales reduced to cost	x

	Purchases return	x
	Goods on sale or return	<u>x</u>
		x
Less:	Purchases	x
	Sales returns	<u>x</u>
	Value of closing inventory at year end	x

10.6 IAS 10 - Contingencies and events after the Statement of Financial Position date.

This deals with post Statement of Financial Position events. Post Statement of Financial Position events that are both favourable and unfavourable are events which occur between the Statement of Financial Position date and the date on which accounts are authorised or approved by the boards of directors. There are of two types, namely adjusting events and non-adjusting events.

<u>Adjusting events</u>

These provide additional evidence on conditions existing at the Statement of Financial Position date and require us to change the accounts, e.g. insolvent of a debtor, sale of inventory below cost, permanent decline in the value of property, plant and equipment, changes in tax rates, discovery of fraud or errors which shows that the financial statements were incorrect.

<u>Non-adjusting events</u>

These are post Statement of Financial Position events, which concern conditions, which did not exist at the Statement of Financial Position date. With these, we do not change the accounts but we disclose by way of note e.g. destruction of property, plant and equipment or inventory by flood, issue of shares and debentures, strikes etc.

It deals with accounting for contingencies. A contingency is a condition, which exists at the Statement of Financial Position date whose outcome will be confirmed only by the occurrence or non-occurrence of one or more certain future events. For example, corporation tax disputes, failure by another party to pay a debt which the company has guaranteed and a legal action which has been brought against the company. It requires a contingency loss. This is shown by way of note. If the probability of the event occurring is remote, ignore the event. A contingent gain should not be included in the financial statements but should be disclosed as a note, if it is probably that the gain will be realised.

10.7 Examination type questions

10.8 Multiple Choice

1. A company has two items in inventory, which require to be repaired before sale.

	Cost $	Selling price $	Repair costs
Item 1	5 260	7 600	880
Item 2	2 360	2 450	190

What is the total inventory value of these items?

A. $6 550
B. $7 620
C. $7 520
D. $8 980

2. A business was started on 1 January. The purchase and sales of inventory for January were:

Date	Purchases	Sales
4 January	3 @ $800	-
13 January	-	2 @ $1 600
26 January	3 @ $1 000	-
28 January	-	2 @ $ 1600

The business used the first in first out (FIFO) method of inventory valuation.

What was the gross profit for January?

A. $2 600
B. $2 800
C. $3 000
D. $4 600

3. A business ends its financial year on 31 December 2004. The inventory was not counted until 10 January 2005 when it was found to be $312 000 at cost. The following transactions took place from 1 to 10 January 2005.

	$
Inventory purchased	48 000
Inventory sold at selling price	45 000

Inventory is sold at a mark-up of 25%

What was the value of inventory at 31 December 2004?

A. $297 750
B. $300 000
C. $324 000
D. $326 250

4. A company uses the Weighted Average Cost (AVCO) method of inventory valuation. During January the following transactions took place.

January		**Total $**
1	Opening inventory of 100 units @ $2.00 per unit	200
12	Received 150 units @ $2.10 per unit	315
15	Issued 100 units	-
27	Received 50 units @ $2.20 per unit	110

What is the value of inventory at 31 January?

A. $440
B. $419
C. $420
D. $425

5. A company sells goods on sale or return at a mar- up of 25%**.** At the Statement of Financial Position date the following information is available.

Goods in warehouse $150 000 (Cost)	$150 000 (cost)
Goods sent on sale or return	$100 000 (at invoice price)

What will be the value of closing inventory in the company accounts?

A. $150 000
B. $225 000
C. $230 000
D. $250 000

6. According to IAS 10, Contingencies and Post Statement of Financial Position events certain events must be disclosed in the notes to the financial statements. To which of the following does this rule apply?
   A. An insolvency of a debtor, existing at Statement of Financial Position date
   B. Destruction of a factory by fire after the year end, resulting in no production.
   C. Sale of inventory after the year- end at a material loss.
   D. Valuation of property, providing evidence of a permanent diminution in value at year-end.

7. Showing property, plant and equipment in the Statement of Financial Position at cost less aggregate depreciation, and inventory at net realizable value or cost, whichever is lower is in adherence to the concept of

   A. Materiality
   B. Money measurement
   C. Realisation
   D. Going concern

8. The value of a firm's inventory at the end of an accounting period is found by

   A. Stock-taking physically
   B. Taking the balance from the inventory account, inventory register or inventory sheet.
   C. Deducing the total of the firm's purchases from that of the sales
   D. Deducing the firm's cost of sales from the total of its sales.

10.9 Structured questions

Question 1

a) IAS 10 covers Contingencies and events occurring after Statement of Financial Position date. Place each of the following events in the relevant column below.

	Adjusting event	Non adjusting event	Neither
i. Government nationalisation of property, plant and equipment on the Statement of Financial Position.			
ii. The sale of property, plant and equipment after the Statement of Financial Position date at a much lower price than it was stated on the draft Statement of Financial Position.			
iii. The sale of inventory after the Statement of Financial Position date a much lower price than it was stated on the draft Statement of Financial Position.			
iv. The takeover of a rival company after the Statement of Financial Position date.			

b) Distinguish between an ‘adjusting event’ and a ‘non-adjusting event’ according to IAS 10. Limbo Ltd produces a range of pharmaceutical products. At the Statement of Financial Position date the following information is available:

i. Ms. Tshuma took one of the company’s products and then felt drowsy when driving home from work. She crashed her car and suffered serious injury which she claims were due to the medication she took. There were no warnings on the product packaging concerning possible side effects and the company’s legal advisors believe that Ms Tshuma has a good chance of winning the forthcoming court case and that the court would agree to the damages claim of $8 000, 000, 00.

ii. Another company, Felix Ltd, has launched a new product which Limbo Ltd believes infringes its patent rights. The company’s legal advisors are confident the current court case will find in favour of Limbo Ltd and the damages requested of $20 000 000 would be awarded.

iii. Mr. Ncube drank one of the company’s cleaning products by mistake and became violently ill. The packaging on the product stated clearly that it was not for internal consumption. The company’s legal advisors do not think that there is much chance that the claim before the courts for damages of $3 000 000 would be accepted.

What accounting treatment and disclosure would you recommend for each of the above?

c) What is a 'contingency' as defined by IAS 10 Contingencies and events occurring after Statement of Financial Position date? How does a contingency differ from a post Statement of Financial Position event?

Question 2

Philani Sibanda's first 6 months of trading showed the following purchases and sales of inventory.

2003	Purchases	Sales
January	380@ $455 each	
February		240 @ $574 each
March	200 @ $483 each	
April		290 @ $595 each
May	330 @ $504 each	
June		300 @ $630 each

Calculate Philani's profit for the 6 months ended 30 June 2003 using the following methods of inventory valuation.

(a) FIFO (First In First Out)
(b) LIFO (Last In Last Out)
(c) AVCO (Weighted Average Cost). Calculate to 2 decimal places.

Question 3
Mary Nkosi is in business as a retailer and her financial year end is 30 June. She was ill on 30 June 2007. She was unable to carry out her end of year inventory-taking until 9 July.

On 9 July her inventory at cost was valued at $196 000. Mary's mark-up is 25% on cost. The following transactions took place during the period 1 to 9 July:

1. Sales, invoiced to customers for $67 440
2. Purchase of goods for resale $63 600
3. Goods returned to suppliers $ 640
4. Goods returned by customers, originally sold for $ 880
5. Goods taken for own use at cost $ 1 600
6. After inventory-taking, Mary discovered the following:
7. Included in the valuation were goods awaiting collection by a customer. These had been sold during June for $4 000.
8. Included in the valuation were goods Mary had acquired for $1 920 on a sale or return basis. She had not yet decided whether to keep them in inventory or return them.
9. Included in the valuation at cost was old inventory which had cost $5 200 but had been damaged during March and was to be sold off for $3 200.

Draw up a financial statements to show the correct inventory valuation at 30 June 2005.

CHAPTER 11

INTRODUCTION TO PARTNERSHIP ACCOUNTING

11.1 Chapter objectives

After studying this chapter *the student should* be able to:

11.2 Introduction

Sole traders may form a partnership in most cases so that they raise more capital. A partnership is regarded as a business entity carried by at least 2 people, maximum 20 people with the objective of making profit and share it using agreed profit and loss sharing ratio, with exception firms of professionals like chartered accountant, solicitors, and etc. were there is no maximum.

The Partnership Deed

This is a verbal or written agreement made by the partners before entering into a partnership. The following are the common provisions of this Deed for the purpose of the examination.

a) Capital to be contributed by each partner.
b) Profit and Loss sharing ratios.
c) Salary allowable to partner(s), if any.
d) Maximum amount of drawings.
e) Interest charged to partners` drawings.
f) Interest allowable on partner's capital and loan.

11.3 Partnership Act (1890)

In the absence of the partnership Deed, we apply the provisions of the Partnership's Act (1890) which states that:

a) Capital contributions should be equal.
b) Profit and Losses to be shared equally.
c) No partner entitled to a salary.
d) No drawings & Interest charged on drawings.
e) 5% interest allowed to partner's loan or additional capital.

If a question is silent on an provision of the partnership Deed, the Partnership's Act of 1890 should automatically be applied.

Salary

Salaries should be credited to current account and debited to the Statement of comprehensive income as either administration or selling and distribution costs. Where a salary or part of the salary is paid during the year the amount paid should be debited to the current account, but the annual salary as per partnership agreement should be credited to the current account in full.

Interest on Loan from a partner

It is a business expense; it should be debited to the Statement of comprehensive income and credited to partner's current account, where you are given the Net profit before interest from a partner. In an examination, you should adjust for interest before appropriation. If the loan is received partway through the year interest should be apportioned on a time basis.

Interest on Capital

It should be debited to the Statement of comprehensive income as finance cost and credited to partner's current account. If capital is introduced in the form of cash or other assets partway through the year interest should be time apportioned.

11.4 Capital accounts

Capital accounts represent the contribution made by the partners in the partnership. These contributions need not necessarily be of the same nature. They can be in any of the following from, as noted in chapter 1 of this book.

- Cash
- Assets
- Expenses paid by the partnership on behalf of the partner

A separate capital account must be opened for each partner, in the ledger. Capital accounts must not be combined with current accounts.

11.5 Current accounts or drawing accounts

In addition to the capital account, which shows each partner's permanent investment in the partnership, a current account must be opened for each partner. This account is record of all income accruing to the partner and drawings made against that income. The following are some of the transactions that will be recorded in the current accounts.

- Interest on capital
- Interest on drawings
- Drawings
- Interest on current accounts
- Salary paid to the partner
- Interest on loan

Example 1

X and Y are in a partnership sharing profits and losses in the ratio 3:2 after charging interest on capital accounts at the rate of 5% per annum and salaries of $9 000 and $6 000 per annum respectively. The capital balances at the beginning of the year X: $50 000, Y: $40 000. In their first year of trading the partnership made a loss amounting to $44 500. The partners do not maintain a separate current a/c.

Required: -

Prepare:

a) Partners' Capital Accounts

b) Statement of changes in equity

Capital Accounts

	X	Y		X	Y
Share of Loss	26 700	17 800	Bal. b/d	50 000	40 000
Balance c/d	34 800	30 200	Salary	9 000	6 000
			Interest on capital	2 500	2 000
	61 500	**48 000**		**61500**	**48 000**
			Balance b/d	34 800	30 200

Statement of changes in equity

	X	Y	Total
Opening balance	50 000	40 000	90 000
Salary	9 000	6 000	15 000
Interest on capital	2 500	2 000	4 500
Share of loss	(26 700)	(17 800)	(44 500)
Closing balance	34 800	30 200	65 000

Notes:

Where you are given the results of trading for partnership, which are less than a year, annual salaries and annual interest should be apportioned on a time basis. The rate of depreciation is given per annum should also be apportioned.

Example 2

M, N and O are in partnership. Their partnership agreement provides for: -

a) Interest on drawings 8%
b) Interest on capital 10%
c) Salary to M $9 000
d) Interest on loan from a partner 15%
e) Profits or losses to be shared M:5 N:4 O:1

The following is their trial balance as at 31 December 2001 after the preparation of the Statement of comprehensive income.

	DR	CR.
	$	$
Capital - M		90 000
N		80 000
O		30 000
Current accounts - M		10 000
N		8 000
O		1 000
Salary of M	4 500	
Loan from N		20 000
Inventory *(on 31 December)*	70 000	
Debtors	95 000	
Creditors		18 000
Net Profit		120 000
Property, plant and equipment	169 500	
Bank	15 000	
Drawings - *M (1 May 2001)*	18 000	
N (30 September 2001)	12 000	
O (31 December 2001)	21 000	
	391 000	**391 000**

Additional Information

Loan from N was received on May 31. Interest on this loan has not been taken into account.

Required:-

i) Profit and loss appropriation account
ii) Partners` current account
iii) Statement of changes in equity
iv) Statement of Financial Position as at 31 December 2001

Solution

Note: in the above question, we have closing inventory in the trial balance because the Statement of comprehensive income has already been prepared and a figure for net profit is in the trial balance. In most cases it is the opening inventory which is in the trial balance.

			$
Profit before interest			120 000
Less interest on loan (15% x 20 000 x 7/12)			1 750
Net profit after interest c/fwd			118 250

PROFIT AND LOSS APPROPRIATION ACCOUNT

Net profit after interest b/fwd			118 250
Add interest on drawings			
M 18000 x 8% x $^{8}/12$		960	
N 12000 x 8% x $^{3}/12$		240	1 200
		119 450	
Salary : **M**	9 000		
			110 450
Interest on capital			
M 90000 x 10%		9 000	
N 80000 x 10%		8 000	
O 30000 x 10%		3 000 20 000	
			90 450
Share of profit **M**			45 225
N		36 180	
O		9 045	
			90 450

Current Account

	M	**N**	**O**		**M**	**N**	**O**
	$	$	$		$	$	$
Balance b/d	-	-	1 000	Balance b/d	10 000	8 000	
Bank (salary)	4500			Salary	9 000		
Drawings	18 000	12 000	21 000	Interest on capital	9 000	8 000	3 000
Int. on Drawings	960	240	-	Interest on loan	-	1 750	-
Balance c/d	49 765	41 690	-	Share of profit	45 225	36 180	9 045
				Balance c/d	-	-	9 955
	73 225	53 930	22 000		73 225	3 930	22 000
Balance b/d		-	9 955	Balance b/d	49 765	41 690	

Statement of changes in equity for the year ended 31 December 2001

	M	N	O	Total
	$	$	$	$
Current account balance at 31/12/01	49 765	41 690	(9 955)	81 500
Current account balance at 01/01/01	10 000	8 000	(1 000)	17 000
Salary	9 000	-	-	9 000
Interest on capital	9 000	8 000	2 000	4 500
Interest on loan	-	1 750	-	1 750
Share of profit	45 225	36 180	9 045	90 450
Salary paid through the bank	(4 500)	-	-	(4 500)
Drawings	(18 000)	(12 000)	(21 000)	(51 000)
Interest on drawings	(960)	(240)	-	(1 200)
Capital account balance at 31/12/01	90 000	80 000	30 000	200 000
Equity at 31/12/01	139 765	121 690	20 045	281 500

STATEMENT OF FINANCIAL POSITION OF M, N & O AS AT 31 DECEMBER 2001

ASSETS		
Property, plant and equipment		169 500
Current Assets		
Inventory	70 000	
Receivables	95 000	
Total current assets		165 000
Total assets		334 500
EQUITY AND LIABILITIES		
Capital and reserves		
Capital		200 000
Current accounts		81 500
Total capital and reserves		281 500
Loan from N		20 000
Current Liabilities		
Trade payables	18 000	
Bank Overdraft	15 000	33 000
Total equity and liabilities		334 500

Example 3

Preparing a statement of Comprehensive income account where the trading results are less than a year.

Runia and Sibongile are in partnership business. The results of the first six months ending 30 June 2005 have shown a net profit of $30 000. The partnership provides for the following provisions: -

a) Interest on capital 10% per annum
b) Annual salaries of $12 000 and $4 500 respectively.
c) Profit to be shared in the ratio 2:1.
d) The opening capital Accounts balances are as follows: Runia $70 000 and Sibongile $65 000.

<u>Required:</u>

Prepare profit and loss appropriation account for the year ended 30 June 2005

<u>Solution</u>

<u>Profit And Loss Appropriation Account for the year ended 30 June 2005</u>

	$	$
Net profit		30 000
Less Salaries: R (12 000 x ½)	6 000	
S (4 500 x ½)	2 250	
Less Interest on capital		
Runia (10% x 70 000 x 6/12)	3 500	
Sibongile (10% x 65 000 x $^{6}/12$)	3 250	15 000
		15 000
Share of profit: Runia ($^{2}/3$ x 15 000)		10 000
Sibongile ($^{1}/3$ x 15 000)		5 000
		15 000

Where a partner or partners guaranteed that one of the partner's share of profit should not be less than a certain figure and after sharing in the normal way. If it amounts to less than the amount agreed, the short fall should be shared by the other partners in their profit sharing ratio excluding the guaranteed partner's ratio.

Example 4

How to prepare profit and loss appropriation where the partners guarantee the income partner a minimum share of profit

A, B and C were in partners in construction business. Their partnership agreement provides for annual salaries of $7 000, $6 000 and $5 000 respectively, share of profit 3:2:1. A and B guaranteed that C`s share of profit should not be less than $5 000. In the second year of trading they made a profit $42 000. The partners' capital balances were:

A $75 000

B $51 000

C $18 000

According to their partnership agreement, they are entitled to interest on capital at 10% p.a. In the year to 30 June 2005, the net profit of the business was $21 000.

Prepare the appropriation account of the partnership for the year ended 30 June 2005.

Required: -

Prepare profit and loss appropriation.

Solution: -

Profit and loss appropriation for A, B AND C

Net profit			42 000
Less Salaries	A	7000	
	B	6000	
	C	5000	18 000
			24 000
Share of profit	A	(12 00 - 600)	11 400
	B	(8 000 – 400)	7 600
	C	(4 000 +1 000)	5 000
			24 000

C's share of profit is falling short by $1 000. The shortfall should therefore be covered by A and B in proportion to their profit and loss sharing ratios as follows:

A = 3/5 * $1 000 = $600
B = 2/5 * $1 000 = $400

Example 5

The following trial balance as at 31 December 2002 was extracted from the books of Sam and Moyo after their first 10 months of trading.

	$	$
Capital : Sam		120 000
Moyo		30 000
Cash drawings : Sam *(1 March)*	18 000	
Moyo *(30 November)*	11 000	
Sales		311 800
Purchases	186 000	
Wages and salaries	36 000	
Telephone expenses	8 600	
Electricity and water	600	
Rent	24 000	
Trade creditors		14 000
Trade debtors	39 000	
Motor vehicles	90 000	
Furniture and fittings	30 000	
Balance at bank	12 000	
Bank charges	5 000	
Stationery	15 600	
	475 800	475 800

Additional information

a) The partnership agreement provided the following

i. Interest on capital at the rate of 10% per annum.
ii. An annual salary of $5 000 to be paid to Sam
iii. The partnership guarantees Moyo a minimum share of profit of $10 000, excluding interest on capital.
iv. Profit and loses to be shared between Sam and Moyo in the following ratios 4 : 1 respectively.

b) Non – current assets are depreciated using the reducing balance method at the following rates:
   i. Motor vehicles 20%
   ii. Furniture and fittings 10%
c) Included in the wages and salaries figure is a salary of $2 000 paid to Sam during the period.
d) Rent paid was for the year ending 28 February 2003.
e) Inventory on hand at 31 December 2002 was valued at $28 000.
f) A telephone bill of $400 was not paid until 2 January 2003.
g) No entry was made in the books for an office desk valued at $12 000 brought into the business by Moyo on 1 September 2002.
h) The accounting fees for the preparation of the accounts will be $9 000.
i) The accounts have not been adjusted for discount received from trade creditors of $200 during the year.

You are required to prepare
a) The Statement of comprehensive income for the period ending 31 December 2002,
b) Statement of changes in equity and
c) A Statement of Financial Position as at that date.

Solution

Statement of comprehensive income for the period ending 31 December 2002

	$	$
Sales		311 800
Less cost of sales		
Opening inventory	-	
Purchases	186 000	
Less closing inventory	28 000	158 000
		153 800
Add discount received		200
Gross profit		154 000
Less operating expenses		
Accounting fees	9 000	
Bank charges	5 000	
Wages & salaries *($36 000 - $2 000)*	34 000	
Telephone expenses *($8 600 + 400)*	9 000	
Electricity and water	600	
Rent *($24 000 – $4 000)*	20 000	
Stationery	15 600	
Depreciation : Motor vehicles *($90 000 x 20% x 10/12)*	15000	
Furniture & fittings *($30 000 x 10% x 10/12*	2 500	
($12 000 x 10% x 4/12	400	111100
Net profit		42900
Less salary: Sam	5 000	
Less interest on capital (Finance cost)		
Sam: *($120 000 x 10% x 10/12)*	10 000	
Moyo: *($30 000 x 10% x 10/12)*	2 500	
($12 000 x 10% x 4/12	400	17 900
		25 000
Share of profit: Sam *($20 000 – $5 000)*	15 000	
Moyo *($5000 + $5000)*	10 000	25000

Statement of Financial Position as at 31 December 2002

	$	$	$
ASSETS			
Non – current assets	Cost	Accumulated Depreciation	CA
Motor vehicles	90 000	15 000	75 000

Furniture & fittings *(30 000 + 12 000)*	42 000	2 900	39 100
	132 000	17 900	114 100
Current assets			
Inventory		28 000	
Accounts receivable		39 000	
Rent prepaid		4 000	
Balance at bank		12 000	83 000
			197 100

EQUITY AND LIABILITIES

	Sam	Moyo	Total
Capital	132 000	30 000	162 000
Current	10 000	1 900	11 900
	142 000	31 900	173 900
Current liabilities			
Creditors (14 000 – 200)		13 800	
Accounting fees		9 000	
Accrued telephone expenses		400	23 200
			197 100

Statement of changes in equity for the year ended 31 December 2002

	Sam	Moyo	Total
	$	$	$
Current account balance at 31/12/02	10 000	1 900	11 900
Current account balance at 01/01/02	-	-	-
Salary	5 000	-	5 000
Interest on capital	10 000	2 900	12 900
Share of profit	15 000	10 000	25 000
Salary paid through the bank	(2 000)	-	(2 000)
Drawings	(18 000)	(11 000)	(29 000)
Capital account balance at 31/12/02	120 000	42 000	162 000
Equity at 31/12/02	130 000	43 900	173 900

Current accounts

	Sam	Moyo		Sam	Moyo
	$	$		$	$
Salary	2 000	-	Salary	5 000	-
Drawings	18 000	11 000	Interest on capital	10 000	2 900
Balance c/d	10 000	1 900	Share of profit	15 000	10 000
	30 000	12 900		30 000	12 900
			Balance b/d	10 000	1 900

11.6 Examination type questions

11.7 Multiple Choice

1. Which of the following is not an appropriation of profit?

   A. Partner's interest on capital
   B. Partner's interest on drawings
   C. Partner's interest on loan
   D. Partners salary

2. What appears as a credit in the Appropriation Account of a partnership?

   A. Goodwill
   B. Interest on capital
   C. Net trading profit
   D. Partnership salaries

3. Interest charged on a Partner's drawings account should be

   A. Debited to the Profit and loss Account
   B. Credited to the Profit and loss Account
   C. Debited to the Appropriation Account
   D. Credited to the Appropriation Account

4. A partnership maintains fixed capital accounts and current accounts for its partners. What is the correct accounting entry for recording interest on capital for partner X?

	Account to be debited	**Account to be credited**
A.	Statement of comprehensive income	X's Capital
B.	Statement of comprehensive income	X's current
C.	X's Capital	Statement of comprehensive income
D.	X's Current	Statement of comprehensive income

5. Mary and Anne are partners in a business and share profits in the ratio of 3:1. their net profit is $80 000. The following information is available:

	Mary	Anne
	$	$

Interest on capitals	3 000	2 500
Interest on drawings	500	1 000

How will the residual net profit be shared?

	Mary	Anne
	$	$
A	57 000	19 000
B	58 875	21 125
C	59 500	20 500
D	60 500	19 500

6. The following appropriation a/c for a partnership contains one error.

	$	$
Profit as per profit and loss a/c		169 749
Interest on capital Angel	9 000	
Belta	4 500	13 500
		156 249
Salary: Angel		8 100
		164 349
Balance of profit shared		
Angel	109 566	
Belta	54 783	164 349

What should Angels' share of the balance of profit be, when the error is corrected.

A. $98 766
B. $104 166
C. $116 766
D. $126 666

11.8 Structured questions

Question 1
The following information relates to Pick and Spade who are trading as equal partners.

	$
Capital accounts (fixed): Pick	150 000
Spade	180 000
Current accounts on 1 April 2005	
Pick (Dr)	6 000
Spade (Cr)	15 000
Long- term loan from Spade	120 000
Sundry debtors	159 900
Accumulated depreciation on 1 April 2005	
- Furniture & equipment	10 500

Furniture & equipment at cost	105 000
Prov. for bad debts: Balance on 1 April 2005	6 000
Bad debts recovered	315
Inventory – 1 April 2005	241 500
Purchases	601 500
Interest on long –term loan	5 400
Stationery	1 800
Salaries & Wages	19 500
Rent	6 000
Cash at Bank	160 215

The following are noted:

a) Make provision for:

- Interest on capital at 9% annum
- Interest on current accounts (opening balances) at 7% per annum.
- A managerial salary of $18 000 per annum to Spade.
- A bonus equal to 10% of the distributable profit to Pick.

b) Bad debts of $900 are to be written off

c) The Provisition for credit loses must be maintained at 5% of trade debtors.

d) Interest of 12% per annum must be provided for the whole year on the long term loan from Spade.

e) Provide for depreciation at 15% per annum on furniture and equipment on the diminished balance.

f) Inventory on hand at 31 March 2006:

Merchandise	$183 000
Stationery	300

g) The profit mark-up is 20% on sales

REQUIRED

a) Prepare the Statement of comprehensive income account of Pick and Spade for the year ended 31 March 2006.
b) Prepare the current accounts of Pick and Spade in columns form.

Question 2

The following details were extracted from the books of the partnership for the year to 30 June 1993:

	$
Receipts: Cash Sales	300 000
Cash received from debtors	170 000
Payments : Purchase	140 000
Selling expenses	30 000
Distribution expenses	20 000
Wages and salaries	100 000
General expenses	15 000
Drawings:	
(to 31.12.92) Road	20 000
Path	30 000
Street	25 000
(Jan-30 June 93	
Path	20 000
Street	25 000
Trade debtors at 30 June 1993	25 000
Trade creditors at 30 June 1993	35 000

The following were owing at 30 June 1993

Selling expenses	$6 000
Distribution expenses	$4 000
General expenses	$1 000

Inventory at 30 June was $20 000

Sales occurred evenly throughout the year and a uniform profit margin was earned on all sales.

<u>You are required to:</u>

Prepare a Statement of comprehensive incomes of Road, Path and Street and Path and Street in columnar form for the half year ended 31 December 1992 and 30 June 1993 respectively.

Question 3

Led and Pencil are partners in a manufacturing business who have prepared the following draft Statement of Financial Position from their books of account as at December 2005.

Property, plant and equipment	**Cost**	**Depr**	**CA**
	$	$	$
Freehold buildings	24 000	-	24 000
Plant & machinery	30 000	14 000	16 000
Motor Vehicle	16 000	5 400	10 600
	70 000	19 400	50 600
Current Assets			
Inventory		10 000	
Debtors		28 000	
Cash in hand		80	
		38 080	
Less Current liabilities			
Creditors	15 600		
Bank overdraft	5 400	21 000	17 080
			67 680
	Led	**Pencil**	**Total**
Capitals:	40 200	20 000	60 200
+ Profit for the year: Led	9 540	9 540	19 080
	49 740	29 540	79 280
- Drawings	4 000	7 600	11 600
	45 740	21 940	67 680

During the course of your examination of the books you ascertain that adjustments are required for the following items?:

1. Freehold buildings are shown at cost less $6 000 being the proceeds of the sale during the year of premises costing $7 000.
2. Plant & machinery having a net book value of $430 had been scrapped during the year. The original cost was $1 230.
3. Motor vehicle licenses for a twelve month period costing $200 had been written off, but did not expire until 30 June 2006.
4. Debts to the value of $1042 were considered to be bad, and a further $540 doubtful requiring 100% provision. Provision had previously been made for $1 000 doubtful debts.
5. Inventory included at a value of $3 740 had a net realizable value of only $2 600, and scrap material having a value of $660 had been omitted from the inventory valuation. Furthermore, goods totaling $1 700 received from a supplier on a sale or return basis have been included in closing inventory. It has now come to your attention that 50% of these goods will be returned to the supplier.
6. The cashier had misappropriated $70.
7. The cash book included payments amounting to $6 924, the cheques having been made out but not mailed to suppliers 1 January 2006.
8. Interest is to be allowed on partners' opening Capital account balances less drawings during the year at 9%.

You are required to

a. Prepare a summary of adjustments to the profit and loss account for the year ended 31 December 2005 and a revised division of profit between the partners.
b. Prepare a revised Statement of Financial Position as at 31 December 2005

Question 4

Mkhululi carriers on business as a sole trader selling office equipment and his Statement of comprehensive income for the year to 31 December 2001 was as follows:

	$	$
Sales		150 000
Less cost of sales		87 000
Gross profit		63 000
Less expenses		
Salaries and wages	30 000	
Rent, rates and insurance	5 700	
Heating and lighting	3 380	
Advertising	6 000	
Delivery expenses	3 000	
Sundry expenses	3 300	51 480
Net profit		11 520

Mkhululi's net profit for the previous two years were:

1999	18 000
2000	14 400

The forecast for the foreseeable future is not good and profits seem set to decline at the same rate as for the past three years. Mkhululi has been trading in old equipment, which is gradually becoming obsolete due to technological advancements. He has employed Sipho as a manager since January 1999 at a salary of $12 000 per annum. Sipho previously worked for a high technology firm and has acquired considerable knowledge and experience in selling laptops, microcomputers and word processors.

In order to arrest the decline in his profits, Mkhululi is now considering taking Sipho into partnership and making him responsible for marketing laptops, micro-computers and word processors as a new line of business. Sipho would introduce $30 000 into the business as capital and would continue to receive his present salary in addition to ⅓ share of the balance of profits.

The two partners agreed on interest on capital at the rate of 10% p.a. In addition, Mkhululi's capital account balance at 31 December 2001 was $75 000. If Sipho is admitted as a partner, to manage the new line of business whilst Mkhululi continues to manage the existing business, the following results are forecast.

	Existing business	New business
	$	$
Sales	120 000	150 000
Gross Profit	69 600	30 630

Further, it will be necessary to engage a new sales assistant at an annual salary of $9 000. The insurance premium will increase by $750 p.a. Advertising and delivery expenses will each increase by 50%.

<u>You are required to:</u>

a) Prepare a forecast Statement of comprehensive income for the year to 31 December 2002 assuming Mkhululi takes Sipho into partnership.
b) State whether in your opinion, Mkhululi should admit Sipho as a partner with reasons.
c) Give your views on the proposed profit sharing arrangements and, in particular, whether or not you think Sipho would be justified in accepting only ⅓ share of the balance of profits.

CHAPTER 12

PARTNERSHIP CHANGES

12.1 Chapter objectives

After studying this chapter *the student should* be able to:

a. **A** Prepare the revaluation account.
b. Prepare the capital accounts of the partner after a change.
c. Prepare the Statement of Financial Position of the new partnership.

12.2 Introduction

A partnership is said to have changed when there is a change in the partnership agreement. This may happen when there is an introduction of a new partner, when one partner retires or when the partners themselves mutually agree to change the partnership agreement, for example they can change the profit/loss-sharing ratio. Partners in the old partnership are regarded differently from partners in the new partnership irrespective of their previous identity. In all the cases there is a need to revalue assets, which requires the opening of Revaluation and Goodwill Accounts which are explained below.

12.3 Changes in the Assets and Liabilities (Revaluation)

When a partner is admitted, in most cases, the old partners revalue the assets and liabilities. When assets are revalued upwards, we debit the asset and credit revaluation A/C, when they are revalued downwards we debit revaluation account and credit the assets. A revaluation account is a temporary account where we record increases/ decreases in the value of assets before they are shared by only old partners in their old profit and loss sharing ratios.

Revaluation Account

Decrease in assets	xxx	Increases in assets	xxx
Increase in Provision for credit loses	xxx	Decrease in liabilities	xxx
Increase in liabilities	xxx	Provision for depreciation	xxx
Costs relating to partnership changes	xxx	Decrease in Provision for credit loses	xxx
Profit on revaluation *(difference)*	xxx	Loss on revaluation *(difference)*	xxx

The profit or loss on revaluation is determined as a balancing figure. If the difference is on the debit side it is a profit, if on the left it is a loss which should be shared by the partners only in their old profit or loss-sharing ratio. The adjustment for goodwill and asset revaluation on admission or retirement of the partners should be dealt with in the partners' capital Accounts.

When a partner is admitted, he can bring

1) **Cash only.**
In this situation, we account for it as follows:
DR. Bank / Cash
CR. Capital

2) **Cash and other assets**

A is admitted into the partnership of D and E who shared profit and loss equally. The value of goodwill agreed was $18 000 and profits and losses to be shared in the ratio 3:2:1. He was required to bring $60 000 including his share of goodwill. As part of his contribution he has brought into the partnership plant and machinery valued at $40 000 and the balance in cash. The capital balances of D & E was D $90 000, E $80 000.
This is accounted for as follows:

DR	Plant and Machinery	40 000
DR	Cash	20 000
CR.	Capital	60 000

12.4 Goodwill account

Goodwill is an intangible asset, which arises due to good reputation. When there is a partnership change, it is valued by the old partners. There are two treatments of goodwill, which are: -

1. Goodwill can be retained in the books of the partnership by debiting the Goodwill Account and crediting Capital Accounts of the old partners in proportion to their old profit/loss sharing ratios.
2. Goodwill can be written off in the books of the partnership by first recording it, as above and then write it off by debiting capital accounts of new partners in proportion to their new profit and loss sharing ratios and credit goodwill account.

Negative goodwill should be transferred to non-distributable reserve if there is no positive goodwill that can be used to make a set-off.

Illustration

D and E are in partnership sharing profits and loss in the ratio 3:1 respectively. The following is their Statement of Financial Position, as at 31 May 2002.

		$	**$**
Property, plant and equipment			
Premises			80 000
Plant and Equipment			50 000
			130 000
Current Assets			
Inventory		40 000	
Accounts receivables		30 000	
Bank		5 000	75 000
Total assets			205 000
Capital Accounts:	D		90 000
	E		60 000
			150 000
Current Accounts:	D	20 000	
	E	10 000	30 000
			180 000
Accounts payables			25 000
			205 000

Additional information

1. F was admitted into the partnership on 1 June 2002. He brought with him the following, Motor vehicle valued at $50 000, Receivables $25 000, cash $15 000. Profit and loss ratio to be 3:2:1 respectively. Goodwill was valued at $36 000.
2. The assets of the partnership were valued as follows:
    a. Premises $100 000
    b. Inventory $ 35 000
3. A Provision for credit loses of 5% of the Receivables was required,
4. Goodwill was not shown in the books.

Required

1. A revaluation account
2. Capital accounts
3. The opening Statement of Financial Position of the new firm.

Solution

On the debit side of revaluation A/c we record decreases and on the credit side we record the increases in the value of assets.

Revaluation Account

	$		$
Inventory (40 000 – 35 000)	5 000	Premises (100 000 – 80 000)	20 000
Provision for credit loses (5% x 30 000)	1 500		
Capital: D	10 125		
E	3 375		
	20 000		20 000

Goodwill A/C

	-	$			$	
Capital :	D	27 000		Capital	D	18 000
	E	9 000			E	12 000
					F	6 000
		36 000				**36 000**

Capital Accounts

	D	E	F		D	E	F
Goodwill	18 000	12 000	6 000	Bal. b/d	90 000	60 000	-
				Goodwill	27 000	9 000	-
				Profit on rev.	10 125	3 375	-
				Motor Vehicle		50 000	
				Receivables			25 000
				Cash			15 000
Bal. c/d	109 125	60 375	84 000				
	127 175	72 375	90 000		127 125	72 375	90 000
				Bal. B/d	109 125	60 375	84 000

Statement of Financial Position For D, E And F As At 31 May 2002.

ASSETS

Property, plant and equipment

		$	**$**
Premises (80 000+ 20 000)			100 000
Motor vehicle			50 000
Plant and Equipment			50 000
			200 000
Current Assets			
Inventory (40 000 – 5 000)		35 000	
Receivables(30 000 + 25 000)	55 000		
Less provision	1 500	53 500	
Bank		5 000	
Cash		15 000	108 500
			308 500

EQUITY AND LIABILITIES

Capital Accounts	253 500
Current Account	30 000
Current liabilities- account payables	25 000
	308 500

Statement of changes in equity for the year ended 31 May 2002

	D	E	F	Total
	$	$	$	$
Capital account balance after change-over	109 125	60 375	84 000	253 500
Capital account balance before change-over	90 000	60 000	-	150 000
Goodwill – initial recognition	27 000	9 000	-	36 000
Profit on revaluation	10 125	3 375	-	13 500
Motor vehicle	-	-	50 000	50 000
Receivable	-	-	25 000	25 000
Cash	-	-	15 000	15 000
Goodwill – derecognizing	(18 000)	(12 000)	(6 000)	(36 000)
Current account balance at 31/05/02	20 000	10 000	-	30 000
Equity at 31/05/02	129 125	70 375	84 000	283 500

12.5 Admission of a partner during the year

Where a partner is admitted partway through the year income and expenses should be apportioned as per question, in the absence of a specific policy, they should be apportioned on a time basis.

Example

Edison and Austin were in partnership sharing profits and losses in the ratio 3:2. They admitted Sam on 30 September 1999; they agreed to share profit & Loss as follows Edison 6; Austin 2; Sam 2. The trial balance as at that date is given below.

Trial balance as at 31 December 1999.

	DR	CR.
CAPITAL ACCOUNTS	**$**	**$**
Edison		130 000
Austin		90 000
Sam		50 000
Sales		280 000
Purchases	150 000	
Accounts payables		20 000
Inventory	18 000	
Wages	13 500	
Provision for depreciation: Plant & equip.		22 100
Motor vehicle		9 000
Telephone expenses	5 000	
Loan from Sam		4 000
Bad debts	500	
Electricity & water	41 000	
Rent	40 000	
Plant & Equipment, at cost	160 000	
Motor Vehicle, at cost	50 000	
Provisition for credit loses		2 000
Stationery	600	
Accounts receivables	79 000	
Bank	49 500	
	607 100	**607 100**

Notes:

Closing inventory was valued at $42 000 bad debts arose before the admission of Sam. All other expenses and incomes accrue evenly through the year. Reduce Provisition for credit loses to $1 560. Sam brought a motor vehicle worth $20 000 and the balance of $30 000 in cash. Motor vehicles are depreciated at the rate of 20% on straight line, and plant and equipment at 10% reducing balance method.

Required

(a) Prepare the Statement of comprehensive income for the year ended 31 December 1999.
(b) Profit and loss appropriation account.

SOLUTION

<u>Statement of comprehensive income account for the year ended 31 December 1999</u>

	$	**$**
Sales		280 000
Less opening inventory	18 000	
Add Purchases	150 000	
	168 000	
Less closing inventory	42 000	126 000
		154 000
Add decease in provision		440
Gross Profit		**154 440**

<u>Less expenses</u>

	9 months to 30 Sept.		**3 months to 31 Dec. 1999**	
Gross Profit		115 830		38 610
Wages	10 125		3 375	
Telephone	3 750		1 250	
Bad debts	500			
Electricity & Water	30 750		10 250	
Rent	30 000		10 000	
Depreciation:				
Plant & Machinery	10 342		3 448	
(16 000 – 221 00) x 10%				
Motor Vehicle				
30 000 x 20%	4 500		1 500	
20 000 x 20%	-		1 000	
Stationery	450		150	
Interest on Loan	-		50	
		90 417		31 023
Net Profit		**25 413**		**7 587**
Less Interest on Capital *(Finance cost)*				
Edison (130 000 x 10%)		9 750		3 250
Austin (90 000 x 10%)		6 750		2 250
Sam (50 000 x 10%x^{3}/12)		-		1 250
		8913		**837**
Share of Profits:				
Edison		5347,80		502,20
Austin		3565.20		167,4
Sam		-		167.4
		8 913		**837**

<u>Notes to the solution</u>

1. Depreciation of motor vehicle brought by Sam is charged for 3 Months only.
2. When a partnership agreement does not cover one of the items, the Partnership Act applies. This is the reason why interest on loan from a partner was charged at 5%.
3. Sam is not entitled to a share of profit in the first 9 months because he was not a partner.
4. The expenses are apportioned on a time basis except when directed otherwise by the question.

12.6 Admission of partner with assets and liabilities

When a partner is admitted with assets and liabilities we make the following accounting entries.

DR assets
CR. Capital
And
DR Capital
CR. Liabilities

Illustration

R and S are in partnership as retailers of blankets and they admitted T on the 1st of January 2002 as the 3rd partner. He was required to contribute $48 000 as his capital. T brought in the partnership his motor vehicle valued at $43 000, inventory $15 000 and liabilities $10 000.

Required: -
Prepare the Capital Account for T.

Capital account - T

Liabilities	10 000	Motor Vehicle	43 000
Bal. c/d	48 000	Inventory	15 000
	58 000		**58 000**
		Bal. B/d	48 000

12.7 Retirement of a partner

When a partner retires, assets should be revalued, including goodwill.

Example
B, C. and D were in partnership sharing profits and losses in the ratio 6:3:1. D retired from the partnership as from 28 February 2000 and the value of goodwill is agreed at $40 000. The assets were valued as follows: -

	$
Inventory reduced by	2 000
Accounts receivables	20 000
Premises	85 000

The Statement of Financial Position as at 28 February 2000

Property, plant and equipment		
Premises		70 000
Fixtures and Fittings		60 000
		130 000
Current Assets		
Inventory	30 000	
Receivables	35 000	
Bank	10 000	75 000
Total assets		205 000
EQUITY AND LIABILITIES		
Capital Accounts		
B		80 000
C		60 000
D		40 000
		180 000
Current Liabilities: Payables		25 000
Total equity and liabilities		205 000

D agreed to leave the amount due to him as a loan to the partnership at an interest rate of 12%. B and C continued with the business sharing profits and losses equally.

Required:

Prepare the following accounts:

1. Goodwill account
2. Revaluation account
3. Capital Accounts
4. Statement of Financial Position of B, D and C

Solution

Goodwill account

Capital: B	24 000	Capital: B	20 000
C	12 000	C	20 000
D	4 000		
	40 000		**40 000**

Revaluation A/C

	$		$
Inventory	2 000	Premises	15 000
Receivables	15 000	Share of loss	
		B	1 200
		C	600
		D	200
	17 000		**17 000**

Capital A/C

	B	C	D		B	C	D
	$	**$**	**$**		**$**	**$**	**$**
Goodwill	20 000	20 000	-	Bal. b/d	80 000	60 000	40 000
Loss on Revaluation	1 200	600	200	Goodwill	24 000	12 000	4 000
Loan			43 800				
Bal. c/d	82 800	51 400	-				
	104 000	**72 000**	**44 000**		**104 000**	**72 000**	**44 000**
				Bal. b/d	82 800	51 400	-

Statement of Financial Position as at 28 February 2000

PROPERTY, PLANT AND EQUIPMENT

Premises (70 000 + 15 000)			85 000
Fixtures & Fittings			60 000
			145 000
Current Assets			
Inventory (30 000 –2 000)		28 000	
Receivables	30 000		
Less Provision	10 000	20 000	
Bank		10 000	58 000
			203 000

EQUITY & LIABILITIES

Capital Accounts		
	B	82 800
	C	51 400
Loan from	D	43 800
		178 000
Current Liabilities		
Payables		25 000
		203 000

12.8 Retirement and admission of a partner at the same time

In this situation you should deal with retirement first before admission.

Mary, Sisa and Musa are in a partnership, sharing profit and losses equally. On 1 September 1998 Musa retired and Thabani was admitted on the same day. Thabani paid $40 000 into the bank. The new profit and loss sharing ratio will be 3:2:1. Goodwill was valued at $24 000. Below is the Statement of Financial Position of Mary, Sisa and Musa as at 31 August 1998.

Property, plant and equipment		180 000
Net Current Assets (except bank)		20 000
Bank	40 000	
		240 000

Capital Accounts:	Mary	150 000
	Sisa	60 000
	Musa	30 000
		240 000

Required

1. Goodwill account
2. Capital accounts
3. Statement of Financial Position of Mary, Sisa , Musa and Thabani as at 1 September 1998

SOLUTION

Goodwill account

Capital:	Mary	8 000	Capital:	Mary	12 000
	Sisa	8 000		Sisa	8 000
	Musa	8 000		Thabani	4 000
		24 000			**24 000**

Capital accounts

	Mary	Sisa	Musa	Thabo		Mary	Sisa	Musa	Thabo
					Bal. b/d	150 000	60 000	30 000	-
Goodwill	12 000	8 000	-	4 000	Goodwill	8000	8000	8000	-
Cash	-	-	38 000	-	Cash	-	-	-	40 000
Bal. c/d	146 000	60 000	-	36 000					
	158 000	**68 000**	**38 000**	**40 000**		**158 000**	**68 000**	**38 000**	**40 000**
					Bal. b/d	146 000	60 000	-	36 000

STATEMENT OF FINANCIAL POSITION FOR MARY, SISA, AND THABANI AS AT 31 AUGUST 1998

Property, plant and equipment			180 000
Net Current Assets			20 000
Bank *(40 000 – 38 000 + 40 000)*			42 000
			242 000
Capital:	Mary		146 000
	Sisa		60 000
	Thabani	36 000	
			242 000

12.9 Examination type questions

12.10 Multiple choice questions

1. X, Y and Z are in business sharing profits in the ratio 3:2:1. At the end of the year, the balance on Y's Capital Account is $197 000. Y retires at the end of the year and, to determine his settlement, the assets are revalued upwards by $285 000. The partnership does not account for goodwill. If Y takes a car valued at $24 000 as part of his settlement, what is the balance remaining on his capital account to be settled in cash?

   A. $197 000
   B. $222 000
   C. $268 000
   D. $295 000

2. A and B are partners in business and share profits and losses equally. They decide to admit C as a partner. The new profit-sharing ratio between A, B and C is to be 3:2:1. Goodwill is valued at $72 000 and is not to be retained in the firm's books. What will be the goodwill in the partner's capital accounts?

	Debit			Credit		
	A	B	C	A	B	C
	$	$	$	$	$	$
A	24 000	24 000	24 000	36 000	24 000	12 000
B	36 000	24 000	12 000	24 000	24 000	24 000
C	36 000	24 000	12 000	36 000	36 000	Nil
D	36 000	36 000	Nil	36 000	24 000	12 000

3. X and Y are partners sharing profits equally. On the admission of Z as a partner, goodwill is agreed at $162 000 and they agree to share profits equally. What is the effect of this change on the capital account of X?

   A. Decrease $27 000
   B. Decrease $54 000
   C. Increase $27 000
   D. Decrease $54 000

12.11 Structured questions

Question 2

On 31 March 1996 the Statement of Financial Position of X and Y who shared profits and losses in the ratio of 2:1 was as follows:

	$	**$**
Property, plant and equipment		120 000
Current assets excluding cash	270 000	
Cash at bank	30 000	
	300 000	
Less Current liabilities	240 000	60 000
		180 000
Financed by:		
Capitals X		120 000
Y		60 000
		180 000

On 1 April 1996 X and Y decided to admit Z as a partner who brought in $90 000, half of which was for his share of goodwill. It was agreed that X and Y would immediately withdraw the cash credited to their respective capital accounts for the goodwill purchased by Z.

You are required to

a) Prepare the partner's capital accounts.
b) Prepare the opening Statement of Financial Position of the new partnership.

Question 3

Lee and Anita are partners sharing profits and losses in the ratio of 3:2. The business Statement of Financial Position as at 31 December 1997 was as follows.

	$	$
Property, plant and equipment		
Property		200 000
Equipment		50 000
		250 000
Current Assets		
Inventory	50 000	
Debtors	25 000	
Cash	40 000	
	115 000	
Current liabilities		
Creditors	115 000	-
		250 000
Financed by		
Capitals: Lee		150 000
Anita		100 000
		250 000

Lee and Anita agree to admit Ben, subject to the following revaluation being incorporated into the books.

a] Properly to be revalued to $350 000

b] Equipment and inventory to be revalued to $60 000 and $40 000 respectively.

c] A Provisition for credit loses of $2 500 is to be created.

d] Goodwill is estimated to be worth $100 000.

Ben is to bring in capital of $150 000, being represented by vehicles of $50 000, inventory of $25 000, debtors of $15 000, cash of $20 000 and goodwill of $40 000.

The new profit sharing ratio is to be in the ratio of 3:2:2 for Lee, Anita and Ben respectively.

You are required to

- **a.** Prepare the revaluation account.
- **b.** Prepare the capital accounts of the new business.
- **c.** Prepare the Statement of Financial Position of the new partnership.

Question 4

Road, Path and Street were in partnership as general dealers. They make up their accounts annually to 30 June. At 30 June 1992, their Statement of Financial Position was as follows:

Property, plant and equipment	Cost	Depreciation	CA
Freehold premises	200 000	50 000	150 000
Motor Vehicles	100 000	60 000	40 000
Office Machinery	90 000	40 000	50 000
	390 000	150 000	240 000
Current Assets			
Inventory		40 000	
Debtors		15 000	
Bank		45 000	
		100 000	
Creditors		30 000	70 000
			310 000
Financed by:			
Capitals Road		150 000	
Path		75 000	
Street		75 000	300 000
Add Current Accounts			
Road		25 000	
Path		15 000	
Street		(30 000)	10 000
			310 000

Additional information

1. The partner's policy was to provide for depreciation of property, plant and equipment on cost as follows:

Freehold Premises	2½%
Motor Vehicles	20%
Office Machinery	25%

2. Road received a salary of $50 000 p.a. and the partners were allowed interest on capitals at 10% p.a. Interest on drawings is charged at 10% p.a. Profits and losses are shared in the ratio of Road ½ Path ¼ and Street ¼.
3. On 31 December 1992, Road retired and the partner's agreed that Road should take over one of the firm's vehicles at a valuation of $20 000. The vehicle had been purchased for $40 000 on 1 July 1991. Of the amount due to Road on his retirement, $150 000 should be transferred from his capital a/c to a loan account carrying interest at 10% per annum. The balance on his capital account was paid to him on 31 December 1992.
4. At 31 December 1992, the property, plant and equipment should be revalued as: Freehold premises $300 000, Motor vehicles (other than the one take by Road) $30 000 and office machinery $20 000.
5. Goodwill to be valued at $100 000 but not to be recorded in the books.
6. Path and Street would continue as partners after Road's retirement on the following conditions:
   i. The balances on their current accounts at 31 December 1992 should be transferred to their capital accounts as at that date. They would then adjust the balances on their capital accounts on that date to $125 000 after the transfer from the current account has been completed. Partners would have to pay in or withdraw from the firms' bank account in order to adjust their capital accounts.
   ii. Path and Street would share Road's duties between them, for which Path would receive a salary of $35 000 and Street $15 000 p.a.
   iii. Profits and losses to be shared equally.
   iv. Depreciation on the property, plant and equipment would still be charged on the old rates but based on the new valuations.

The following details were extracted from the books of the partnership for the year to 30 June 1993:

	$
Receipts: Cash sales	300 000
: Cash received from debtors	170 000
Payments :	
Purchases	140 000
Selling expenses	30 000
Distribution expenses	20 000
Wages and salaries	100 000
General expenses	15 000
Drawings to 31 December 1992:	
Road	20 000
Path	30 000
Street	25 000
Drawings from 1 January to 30 June 1993:	
Path	20 000
Street	25 000
Trade receivables at 30 June 1993	25 000
Trade payables at 30 June 1993	35 000

The following were owing at 30 June 1993:

(i) Selling expenses $6 000
(ii) Distribution expenses $4 000
(iii) General expenses $1 000

Inventory at 30 June was $20 000

Sales occurred evenly throughout the year and a uniform profit margin was earned on all sales.

Required

Prepare statement of comprehensive income of Road, Path and Street in columnar form for the half year ended 31 December 1992 and 30 June 1993 respectively.

Question 5
Mum and Dad, who make up their accounts to 30 September each year, carried on business in partnership under the firm name of family. Their partnership agreement provided.

1. Profits and losses to be shared Mum 2/3 and Dad 1/3
2. Interest on capital to be allowed at the rate of 6% per annum but no interest should be allowed or charged on current accounts.
3. On the retirement or admission of a partner:
   (i) If the change takes place during the year, such partners share of profits or losses for the period up to retirement or from admission is to be arrived at by apportion on a time basis except where otherwise agreed.
   (ii) No account for goodwill is to be maintained in the books.
   (iii) Any balance due to an outgoing partner is to carry interest at 8% per annum from the date of his retirement to the date of payment.

Mum retired from the firm on 31 March 2002 and on the same day Dad took into partnership Son, an employee of the firm. It was agreed that the terms of the previous partnership agreement should apply in all respects except that, as from that date, profits or losses are to be shared Dad 3/5 and Son 2/5.

The trial balance extracted from the books of the firm as at 30 September 2002 was as follows:

	$	$
Capital accounts – 30 September 2001		
Mum		24 000
Dad		18 000
Current accounts – 30 September 2001		
Mum		7 200
Dad		4 800
Son – Cash introduced on 31 March 2002		9 000
Plant & machinery at cost	42 000	
Plant & machinery: provision for depreciation		
30 September 2001		8 400
Motor vehicles at cost	18 600	
Motor vehicles: provision for depreciation		
30 September 2001		10 200
Purchases	186 000	
Inventory 30 September 2001	37 200	
Wages	43 800	
Salaries	32 400	
Debtors	13 800	
Sales		288 000
Trade expenses	4 800	
Creditors		18 600
Rent and rates	4 200	
Bad debts	1 800	
Balance at bank	3 600	
	388 200	**388 200**

Additional Information:

1. Goodwill on 31 March 2002 was agreed to be $36 000.
2. On 31 March 2002, Son had paid Mum $15 000 on account of the balance due to her on retirement. No entire have been made in the books in respect of this payment. The balance due to Mum after taking into account this payment remained unpaid as on 30 September 2002.
3. Mum on retirement had taken over one of the firm's motor vehicles and it was agreed that she should be charged for it at its written down value at the date of her retirement. The vehicle had cost $4 200 and up to 30 September 2001 depreciation of $1 875 had been provided on it.
4. The inventory as on 30 September 2002 was valued at $42 600.
5. Partners' drawings which are included in salaries were as follows:
   Mum $5 400 Dad $7 200 Son $2 700

6. Salaries also included $3 600 paid to Son prior to being admitted as a partner and which amount to be charged against the profits of the first half of the year.
7. Professional charges of $750 included in trade expenses are specifically attribute\le to the second half of the year.
8. The whole of the charge of $1 800 for bad debts related to the period ending 31 March 2002.
9. A bad debts provision specifically attributable to the second half of the year of 5% of the total debts is to be made as at 30 September 2002.
10. On 30 September 2002, rent paid in advance amounted to $1 200 and traded expenses accrued amounted to $540.
11. Provision is to be made for depreciation on plant and machinery and on motor vehicles at the rates 10% and 25% per annum respectively, calculated on cost.

<u>REQUIRED</u>

a. Prepare A Statement of comprehensive income for the year ended 30 September 2002.
b. Prepare the partners' capital and current account covering the year ended 30 September 2002.
c. Prepare the Statement of Financial Position as at 30 September 2002

Question 5

Somandla and Thabani are partners who share profits and losses equally. At 31 December 2003 their Statement of Financial Position was as follows:

		$	$
Property, plant and equipment:	Premises		50 000
	Motor Cars		20 000
	Furniture		3 000
			73 000
Current Assets:	Inventory of work – in progress	10 000	
	Debtors	24 000	
	Bank	6 000	
		40 000	
Current liabilities:	creditors	4 000	36 000
			109 000
Capitals:			
	Somandla	50 000	
	Thabani	50 000	100 000
Current accounts:	Somandla	6 000	
	Thabani	3 000	9 000
			109 000

Gift, their senior clerk, was admitted as a partner on 1 January 2004 and he introduced $25 000 as capital plus his private car which was valued at $6 000 on the same day. The following revaluations were agreed in:

Premised to be revalued at	$65 000
Motor cars of the old firm at	$17 500
Furniture at	$500

The partners agreed that a Provision for credit loses of 5% of outstanding debtors should be created.

The new profit sharing ratio was to be Somandla 2/5 Thabani 2/5 and Gift 1/5.

Goodwill was to be revalued at $25 000 but was not to be recorded in the books.

Required

a) Journal entries to record the entries in the accounts of the partnership on the admission of Gift.
b) The partners' capital accounts as at 1 January 2004.
c) The opening Statement of Financial Position of the firm of Somandla, Thabani and Gift.

CHAPTER 13

DISSOLUTION OF PARTNERSHIP

13.1 Chapter objectives

After studying this chapter *the student should* be able to:

a) Prepare a realisation account.
b) Prepare a Bank/cash a/c
c) Prepare partners' capital accounts

13.2 Introduction

Unlike a limited liability company a partnership does not have an infinite life. At some point in time, the partnership will terminate. The following are some of the factors leading to partnership dissolution

- Low demand for product
- The death of one of the partners
- Mutual agreement of the partners – The partners could decide among themselves to dissolve the partnership
- Attainment or lapse of the purpose for which the partnership was originally formed.
- Passage of time – a partnership formed for a certain period of time will automatically dissolve when the time has lapsed.
- Retirement of old partners
- Insolvency of the partnership or one of the partners
- Unlawful acts by partners
- A partnership is automatically dissolved when the number of partners has exceeded 20. this will result in the formation of a company.
- Other events stipulated in the partnership agreement may necessitate the termination of a partnership.

13.3 Accounting procedure

Where a partnership is dissolved for whatever reasons a realization account is opened. It is debited with the net book value of assets except bank and Cash and credited with liabilities, as well as amounts realised from the dissolution.

a) Dissolution costs
DR Realisation
CR. Bank

b) Assets taken over by partner

$\left.\begin{array}{l}\text{DR Capital Account}\\ \text{Cr. Realisation}\end{array}\right\}$ With agreed takeover values

c) Liabilities taken over by partner
Dr. Realisation account
Cr. Capital account

d) Discount received from creditors:
DR Creditors
CR. Realisation

e) Discount allowed to debtors
DR Realisation
CR. Debtors

f) When assets are sold
DR Bank
CR. Realisation

Realisation A/C format looks like this:

Realisation account

Assets at CA	xxx	Sales value of assets	xxx
Dissolution expenses	xxx	Discount received	xxx
Discount allowed	xxx	Assets taken over at take over value	xxx
Liabilities taken over by partners	xxx	Balancing figure (Loss)	xxx
Liabilities taken over by partners	xxx		
Balancing figure (Profit)	xxx		

Example 1

Moyo and Dube have been in partnership for several years sharing profit and loss equally. Owing to old age, they decided to dissolve their partnership on 1 July 2000. Their last Statement of Financial Position as at 30 June 2000 is given below

Statement of Financial Position for Moyo and Dube as at 30 June 2002

			$
Property, plant and equipment			
Premises			90 000
Motor vehicles			70 000
			160 000
Current Assets			
Inventory	8 000		
Receivables	20 000		
Bank	30 000		58 000
			218 000
Equity and liabilities			
Capital Accounts: Moyo			80 000
Dube			60 000
			140 000
Current Accounts: Moyo			8 000
Dube			10 000
			158 000
Liabilities			
Loan from Moyo	50 000		
Payables	10 000	60 000	
			218 000

Additional Information

1) The partners agreed to retain the vehicles, which they have been using at the following values
   a) Moyo $5 000
   b) Dube $6 000
2) Dissolution expenses amounted to $4 200

3) Discount received from creditors $1300
4) The assets realised the following:
   a) Premises $140 000
   b) Motor Vehicle $60 000
   c) Accounts receivables $19 500

Required: Open, post and balance the relevant accounts in the ledger of the partnership.

Solution

Premises account

	$		$
Bal. b/d	90 000	Realisation account	90 000

Motor vehicles account

	$		$
Bal. b/d	70 000	Realisation account	70 000

Inventory account

	$		$
Bal. b/d	8 000	Realisation account	8 000

Accounts receivables account

	$		$
Bal. b/d	20 000	Bank	19 500
		Discount allowed	500
	20 000		20 000

Loan account

	$		$
Bank	50 000	Bal. b/d	50 000

Accounts payables account

Bank	8 700	Bal. b/d	10 000
Discount Received	1 300		
	10 000		10 000

Realisation account

Premises	90 000	Discount Received	1 300
Motor Vehicles	70 000	Bank (Premises)	140 000
Inventory	8 000	(Motor Vehicle)	60 000
Discount allowed	500	Inventory	8 000
Dissolution expense	4200		
Share of profit:		Capital Account:	
Moyo	23 800	Moyo	5 000
Dube	23 800	Dube	6 000
	220 300		**220 300**

Bank A/C

Balance b/d	30 000	Dissolution Expenses	4 200
Premises	140 000	Payables	8 700
Motor vehicle	60 000	Loan	50 000

Inventory	8 000	Capital A/c: -		
Receivables	19 500		Moyo	106 800
			Dube	87 800
	257 500			**257 500**

Capital A/C

	Moyo	Dube		Moyo	Dube
Realisation	5 000	6 000	Bal. b/d	80 000	60 000
Bank	106 800	87 800	Current A/C	8 000	10 000
			Share of profit	23 800	23 800
	111 800	**93 800**		**111 800**	**93 800**

13.4 Examination type questions

13.5 Multiple Choice

1. The order of discharging these liabilities is

   A. (i) (ii) (iii) and (iv)
   B. (i) (iii) (ii) and (iv)
   C. (i) (iv) (iii) and (ii)
   D. (iv) (i) (iii) and (ii)

2. When closing partner's capital accounts upon dissolution, if it is found that a partner's capital account remains with a debit balance, the partner concerned should.

   A. Deposit the balance into the business bank A/C
   B. Withdraw the balance from the business bank A/C
   C. Set off the balance against realization profits
   D. Set off the balance against the current A/C

3. When a partnership business is dissolved and it is found that a loan extended by a partner to the business still stands, the accounting procedure to be followed is.

   A. Write off the loan as a loss in the partner's capital a/c
   B. Pay off the loan from the business bank a/c
   C. Share the amount of the loan among the partners in their profit & loss sharing ratios.
   D. Repay the loan from the trading profits of the year when the business closes down.

13.6 Structured Questions

Question 1

Mary and Joseph were in partnership sharing profits and losses in the ratio of 3:1 respectively. The Statement of Financial Position for the partnership at 31 March 2005 was as follows:

Statement of Financial Position as at 31 March 2005

	$	$
Property, plant and equipment		
Plant and Equipment		222 000
Motor cars		39 000
		261 000
Current Assets		
Inventory	111 600	
Debtors	55 800	
Bank	14 400	
	181 800	
Less Current liabilities		
Creditors	72 000	109 800
		370 800
Less long-term loan from Mary		36 000
		334 800
Financed by		
Capitals: Mary	180 000	
Joseph	126 000	306 000
Current Accounts		
Mary	27 000	
Joseph	1 800	28 800
		334 800

The partners agreed to dissolve their partnership on 31 March 2005. The loan from Mary was repaid, the creditors were paid $70 200 in full settlement. Joseph took over one vehicle for $6 000 and the remaining assets realised the following amounts:

Plant and equipment	$276 000
Vehicles	$ 21 000
Inventory	$102 600
Debtors	$52 200

You are required to prepare the following ledger accounts to record the dissolution of the business.

d) The Realisation account.
e) The Bank a/c
f) The partners' capital accounts.

Question 2

Black and White have been sharing profits and losses equally in their partnership for many years. Black feels he needs to migrate and so they decided to dissolve their business on 31 March 2005. Their Statement of Financial Position on that date was as follows.

Property, plant and equipment	$	$
Premises		80 000
Office		85 000
		165 000
Current Assets		
Debtors	280 000	
Cash	180 000	
	460 000	
Less current liabilities		
Creditors	275 000	185 000
		350 000
Financed by		
Capitals: Black		200 000
White		150 000
		350 000

<u>Additional information</u>

1. The debtors paid up $270 000 in full and final settlement.
2. Premises realised $40 000 and office fittings $95 000.
3. Dissolution expenses amounted to $10 000.
4. Creditors were paid $255 000.

To close the business books prepare:

a] The realisation accounts.

b] The capital accounts.

c] The cash account.

CHAPTER 14

ACCOUNTS FOR LIMITED LIABILITIES COMPANIES

14.1 Chapter objectives

After studying this chapter *the student should* be able to:

1. *State the contents of the memorandum and articles of association.*
2. *Distinguish between private and public companies.*
3. *Distinguish between the ordinary shares and preference shares, shares and debentures and issued share capital and authorised share capital.*
4. *Explain the differences between reserves and provisions as well as revenue reserves and capital reserves citing examples for each.*
5. *List the contents of the director's report and the auditor's report.*
6. Prepare the Statement of comprehensive income and statement of changes in equity of a limited company.
7. Draw up the Statement of Financial Position of a limited company.
8. Prepare a statement of changes in equity.

14.2 Introduction

A company is a legal entity, which is formed by registration under the Companies Act *[Chapter 24: 03]*, in Zimbabwe. The registration is achieved by making an application to the Registrar of Companies, which should be accompanied by two statutory documents namely, the Memorandum of Association and the Articles of Association.

14.3 The memorandum and the articles of association

The Memorandum governs the company with outside world. The following are the provisions, which should appear in the memorandum:

a) The name of the company, which shall have *limited* as the last word.
b) The objectives of the company.
c) A statement that the liability of members is limited
d) The amount of share capital with which the company propose to be registered.
e) Registered office of the company *(domicile).*

The Articles of Association contain rules that regulate the internal affairs of the Company. In the absence of written down articles, the company can adopt all or any of Table A articles in the First Schedule of the Act. The following are some of the articles:

a) The transfer of shares.
b) Forfeiture of shares.
c) Conversion of shares into stock.
d) Powers and duties of directors.
e) Disqualification of directors.
f) Proceedings at general meetings.
g) Votes of members.

14.4 Private and public companies

Two types of limited companies can be formed under the Zimbabwean Companies Act namely companies limited by guarantee and those limited by shares. At this level we only deal with companies limited by shares. A company limited by shares is one in which the liability of the member is limited to the maximum amount of capital paid or credited on the shares received. We have two types, Private Company and Public Company.

The following are some of the attributes of a private company:

a) It is prohibited by the Act to offer its shares to the public for subscription.
b) It restricts the transfer of shares.
c) An individual can form a private company.
d) The number of its members is limited to fifty.
e) Cannot trade its shares on the Stock market.

With a public company,

a) It is allowed to offer its shares to the public for subscription.
b) The shares can be traded on the stock market.
c) There is no limit to the number of members forming a public company. The limit is set by the shares on offer for subscription.
d) A minimum of 7 members can form a public company.

14.5 Ordinary and preference share capital

People who buy shares in a company are known as shareholders. The capital that shareholders invest in a company is known as share capital. A limited company can be registered with different classes of share capital. The main classes of share capital are ordinary shares and preference shares. These shares give rise to ordinary and preference share capital. The following are some of the characteristics of the ordinary shares and ordinary shareholders:

Ordinary shares

a) Ordinary shares carry voting rights.
b) Ordinary shares do not carry a fixed rate of dividend.
c) Ordinary share dividend is paid after preference dividend and is proposed by the directors of the company at each annual general meeting. The shareholders do not have the power to force the company to pay them a dividend if the director decides not to pay them.
d) An ordinary share is irredeemable.
e) Ordinary shares are traded on the stock market, in the case of a public company.
f) Ordinary shares are used to measure the value of the company.

Ordinary shareholders

a) Ordinary shareholders are owners of the company.
b) All reserves belong to ordinary shareholders.
c) Ordinary shareholders vote at meetings

Preference share and preference shareholders have the following characteristics:

Preference shares

a) They do not carry voting rights.
b) If a preference share dividend is in arrears for 3 consecutive years, preference shareholders are given some voting rights.

c) Preference shares are not always redeemable. Where they are redeemable there should have been issue on the term that there are liable to be redeemed.
d) Cannot be traded on the stock market.
e) Carries a fixed rate of dividend, which should be paid whether the company has made some profits, or not.
f) Preference share dividend is paid before the ordinary share dividend is paid.
g) Preference shares are of two types that are cumulative and non- cumulative. Cumulative preference shares are entitled to receive all the arrears dividends before ordinary shareholders receive any dividend. Non-cumulative preference shares are not entitled to any arrears dividend.

Preference shareholders

a) Preference shareholders are technically creditors to the company.
b) Preference shareholders do not ordinarily vote at the annual general meeting unless if their dividend is in arrears for the past 3 consecutive years or are participating preference shares.

Authorised share capital
This is the maximum share capital that a company may issue as authorised by the Registrar of Companies. It is also known as the registered or nominal capital.

Issued Share Capital
These are shares issued to shareholders and can be less than or equal to the Authorised Share Capital. In return for their investment, the shareholders will receive a dividend that is a share of profit. They are of two types; interim and final.

14.6 Debentures

A company, in addition to the issued share capital, can also issue debentures which represent a loan to the company carrying a fixed rate of interest per annum based on the nominal value and should be paid whether a company makes a profit or not. Debentures are not part of the share capital. These are long-term debt funding. Debenture holders are not owners of the company but rather they are creditors to the company. Debentures carry a fixed rate of interest e.g. 10% Debentures. 10% percent is the rate of interest on those debentures. The debenture interest is an expense to the company not an appropriation of profits.

14.7 Final Accounts of a limited company

The manufacturing and trading accounts of limited companies are basically the same as those of sole traders and partnerships. Refer to **Chapter 1** for a template of the financial statements of a company.

In addition to the normal revenue and expense, the profit and loss account of a limited company also shows the following expenses:
1) Directors' emoluments – these are the salaries and fees paid to the company directors. They are charged to the profit and loss accounts because directors are employees of the company.
2) Debenture interest
3) Auditors' remuneration
4) Income from investment which is dividends or interest received from another company in which the company bought shares or debentures
5) Preliminary expenses or goodwill written off.

14.8 Provision and Reserves

A provision is an amount of pre-tax profit set aside for a known expense whose amount is uncertain e.g. Provision for depreciation, Provision for bad and doubtful debts, and Provision for damages on a case which is before the law courts whose outcome is uncertain but there is a greater probability of our losing the case. A reserve is any post tax profit set aside which is not a provision e.g. general reserve, distribution reserve, however, there are other reserves which do not arise from profit but from the requirement of the Company's Act e.g. share premium. Provision can be distinguished from revenue in that provisions are entered in the Statement of comprehensive income as expenses (in case of increases) and as income (in case of decreases) whereas reserves are appropriation of profits.

14.9 Reserves

Reserves are of two types, capital reserve, which are non-distributable reserves, which are created as per requirements of Company's Act e.g. share premium, capital redemption reserve and revaluation reserve. While revenue reserves are distributable reserves and are created on the discretion of the directorate e.g. retained profit and general reserve.

14.9.1 Revenue reserves

They are sometimes referred to as distributable reserves, in the sense that they can be used to pay for cash dividends to shareholders. They may also be used to provide for additional working capital, business expansion. As explained earlier, transferring some funds from the appropriation account to such a reserve creates a revenue reserve.

14.9.2 Capital reserves

A capital reserve is sometimes referred to as a non-distributable reserve because it cannot be used to pay cash dividends. It is created by the requirements of the Companies Act. The following are some of the examples of capital reserves.

Share premium

This reserve is created when shares are issued at a price that is above their nominal value. Lets suppose that shares with a par value of $1 are being issued at a price of $1.50. The par value of $1 per share should be transferred to share capital account whilst the balance of $0.50 is transferred to a share premium account.

Capital redemption reserve

This reserve is created when shares are being redeemed out of internally generated funds. It is created for the protection of creditors whose interests are secured by the fixed capital of the business. It is created by transferring an amount equal to the nominal value of shares being redeemed from a suitable revenue reserve to the capital redemption reserve.

Revaluation reserve

This reserve is created when property, plant and equipment change in value resulting in a higher value. Lets take an example of land and buildings with a net book value of $450 000. If they are valued to $500 000, the difference of $50 000 should be transferred to a revaluation account.

Example 1

The Trial balance of Makuvaza limited as at 31 March 2002

	Debit $	Credit $
Land & Building	85 920	
Ordinary share capital		85 000
Sales		75 000
Opening inventory	5 000	
Purchases	28 000	
Retained profit		23 700
Motor vehicle at cost	40 000	
Provision for depreciation on motor vehicle		8 000
Preference Dividend	1 920	
Rent	1 500	
Light and Water	1 900	
10% Debentures		50 000
8% Preference shares		48 000
Advertisement cost	500	
Accounts receivables	20 000	
Bank	8 080	
Motor expenses	1 500	
Debenture interest	2 500	
Wages and Salaries	2 100	
Bad debts	200	
Provision for credit loses		1 000
Directors emoluments	21 580	
Auditing fees	5 000	
Accounts payables		5 000
Cash on hand	70 000	
	295 700	295 700

Notes: -

1. Inventory at 31 March 2002 was valued at cost at $ 9 000
2. Motor vehicles are depreciated using the reducing balance method at 20%
3. Rent prepaid $500 and wages & Salaries accrued $3 300.
4. Provision for credit loses to be 4 % of Receivables
5. Tax of $2 200 is to be provided.
6. The directors proposed the following: -
    a. To transfer $2 000 to general reserve
    b. To pay a dividend of 10% on ordinary shares.

Required

1) Statement of comprehensive income for the year ended 31 March 2002.
2) Statement of Financial Position as at 31 March 2002
3) Statement of changes in equity for the year ended 31 March 2002

The accounts should be presented in accordance with IAS 1.

Solution

<u>Statement of comprehensive income for the year ended 31 March 2002</u>

		$	$
Sales			75 000
<u>Less Cost of Sales</u>			
Opening inventory		5 000	
Purchases	<u>28 000</u>		
		33 000	
Less closing inventory	<u>9 000</u>	<u>24 000</u>	
Gross profit			51 000
Decrease in prov. for bad debts *(1000 – 800)*		<u>200</u>	
			51 200
<u>Less expenses</u>			
Rent (1 500 – 500)		1 000	
Wages & Salaries *(2 100 + 3 300)*		5 400	
Light & Water		1 900	
Debenture interest *(50 000 x 10%)*		5 000	
Dep - Motor vehicle *20% (40 000 – 8000)*		6 400	
Director's emoluments		21 580	
Audit fees		5 000	
Bad debts		200	
Advertisement cost		500	
Motor expenses		<u>1 500</u>	
Total expenses			<u>48 480</u>
Profit before tax			2 720
Tax		<u>2 200</u>	
Profit after tax			520

Statement of Financial Position as at 31 March 2002

	$	$	$
ASSETS			
Property, plant and equipment			
Land & Buildings			85 920
Motor vehicle *(40 000-8000-6400)*			25 600
			111 520
Current Assets			
Inventory		9 000	
Receivables	20 000		
Less Provision for credit loses	800	19 200	
Bank		8 080	
Cash		70 000	
Prepayment		500	106 780
Total assets			218 300
EQUITY AND LIABILITIES: -			
Share capital and reserves			
Ordinary share capital			85 000
Preference Share capital			48 000
General Reserve			2 000
Retained profits			9 880
Total for share capital and reserves			144 880
Non-current liabilities - 10% debentures			50 000
Current Liabilities			
Tax		2 200	
Unpaid dividends *(1 920 + 8 500)*		10 420	
Unpaid wages		3 300	
Unpaid debenture Interest		2 500	
Payables		5 000	
Total for current liabilities			23 420
Total for equity and liabilities			218 300

Statement of changes in equity for the year ended 31 March 2002

	Ordinary Share capital	Preference Share capital	General Reserves	Retained Profits	Total
	$	$	$	$	$
Balance b/fwd at 01/04/01	85 000	48 000	-	23 700	156 700
Profit after tax - from I/S	-	-	-	520	520
Transfer to general reserve	-	-	2 000	(2 000)	-
Preference dividend paid - Interim	-	-	-	(1 920)	(1 920)
Preference dividend paid – Final	-	-	-	(1 920)	(1 920)
Ordinary dividend – proposed	-	-	-	(8 500)	(8 500)
Balance c/fwd at 31/03/02	85 000	48 000	2 000	9 880	144 880

Tutors Notes

1) *A tax provision that is provided for is a current liability because it will be payable in the next financial year. In most cases in a period of not more than 9 months from the Statement of Financial Position date.*
2) *Part of the preference dividend (final) together with the ordinary dividend will also be paid in the next financial year.*
3) *Half of the debenture interest remained unpaid at the end of the year.*

Total debenture interest	*10% of $50 000 =*	*5 000*
Less Debenture interest paid		*2 500*
Current liability		*2 500*

14.10 Published accounts

All the financial statements prepared so far for limited liability companies, were for internal use only. Large public companies, in addition to accounts prepared for internal use by management, would prepare a set of accounts for publication. It is easier to prepare accounts for publication by summarising the information from accounts for internal use. The following is how the Statement of comprehensive income for publication should be presented in accordance with IAS 1:

	$
Revenue	xxx

Cost of sales	xxx
Gross profit	xxx
Other operating income	xxx
Distribution costs	(xxx)
Administrative expenses	(xxx)
Other operating expenses	(xxx)
Profit from operations	xxx
Finance cost	(xxx)
Income from associates	xxx
Profit before tax	xxx
Income tax payable	(xxx)
Profit after tax	xxx
Extra ordinary items after tax	xxx
Net profit for the period	xxx

The following is how the Statement of Financial Position should be presented in accordance with the standard

Assets		
	$	**$**
Property, plant and equipment		xxx
Goodwill		xxx
Long term investments		xxx
		xxx
Current assets		
Inventories	xxx	
Trade and other receivables	xxx	
Prepayments	xxx	
Cash and cash equivalents	xxx	xxx
Total assets		xxx
Equity and liabilities		
Capital and reserve		
Issued share capital		xxx
Non distributable reserves		xxx
Distributable reserves		xxx
		xxx
Non- current liabilities		
Debentures	xxx	
Other	xxx	xxx
Current liabilities		
Trade and other payables	xxx	
Bank overdraft	xxx	xxx
Total equity		xxx

14.11 Notes to the financial statements

In accordance with the standard, the following information requires minimum disclosure in the Statement of Financial Position but should be presented by way of notes:

Share capital

Both authorized and issued share capital should be disclosed, in accordance to their classes.

Accounting policies

Accounting policies are the specific accounting bases judged by business enterprise to be most appropriate to their circumstances and adopted by them for the purpose of preparing their financial accounts e.g. the writing off of goodwill.

Property, plant and equipment and depreciation

A schedule of Property, plant and equipment should be prepared as follows. You should also refer to ***Chapter 4*** of this book, for an example of the disclosure note on property, plant and equipment.

	Equipment	Motor vehicles	Furniture	Computers	Cell phones	Total
	$	$	$	$	$	$
Balance b/d at cost	xxx	xxx	xxx	xxx	xxx	xxx
Add purchased	xxx	xxx	xxx	xxx	xxx	xxx
Less disposal at cost	(xxx)	(xxx)	(xxx)	(xxx)	(xxx)	(xxx)
Adjustment for revaluation	xxx	xxx	xxx	xxx	xxx	xxx
	xxx	xxx	xxx	xxx	xxx	xxx
Bal. b/d of depreciation	xxx	xxx	xxx	xxx	xxx	xxx
Add depreciation for the year	xxx	xxx	xxx	xxx	xxx	xxx
Less disposals	(xxx)	(xxx)	(xxx)	(xxx)	(xxx)	(xxx)
Bal. b/d of depreciation	xxx	xxx	xxx	xxx	xxx	xxx
Net book values	xxx	xxx	xxx	xxx	xxx	xxx

Director's remuneration

Shareholders of a company would want to know how much the directors are paying themselves. If this information is kept to the directors themselves, they might pay themselves a lot in salaries and allowances which might lead to the liquidation of the company. Directors' remuneration are the amounts paid to directors should be disclosed as follows:

- Emoluments of the chairman
- The emoluments of the highly paid director.
- The range of emoluments of other directors.

Auditors' remuneration

The shareholders of a company would also want to know how much was paid to the auditors of the company.

Loan interest paid

This again should also be disclosed.

14.12 The directors' report

The shareholders must receive a copy of the directors' report along with the Statement of comprehensive income and the Statement of Financial Position. You are advised to get a copy of the directors' report from the press. The following are some of the issues which should be included in the directors' report:

a) A fair review of the business.
b) The dividends proposed.
c) The amounts transferred to reserves.
d) The principal activities of the company.
e) Post balance events.
f) The future outlook of the business.
g) Changes in the market value of non – current assets.
h) Political and charitable contributions.
i) Details of employment of disabled persons.
j) Names of all persons who are directors of the company.

14.13 The auditors' report

This is an independent report which is prepared by an independent external auditor. The purpose of this report is to express an opinion whether financial statements show a true and fair view of the company. This report must be appended to the published financial statements of a company. The independent auditors' report should include the following:

a) Title
b) Date
c) Name of the auditor or the audit firm
d) The opinion paragraph.
e) The scope of work undertaken
f) Signature of the auditor

Example 2

You are required to prepare the final accounts for Makuvaza Ltd. in ***Example 1*** above, for publication.

Solution

Statement of comprehensive income for the year ended 31 March 2002

	$
Revenue	75 000
Cost of sales	24 000
Gross profit	51 000
Other operating income	200
Distribution costs	(700)
Administrative expenses	(42 780)
Profit from operations	7 720
Finance cost	(5 000)
Taxation	2 720
Income tax payable	(2 200)
Profit after tax	520

Author's note

1. Revenue is made up of sales
2. Cost of sales is made up of the following:
   a) Opening inventory
   b) Purchases
   c) Closing inventory
3. Like other operating income items e.g. rent receivable or commission earned. Decrease in Provisition for credit loses is an adjustment to bad debts and technically is an adjustment of previously set aside profits (commonly associated with preceding trading years).
4. Distribution costs consists of the following:
   a) Advertising costs
   b) Motor vehicle expenses
   c) Depreciation expense charged on motor vehicles
5. Administration expenses consists of the following items;
   a) Rent
   b) Wages and salaries
   c) Light and water
   d) Depreciation of motor vehicles
   e) Directors' emoluments
   f) Audit fees
   g) Bad debts
6. Finance cost consists of debenture interest

Statement of Financial Position as at 31 March 2002

Assets

	$	$
Property, plant and equipment		
Property, plant and equipment		111 520
Current assets		
Inventories	9 000	
Trade and other receivables	19 200	
Prepayments	500	
Cash and cash equivalents	78 080	106 780
Total assets		218 300

Equity and liabilities

Capital and reserve	
Issued share capital	133 000
Distributable reserves	11 880
	144 880
Non- current liabilities	
Debentures	50 000
Current liabilities	
Trade and other payables	23 420
Total equity and liabilities	218 300

Statement of changes in equity for the year ended 31 March 2002

	Ordinary Share capital	Preference Share capital	General Reserves	Retained Profits	Total
	$	$	$	$	$
Balance b/fwd at 01/04/01	85 000	48 000	-	23 700	156 700
Profit after tax - from I/S	-	-	-	520	520
Transfer to general reserve	-	-	2 000	(2 000)	-
Preference dividend paid - Interim	-	-	-	(1 920)	(1 920)
Preference dividend paid – Final	-	-	-	(1 920)	(1 920)
Ordinary dividend – proposed	-	-	-	(8 500)	(8 500)
Balance c/fwd at 31/03/02	85 000	48 000	2 000	9 880	144 880

Notes to the financial statements

Property, plant and equipment

	Land & buildings	**Motor vehicles**	**Total**
	$	$	$
Balance b/d at cost	85 920	40 000	125 920
Bal. b/d of depreciation		8 000	8 000
Add depreciation for the year		6 400	6 400
Bal. b/d of depreciation		14 400	14 400
Net book values	85 920	25 600	111 520

Director's remuneration

Profit before tax has been calculated after paying directors a remuneration of $21 580.

Auditors' remuneration
Profit before tax has been calculated after paying the auditors a fee of $5 000.

Loan interest paid

Half of the interest on debentures of $2 500 was paid during the year just ended. The balance of 50% will be paid during the year ended 31 March 2002.

Example 3

The following is the trial balance of Tonde Ltd, a car dealer as at 30 June 2001.

	Dr $	Cr $
Issued share capital		
Ordinary shares of $0.5 each		300 000
8% preference shares of $1 each		30 000
Buildings at cost	510 000	
Motor vehicle at cost	84 000	
Provision for depreciation – *Buildings*		30 600
Motor vehicles		33 600
Inventory	9 600	
Debtors and creditors	40 000	60 000
Purchases and sales	142 000	324 500
Directors' salaries	42 000	
Provision for credit loses		700
Insurance	4 800	
Light and heat	1 200	
Bank charges	620	
Balance at bank		7 675
Postage and telephone	5 100	
Penalty fees	835	
Accumulated profits		61 200
Rent and rates	8 120	
	845 275	845 275

<u>Additional information</u>

1. Rent and rates included $2 300 for the 6 months ending 30 September 2001.
2. A motor car was transferred from the showroom for permanent use by the company's sales manager in the course of his company's duties on 31 January 2001. It had a selling price of $45 000 and had cost the company $30 000. No entry has been made to record this transaction.
3. Non-current assets are depreciated using the straight – line method as follows:
   - 20% on vehicles
   - 2% on buildings and assuming a nil residual value.
4. Bad debts amounting to $2 000 should be written off. The company also wishes to provide against the possibility of not receiving 3% of the remaining debtors.

5. Audit fees outstanding amount to $2 500.
6. A payment of $800 for light and heat was incorrectly charged to insurance account.
7. The directors proposed an ordinary dividend of 5 cents per share and a preference dividend of 8%.
8. Closing inventory was valued at $21 000.
9. A tax provision of $56 700 is to be made.

You are required to:
1. Prepare the Statement of comprehensive income for the year ended 30 June 2001,
2. A Statement of Financial Position as at 30 June 2001 and
3. a statement of changes in equity for the year ended 30 June 2001

Solution

Statement of comprehensive income of Tonde Ltd for the year ended 30 June 2001

	$	$
Sales		324 500
Less cost of sales		
Opening inventory	9 600	
Add purchases *(142 000 – 30 000)*	112 000	
	121 600	
Less closing inventory	21 000	100 600
Gross profit		223 900
Less expenses		
Bad debts	2 000	
Provisition for credit loses	440	
Directors salaries	42 000	
Insurance *($4 800 – $800)*	4 000	
Light & heat *($1 200 + $800)*	2 000	
Bank charges	620	
Postage and telephone	5 100	
Audit fees	2 500	
Penalty fees	835	
Rent & rates *($8 120 – $1 150)*	6 970	
Depreciation – Buildings	10 200	
Motor vehicles (1)	16 800	
(2)	500	93 965
Net profit before tax		129 935
Tax payable		56 700
Profit after tax		73 235

Statement of Financial
Position of Tonde Ltd as at
30 June 2001

ASSETS

Non – current assets	Cost	Depreciation	CA
Buildings	510 000	40 800	469 200
Motor vehicles	114 000	50 900	63 100
	624 000	91 700	532 300
Current assets			
Inventory		21 000	
Accounts receivable	38 000		
Less bad debts provision	1 140	36 860	
Rent prepaid		1 150	59 010
			591 310

EQUITY AND LIABILITIES

Share capital and reserves		
Ordinary share capital		300 000
8% Preference share capital		30 000
Accumulated profits *(61 200 + 40 835)*		102 035
		432 035
Current liabilities		
Accounts payable	60 000	
Preference dividend	2 400	
Tax provision	56 700	
Ordinary dividend	30 000	
Bank overdraft	7 675	
Accrued audit fees	2 500	159 275
		591 310

Statement of changes in equity for the year ended 30 June 2001

	Ordinary Share capital	Preference Share capital	Retained Profits	Total
	$	$	$	$
Balance b/fwd at 01/07/2000	300 000	30 000	61 200	391 200
Profit after tax - from I/S	-	-	73 235	73 235
Preference dividend	-	-	(2 400)	(2 400)
Ordinary dividend	-	-	(30 000)	(30 000)
Balance c/fwd at 30/06/2001	300 000	30 000	102 035	432 035

Note: Accumulated profit at the start of the year must be used in the Statement of comprehensive income

14.14 Examination type questions

14.15 Multiple choice questions

1. A company has an authorized capital of $800 000. Which statement must be true?

   A. The shares and debentures must not exceed $800 000
   B. The shares issued must not exceed $800 000
   C. The company must not issue more than 800 000 shares
   D. The company must issue $800 000 in shares

2. The table below shows the share capital structure of a company.

	Ordinary Shares of $1	5% Preference shares of $0.50
Number of shares authorised	100 000	60 000
Number of shares issued as fully paid	60 000	40 000

The directors declare an ordinary dividend of 7.5%. What will be the dividend for the year?

   A. $5 500
   B. $6 500
   C. $9 000
   D. $10 500

3. For which purpose can a Share Premium account legally be used?

   A. To make a rights issue
   B. To pay an ordinary dividend
   C. To repay debentures
   D. To write off preliminary expenses.

4. The company valued the tangible property, plant and equipment of the sole trader at $750 000, current assets at $450 000 and current liabilities at $350 000. What is the value of purchased goodwill?

   A. $100 000
   B. $250 000
   C. $450 000
   D. $550 000.

5. Which of the following is not required to be disclosed in the published company accounts.

   A. Auditors' remuneration
   B. Depreciation policy
   C. Legal costs
   D. Salary of highest paid director.

14.16 Structured questions

Question 1

With reference to a public limited company:

(a) Outline the contents of the directors' report.

(b) Outline the contents of an auditor's report to the shareholders.

Question 2

The following is the trial balance of Sam Ltd. as at 30 September 2002

	Dr.	Cr.
	$	$
Ordinary share capital of $1 each, fully paid		49 100
Plant & equipment	115 000	
Furniture & fittings	32 000	
Motor vehicles	86 000	
Inventory	29 000	
Purchases and sales	210 000	546 000
Debtors and creditors	71 900	59 600
Provision of depreciation: Plant & equipment		21 850
Motor vehicles		34 160
Furniture & fittings		3 200
Fuel and oil	24 600	
Repairs and maintenance	18 000	
Telephone expenses	11 200	
Wages and salaries	61 000	
Stationery	4 200	
Cash at bank	30 700	
Accumulated profits		27 190
Long term investment	50 000	
Dividend received		2 500
	743 600	743 600

Additional information

1. Inventory on hand was valued as follows: at cost at $59 000 and at net realisable value at $54 000.
2. A Provision for credit loses of 3% of debtors to be created.
3. Non – current assets are depreciated using the reducing balance method as follows:

Plant and equipment	10% per annum.
Motor vehicles	20% per annum.
Furniture and fittings	10 % per annum.

4. A motor vehicle which cost $6 500 and had a written down value of $5 265 was traded in for a new one with a cost price of $20 000. The supplier allowed $4 000 as the trade in value of the old vehicle. The bookkeeper debited the motor vehicle account and credited the bank account with $16 000. No other entries were made. No depreciation is charged in the year of disposal and a full year's depreciation is charged in the year of purchase.
5. A receipt of $6 000 from a debtor was debited to the cash book and credited to the sales account.
6. Telephone owing amounted to $1 500 and a salary of $2 000 was paid to an employee going on leave in October 2002.

You are required to prepare:
1. A Statement of comprehensive income for the year ended 30 September 2002 and
2. A Statement of Financial Position, for internal use as at 30 September 2002.

Question 3

The following trial balance was extracted from the books of Daises Ltd on 31 December 2004.

	$	$
800 000 ordinary shares of $7 each		5 600 000
Share Premium		2 800 000
Retained Earnings		649 600
Sales		22 252 300
Bad debts provision		60 200
Creditors		1 226 400
Freehold premises at cost	4 550 000	
Plant at Cost	4 200 000	
Prov. For depreciation-Plant		1 456 000
Purchases	14 119 000	
Wages	2 184 000	
Salaries	1 618 400	
Rent and Rates	301 000	
Light and Heat	108 000	
General expenses	2 218 300	
Bad debts	52 500	
Debtors	1 524 600	
Inventory	1 798 300	
Bank	1 215 900	
Suspense	154 000	
	34 044 500	34 044 500

Additional information.

1. In preparing the trial balance, the errors below were made.
   - Debtor balances were under cast by $140 000

-An item of plant purchased for $7 000 had been correctly credited to the bank account but had been credited instead of debited to the plant account

2. It has been discovered that debts totaling $37 100 are irrecoverable and $55 300 are doubtful.
3. Inventory at the end was valued at $2 192 400.
4. Plant which cost $140 000 with an accumulated depreciation of $126 000 at 1 January 2004 was sold for $21 000. The only accounting entry made so far for this transaction has been to debit bank and credit the sale proceeds to the sales account.
5. The company's policy is to depreciate plant on the straight line method at 10% per annum. The company provides a full years' depreciation in the year of purchase and no depreciation in the year of sale.
6. Payments due at the end of the year were:

	$
Wages	40 600
Light and heat	13 300

7. Rates prepaid at the end of the year were $22 400.
8. A final dividend of $700 000 is proposed for the year.

<u>You are required to</u>

(a) Prepare a statement of comprehensive income account for the year ended 31 December 2004.

(b) Prepare a Statement of Financial Position as at 31 December 2004.

Question 4

A year ago, Maplanka a building contractor formed a limited company with his wife, Mildred. They do repair work for local householders and Mildred keeps some accounting records but not on a double entry basis. Since Maplanka Co. (Pvt) Ltd is a small family business, they did not think it was important to keep a full set of accounting books, but because the tax department has insisted on knowing what profit the business has made over the last 12 months, Mildred has approached you to help her prepare final accounts for the year ended 30 June 2007.

The assets and liabilities of the business at 30 June 2006 were as follows:

<u>Assets</u>	$
Plant & equipment: cost	50 400
: depreciation to date	23 200
Motor vehicles: cost	36 000
: depreciation to date	26 000
Inventory of materials	56 640

Debtors	37 960
Rent prepaid to 30 September 2006	3 000
Prepaid insurance to 32 December 2006	2 800
Bank balance	7 440
Cash in hand	920

<u>Liabilities</u>

Creditors	13 840
Telephone bill owing	840
Electricity owing	720

The cash and bank transactions for the year ended 30 June 2007 are given below.

Cash and Bank Summary

Receipts	**Cash**	**Bank**		**Payments**	**Cash**	**Bank**
	$	$			$	$
Opening balances	920	7 440		Suppliers		335 960
Receipts from customer	210 560	603 520		Rent of premises		14 400
Loan received		40 000		Insurance to		
Proceeds from sale of				(31.12.2007)		6 400
Vehicle at the start				Pur. Of plant		
Of the year		12 000		& equipment		33 600
Cash paid into bank		96 160		Pur. Of new		
Cash withdrawn from				Vehicle		51 200
The bank	193 040			Telephone		3 440
Closing balance			8 400	Electricity		3 560
				Wages of repair		
				Workers	272 800	
				Miscellaneous		
				Expenses		5 120
				Director's salary		
				Paid to		
				Maplanka	32 000	
				Refund to		
				Customer		1 600
				Cash paid into		
				The bank	96 160	
				Cash withdrawn		
				From the bank	193 040	
				Dividends paid		119 200
				Closing balance	3 560	
		404 520	767 520		404 520	767 520

The following further information is available:

a) Plant and equipment is to be depreciated at 25% per annum on the reducing balance method with a full year's charge in the year of purchase.
b) The new motor vehicle was purchased on 1 January 2007. Depreciation on motor vehicles is to be charged at 25% per annum on the straight – line basis, with a proportionate charge in the year of purchase both none in the year of sale.
c) The rent of premises was increased by 20% from 1 October 2006.
d) The loan of $40 000 was obtained from Maplanka's brother on 1 April 2007. It carries interest at 10% per annum, payable on 30 September and 31 March.
e) At 30 June 2007, the following amounts were outstanding

Creditors	$16 360
Telephone	$960
Electricity	$880
Miscellaneous expenses	$1 960

f) At 30 June 2007, amounts due from customers totaled $43 440. Of this amount, it was considered that amounts totaling $5 120 were bad and should be written off.
g) Inventory of materials at 30 June 2007 was $48 680
h) Maplanka agreed to pay Mildred $20 000 for her assistance with office work during the year. This amount was actually paid in August 2007.
i) Mildred and Maplanka agree to pay themselves a dividend of $119 200 for the year.
j) Taxation of $5 450 is to be provided for
k) It is agreed to transfer $16 000 to a general reserve.
l) It was agreed that the value of Ordinary Shares in Maplanka & Co. Pvt Ltd was to be $2.00 per share.
m) The company made a loss last year of $43 550.

REQUIRED

a) Prepare A statement of comprehensive income account of Maplanka and Co Pvt Ltd for the year ended 30 June 2007.
b) Prepare a Statement of Financial Position of Maplanka and Co Pvt Ltd as at 30 June 2007.

Question 5

Spanky Ltd Co. had the following balances in its books at 30 June 2002.

Freehold land and buildings at cost $750 000 in 1974, and had been revalued in 1981 at $1 200 000

Plant and Machinery purchased on 1 July 2000 at a cost of	$720 000
Plant and Machinery purchased on 1 July 2001 at cost	$468 000
Motor vehicles purchased on 1 January 2001 at a cost of	$240 000
Motor vehicles purchased on 1 July 2001 at a cost	$150 000

The annual rates of depreciation, based on cost with estimated nil residual values and which have always been used are:

Freehold land and buildings	not depreciated
Plant and machinery	20% straight line
Motor vehicles	25% straight line.

When the freehold land and buildings were purchased in 1974, the cost was allocated as land $150 000,

buildings $600 000. The revalued amount for this asset in 1981 was allocated as follows: land $300 000; buildings $900 000.

In the year to 30 June 2003, the following events took place;

1. Freehold land and buildings were again revalued by a group of chartered surveyors Black and Blue Surveyors on 1 July 2002 at $3 000 000 of which $600 000 related to the land. The freehold buildings were estimated to have a residual life of 20 years.

2. The following disposals took place:

   - 1 January 2003; plant and machinery, which had been, purchased on 1 July 2000 at a cost of $300 000.
   - 1 April 2003; plant and machinery, which had been, purchased on 1 July 2001 at a cost of $18 000.
   - 1 April 2003; motor vehicles which had been purchased on 1 January 2001; at a cost of $60 000.

3. The following acquisitions took place.

   - 1 July 2002, A lease on property for 20 years for $300 000 was secured.

   - 1 October 2002; motor vehicles for $96 000
   - 1 January 2003; plant and machinery for $330 000.

The directors decided to depreciate freehold property and to amortise the lease as from 1 July 2002 in accordance with accepted accounting practice. The depreciation policy for the other items of property, plant and equipment remained in force as before.

<u>You are required to:</u>

Prepare notes to the published accounts Of Spanky Ltd Co. to show the information that should be disclosed concerning the tangible property, plant and equipment in the Statement of Financial Position at 30 June 2003.

Question 6
Using the information in Example 3, you are required to prepare the published Statement of comprehensive income of Tonde Ltd, for the year ended 30 June 2001

CHAPTER 15

AMALGAMATION AND ABSORPTION OF BUSINESSES

15.1 Chapter objectives

After studying this chapter *the student should* be able to:

(1) *Demonstrate an understanding of the forms of* amalgamation and absorption.
(2) *Determine the opening capital account for each partner upon amalgamation and absorption.*
(3) *Make journal entries to record the takeover of a sole trader and partnership businesses by a limited company.*
(4) *Prepare: The realisation account, The partners' capital accounts and The partnerships bank account in the books of the acquiree.*
(5) *Prepare the business purchase account (showing clearly any Goodwill arising) and the Statement of Financial Position of acquirer immediately after the takeover.*

15.2 Introduction

Two or more businesses may amalgamate into a large one. Aquisition is when one business is formed to take over another business or when an existing business takes over another business. In both cases, one business is wound up. Amalgamation is when two businesses pool their resources together to form one business entity. Amalgamation and absorption can take the following forms.

1. A partnership may admit a sole trader.
2. Two sole traders may form a partnership.
3. Two or more partnerships may form a larger partnership business.
4. A limited liability company (a new form of enterprise to be covered in detail in later chapters) taking over a sole trader or a partnership.
5. A limited liability company taking over another limited liability Company.

In each of the above situations, the assets are usually revalued. Where assets are revalued, the amount should be used to determine the capital accounts of the individual partners and should be recorded in the books of the new partnership business. It is quite common for partners to agree on the value of goodwill.

<u>How to determine the opening capital of each partner</u>

The opening capital accounts are determined by the accounting equation =
Assets – Liabilities = Capital

Only assets (including goodwill) and liabilities taken over by the new business are included. Assets must be included at the revalued amount.

The following are the Statement of Financial Positions of two sole traders as at 31 December 1995.

	Evelyn		Esther	
	$	$	$	$
Property, plant and equipment				
Premises		30 000		22 000
Furniture and fittings		5 000		8 000
Motor vehicles				6 000
		35 000		36 000
Current assets				
Inventory	8 000		4 000	
Debtors	2 000		4 000	
Cash at bank	500		2 000	
	10 500		10 000	
Less creditors	5 000	5 500	6 000	4 000
		40 500		40 000
Capital		40 500		40 500

Additional information:
Evelyn and Esther agreed to amalgamate their businesses to form a partnership known as Moyondizvo with effect from 1 January 1996. The partners agreed upon the following valuations.

	Evelyn	Esther
	$	$
Goodwill	12 000	8 000
Premises	38 000	25 000
Motor vehicle	--------	8 000
Inventory	7 500	3 900
Accounts receivables	1 800	3 100

All other assets were taken over at book value. Evelyn decided not to bring into the new business cash at bank while Esther paid creditors $1500 out of her private resources.

Required

1. Calculate the capital contributed by each partner
2. Prepare a Statement of Financial Position of Moyondizvo as at 1 January 1996

Solution

Calculation of capital

	Evelyn	**Esther**
	$	**$**
Furniture & Fittings	5 000	8 000
Goodwill	12 000	8 000
Premises	38 000	25 000
Motor vehicle	--------	8 000
Inventory	7 500	3 900
Receivable	1 800	3 100
Bank	--------	2 000
Total assets	64 300	58 000
Less Liabilities	(5 000)	(4 500)
Capital	59 300	53 500

Moyondizvo

Statement of Financial Position as at 1 January 1996

		$	$
Property, plant and equipment			
Premises	(38 000 + 25 000)		63 000
Furniture & Fittings	(5 000 + 8 000)		13 000
Motor vehicle			8 000
Goodwill			20 000
			104 000
Current assets			
Inventory (7 500 + 3 900)		11 400	
Receivables (1 800 + 3 100)		4 900	
Bank		2 000	18 300
Total Assets			122 300
Equity & Liabilities			
Capital			
Evelyn			59 300
Esther			53 500
			112 800
Creditors (5 000 + 4 500)			9 500
Total Equity & Liabilities			122 300

The accounting procedure we have adopted above also applies when a partnership takes over the business of a sole trader. Goodwill can be written off against capital accounts of the new partners in proportion to their profit and loss sharing ratios.

15.3 Limited liability companies taking over other businesses

An incorporated business entity can take over other business entities. In this chapter we are going to look at a situation whereby a limited company takes over a sole trader and a partnership. This business combination is termed absorption.

15.4 A Limited company taking over a sole trader

A Limited Company can take over a sole trader by paying the sole trader cash or issue shares and / or debentures.

Example 1

The summarised Statement of Financial Position of Shadow Ltd. as at 31 December 2001 is given below.

		$
Property, plant and equipment		280 000
Current Assets		
Bank	84 000	
Inventory and accounts receivable	129 000	213 000
		493 000
Capital & Reserves		
Ordinary share capital of $1 each		200 000
Capital reserves		175 000
Revenue Reserves		75 000

Current Liabilities	43 000
	493 000

On the same date, they took over a business owned by Wabaya, paying him $17 800 in cash and issuing him 15 000 ordinary shares of $1 each at par.

Wabaya`s assets & liabilities were taken over at the following agreed values.

	Book Value	Agreed Value
	$	**$**
Motor Vehicles	30 000	23 000
Inventory	1 700	2 920
Accounts receivable	3 900	3 900
Accounts payables	2 200	2 200

Required:
Prepare Shadow LTD's Statement of Financial Position soon after the takeover.

Solution
Since the purchase consideration (cash and shares = 17 800 + 15 000) exceeds the agreed takeover value of net assets, the excess is goodwill.

Calculation of Goodwill

Business purchase account

	$		$
Accounts payable	2 200	Motor vehicles	23 000
Purchase consideration	32 800	Inventory	2 920
		Accounts receivable	3 900
		Goodwill *(difference)*	5 180
	35 000		35 000

Journal entries to record the transaction

Details	**Debit**	**Credit**
Motor Vehicles	23 000	
Business Purchase Account		23 000
Being the recognition of motor vehicles in the ledger		
Inventory	2 920	
Business Purchase Account		2 920
Being the recognition of inventory in the ledger		
Accounts receivable	3 900	
Business Purchase Account		3 900
Being the recognition of accounts receivable in the ledger		
Goodwill	5 180	
Business Purchase Account		5 180
Being the recognition of goodwill in the ledger		
Business Purchase Account	2 200	
Accounts payable		2 200
Being the recognition of creditors in the ledger		

Business Purchase Account	32 800	
Bank		17 800
Ordinary share capital		15 000
Being the purchase consideration given up		

Statement of Financial Position of Shadow ltd. after the take over

		$	$
Intangible property, plant and equipment	- Goodwill		5 180
Tangible property, plant and equipment (280 000 + 23 000)			303 000
			308 180
Current Assets			
Bank (84 000 – 17 800)		66 200	
Other (129 000 + 2 920 + 3 900)		135 820202 020	
			510 200
Equity and Liabilities			
Ordinary share capital of $1 each (200 000 + 15 000)			215 000
Capital Reserves			175 000
Revenue reserves			75 000
Current Liabilities (43 000 + 2 200)			45 200
			510 200

Please Note: The assets in the Ltd. Company's Statement of Financial Position are shown at the agreed value, **NOT** at their Net Book Value (CA) in the sole trader's books.

15.5 Taking over of a partnership by a limited company

In partnership conversion the accounting entries are just the same whether a limited liability Company is taking over the partnership or the partners themselves mutually agree to convert their business into a limited liability company. In actual fact, there is an element of partnership dissolution and the formation of a new company. The following accounts should be opened.

15.6 Realisation account

It is in this account that the profit or loss on conversion is calculated. **Only** those assets and liabilities being taken over by the company should be entered in this account. The purchase consideration being the cash, shares or debentures paid by the purchasing company should be credited to the realization account and the corresponding debits to the capital accounts of the partners. Assets taken over by the partners should be credited to this account at agreed value. The corresponding entry will be debited to the capital account of such partner.

Example 2

Susan and Tarisai have been in partnership for 2 years sharing profits & losses in the ratio 2:3 respectively. On 31 December 2001, they sold their business to a company – ST Ltd. such that they would enjoy the limited liability. Their Statement of Financial Position as at that date is given below:

Statement of Financial Position for Susan and Tarisai as at 31 December 2001

	$	$
Property, plant and equipment		
Land & buildings		200 000
Motor vehicles		100 000
		300 000
Current Assets		
Inventory	84 000	
Receivables	39 400	
Bank	14 000	137 400
Total assets		437 400

EQUITY AND LIABILITIES

	Capital	Current	Total
Susan	190 000	8 680	198 680
Tarisai	160 000	(1 200)	158 800
	350 000	7 480	357 480
Long term loan from Tarisai			50 000
			407 480
Current Liabilities - Payables			29 920
Total equity and liabilities			437 400

Notes:

1. The new Company will take over the assets and liabilities with the exception of bank account and one motor vehicle (note 2). The assets will be taken over at the following valuation.

		$
a.	land & buildings	230 000
b.	motor vehicles	40 000
c.	inventory	80 000

2. Susan took over one of the vehicles at an agreed value of $25 000. The cost of the vehicle was $60 000 and had a written down value or (CA) of $45 000.
3. The purchase consideration of $390 000 is to be satisfied as follows:
   a. A cash payment of $50 000
   b. An issue of 200 000 Ordinary shares of $1 each to be shared in proportion to their profit & loss sharing ratio.
   c. An issue of 10% Debenture inventory that will enable Tarisai to earn as much interest as she earned from her loan to the partnership. The loan was carrying an interest of 8% per annum.
4. At the same date, the company issued 20 000 12% Preference shares of $2 each at par that were fully taken up.

Required

1) In the partnerships books prepare:
   i) The realisation account
   ii) The partners' capital accounts
   iii) The partnerships bank account
   iv) ST Ltd. Account
2) In ST Ltd. Books, prepare
   i) The business purchase account (showing clearly any Goodwill arising)
   ii) The Statement of Financial Position of ST Ltd. Immediately after the takeover.

1. (a) Solution

Realisation A/c

	$		$
Land & buildings	200 000	Purchases consideration	390 000
Motor vehicles	100 000	Capital- Susan	25 000
Inventory	84 000	Payables	29 920
Receivables	39 400		
Capital: Susan	8 608		
Tarisai	12 912		
	444 920		444 920

Capital a/c

	Susan	Tarisai		Susan	Tarisai
	$	$		$	$
Current a/c	-	1 200	Bal. b/d	190 000	160 000
Realisation – Motor	25 000	-	Current a/c	8 680	-
10% Debentures	-	40 000	Loan	-	50 000
Shares in ST Ltd.	120 000	180 000	Realisation	8 608	12 912
Bank	62 288	1 712			
	207 288	222 912		207 288	222 912

Partnership Bank account

	$		$
Bal. b/d	14 000	Capital : Susan	62 288
ST Ltd.	50 000	Tarisai	1 712
	64 000		64 000

ST Ltd. account

	$		$
Realisation	390 000	Ordinary shares	200 000
		Share premium	100 000
		Debentures	40 000
		Bank	50 000
	390 000		390 000

2.(a)

Business purchase account

	$		$
Payables	29 920	Buildings & Land	230 000
Ordinary Share Capital	200 000	Motor Vehicles	40 000
Share Premium	100 000	Inventory	80 000
Bank – Cash to partners	50 000	Receivables	39 400
12% Debentures	40 000	Goodwill *(difference)*	30 520
	419 920		**419 920**

2.(b) **STATEMENT OF FINANCIAL POSITION FOR ST LTD AS AT 31 DECEMBER 2001**

			$
Intangible property - Goodwill *(See above)*			30 520
Property, plant and equipment - Land & Buildings			230 000
- Motor vehicle			40 000
			300 520
Current Assets			
Inventory		80 000	
Receivables		39 400	119 400
TOTAL ASSETS			**419 920**
Equity and liabilities			
200 000 Ordinary shares			200 000
20 000 10% preference shares			40 000
Share premium		100 000	
			340 000
40 000, 10% Debenture inventory			40 000
			380 000
Current liabilities – Payables	29 920		
Bank	10 000		39 920
Total equity and liabilities			419 920

Care should be taken when determining the value of shares to be debited to capital account and credited to Realisation account. The amount to be entered is the issue value of shares; this is not always the par value.

15.7 Issue value of shares.

The questions in almost all situations do not show the amount of the premium

To get the premium, we say

Total purchases consideration	xxx
Less cash payment (if any)	(xxx)
*Less*debentures (if any)	(xxx)
Less par value of shares	(xxx)
Premium at issue	**xxx**

At times, it is not easy to determine the value of goodwill, this can be determined as follows:

Total Purchase consideration	xxx
Less Net Assets acquired	xxx
Goodwill	xxx
Where Net assets is equal to	
Asset acquired at agreed value	xxx
Less liabilities assumed	xxx

When the purchase consideration is not given, we determine it be adding goodwill to Net assets acquired.

15.8 Examination type questions

15.9 Multiple Choice

1. The table shows the assets and liabilities of a company.

	Book value	Market value
	$000	$000
Tangible property, plant and equipment	120	140
Current Assets	100	90
Goodwill	-	30
Share Capitals	80	
Retained Profits	80	
Current liabilities	60	50

What would be the purchase price of the net assets of the company?

A. $190 000
B. $210 000
C. $220 000
D. $260 000.

2. A company has just purchased a business with net assets of $220 000. in addition, the goodwill of the business is valued at $20 000. The purchase price of the business is settled by the issue of 80 000 $2.00 ordinary shares in the company. What will be the entry in the company's share premium account?

A. Debit $80 000
B. Credit $80 000
C. Debit $60 000
D. Credit $60 000

3. A Ltd purchases the business of B White by issuing 40, 50 cent shares at a premium of $0.10. A Ltd agrees to take over B White's assets and liabilities at the date of the acquisition as follows.

	$
Property, plant and equipment	75 000

Current Assets	37 500
Creditors	2 500
Bank loan	10 000

A. 79 000
B. 87 500
C. 100 000
D. 105 000

4. A company agrees to buy assets from another company for $400 000. The book value of the assets is $340 000. The purchase price comprises cash of $120 000, an issue of $100 000 debenture inventory at a discount of 5% and an issue of 18 500 ordinary shares with a nominal value of $1.00 each. What is the market value of each ordinary share?

A. $0.48
B. $6.76
C. $9.72
D. $10.00

5. A sole trader sold his business to a limited company on 28 February. The net assets of his business had a total book value of $800 000 and a total fair value of $1 000 000. The consideration for the sale was satisfied by the issue of 200 000 $5 ordinary shares (worth $6.25 each) and a cash payment of $100 000. What is the amount of goodwill arising on the transfer?

A. $100 000
B. $300 000
C. $350 000
D. $550 000

6. A limited company purchases a business by issuing 320 000 ordinary shares of $2.00 each at a premises of $1.50 per share. Goodwill of $300 000 arises on the purchase. What is the fair value of the separate net assets?

A. $340 000
B. $205 000
C. $280 000
D. $355 000

7. The following is an extract from the Statement of Financial Position of a company

<u>Share capital and Reserves</u>

	$m
5 000 000 ordinary share of $1 each	5.0
1 000 000 8% preference shares of $1 each	1.0
Share premium account	2.0

Property revaluation reserve	4.0
General reserve	3.5
Profit and loss account	2.5

The company also issued 10% debentures amounting to $5m. Each ordinary shares will be valued on a Statement of Financial Position basis at

A. $12.00
B. $13.00
C. $17.00
D. $18.00

8. In relation to the purchase of a business, when the purchase price exceeds the values ascribed to the assets taken over, the difference is known as

A. Goodwill
B. A capital reserve
C. Negative goodwill
D. A premium

9. A company with an existing issued capital of $800 000 $2 ordinary shares made a 1 for 5 Bonus issue. This was later followed by a 1 for 3 Rights Issue.

What will be the balance on the Share Capital Account after these transactions?

A. $800 000.00
B. $960 000.00
C. $1 226 666.00
D. $1 280 000.00

15.10 Structured questions

Question 1

Sam & Gamu and Vimbai & Upenyu are two partnerships. The profit sharing ratios were 3:2 for Sam and Gamu and 2:1 for Vimbai and Upenyu. They decided to amalgamate their businesses under the name of E.S. Accounting Services from 1 October 2000.

The Statement of Financial Positions of the two partnerships as at 30 September 2000 were as follows:

Sam and Gamu

	$
Assets	
Property, plant and equipment	
Premises	**30 000**
Machinery	10 000
Current assets	
Inventory	9 000
Receivable	6 000
Bank	10 000
Total Assets	65 000
Equity & Liabilities	
Capital A/c	
Sam	30 000
Gamu	17 800
Current A/c	
Sam	1 200
Gamu	1 000
Creditors	15 000
Total equity and liabilities	65 000

Vimbai & Upenyu

	$
Assets	
Property, plant and equipment	
Premises	70 000
Machinery	40 000
Current assets	
Inventory	32 000
Bank	8 000
	150 000
Equity & Liabilities	
Capital A/c	
Vimbai	64 500
Upenyu	64 500
Current Liabilities	
Creditors	21 000
	150 000

The assets of the two partnerships were revalued as follows:-

	Sam & Gamu	***Vimbai & Upenyu***
Premises	50 000	100 000
Machinery	--------	30 000
Vehicles	60 000	--------
Inventory	8 500	28 000
Receivable	5 100	--------
Goodwill	12 000	28 000

Other assets and liabilities were taken over at their book values and goodwill should not be shown in the books. Current accounts are to be capitalised.

Required

a) Open, post and balance the following accounts:
b) Goodwill account
c) Capital accounts of partners
d) Prepare the Statement of Financial Position of the new partnership as at 1 October 2000

Question 2
Pink and Blue had been trading as a partnership for several years, sharing profits and losses in the ratio of 3:2. Their Statement of Financial Position as at 31 May 2003 was as follows:

	$	$
Property, plant and equipment at net book value		432 000
Current Assets		
Inventory	180 000	
Debtors	108 000	
Bank	24 000	
	312 000	
Less Creditors	18 000	294 000
		726 000
Financed by		
Capitals : Pink		288 000
Blue		384 000
		672 000
Current Accounts: Pink	2 400	
Blue	3 600	6 000
		678 000
Add loan from Blue		48 000
		726 000

Additional information

1. On 1 June 2003, Pink and Blue converted their partnership business to a new limited company, Browns Ltd. The business was valued at $840 000. The purchase consideration was to be satisfied by the issue of $10 500 ordinary shares of $8 each, fully paid.

2. The issued and authorised share capital of Browns Ltd is $420 000. The preference shares, issued at par, were distribution between the partners in proportion to their capital accounts at 31 May 2003. The ordinary shares were allocated in their partnership profit and loss sharing ratios.

3. All the partnership assets were transferred to Browns Ltd, with the exception of debtors and the bank balance. The loan from Blue and the creditors were repaid in full on 1 June 2003, and the debtors paid $104 000 in full settlement on the same date.
4. The partners paid in or withdrew cash to close their capital accounts.

You are required to:

a) Prepare the partnership realisation account, showing the entries necessary to transfer the business to Browns Ltd. [8]
b) Prepare the capital accounts of the partners, showing entries required to close off the partnership books. [12]
c) Show the Bank account of the partnership. [5]
d) Show the opening Statement of Financial Position (including any goodwill arising) of Browns Ltd.[5]

Question 3

Two sole traders, Den and Norton, agreed to amalgamate their businesses to form a partnership to be called Tin- tan Suppliers, with effect from 1 January 2005. Their separate Statement of Financial Positions disclosed:

Statement of Financial Positions as at 31 December 2004

Den			Norton	
$	$		$	$
		Property, plant and equipment (written down value)		
44 000		Shop premises	58 000	
13 600		Equipment	18 400	
7 200		Fittings and Fixtures	8 200	
64 800			84 600	
		Current Assets		
10 800		Inventory	16 000	
1 400		Debtors	2 200	
2 600		Bank and cash	3 000	
14 800			21 200	
		Less Current Liabilities		
5 800		Creditors	9 000	
-		Bank overdraft	4 400	
5 800			13 400	
	9 000	Working Capital		7 800
	73 800	Net Assets employed		92 400
		Finances by		
	73 800	Capital		92 400
	73 800			92 400

The assets and liabilities of the two parties were revalued as part of the amalgamation procedure and the following figured were agreed.

	Den	Norton
	$	**$**
Premises	80 000	100 000
Equipment		17 600
Fittings and fixtures	15 200	
Inventory	10 200	15 200
Debtors	1 200	1 800

All other assets were taken over by Tin- Tan Suppliers at their book values.

Den agreed to pay creditors amounting to $2 400 out of his private resources. The partnership assumed responsibility for the remainder and for the loan from Bingo. Norton settled the bank overdraft privately. It was agreed that the capital of Tin- Tan suppliers should be subscribed by Den 2/3 and Norton 1/3.

REQUIRED:

Prepare the Statement of Financial Position of Tin- Tan Suppliers immediately after the amalgamation has taken place.

Question 4

Bukhosi, Masi and Thandi have been in partnership for a number of years sharing profits and losses in the ratio 3:2:1 respectively. The partners have decided an offer of $210 000 from ABC Ltd to buy all the assets of the company except for debtors and three of the vehicles which have been used by the partners over the last year. The summarized Statement of Financial Position of the partners as at 28 February 2004, before the takeover was as follows:

		$	$	$
Property, plant and equipment				
Premises				112 000
Machinery				36 000
Vehicles				54 000
				202 000
Current Assets				
Inventory			22 000	
Debtors			37 000	
			59 000	
Less Current Liabilities				
Creditors		28 000		
Bank overdraft		19 000	47 000	12 000
				214 000
Less Long term loan from Masi				10 000
				204 000
Capital Accounts:	Bukhosi			100 000
	Masi			60 000
	Thandi			36 000
				196 000
Current Accounts:	Bukhosi		6 200	
	Masi		3 800	
	Thandi		(2 000)	8 000
				204 000

The purchase consideration was settled by the issue of 75 000 ordinary shares of $1.00 each and the payment to the partnership of $120 000 cash. The shares were divided equally between the partners. The final balances on the partners’ capital accounts were settled in cash.

Each partner agreed to take over personally the vehicle which he had been using during the year. Details of these vehicles were:

	Book Value Of vehicle	Agreed take-over price
Bukhosi	\$10 000	\$12 000
Masi	\$10 000	\$10 000
Thandi	\$14 000	\$16 000

Cash collected from debtors amounted to \$35 800 and the partners paid \$25 000 to creditors in full settlement of the amounts due to them. Dissolution costs amounted to \$9 000 and were paid by the partnership.

REQUIRED

a) A calculation of the profit or loss on the dissolution and sale of the partnership.
b) Write up the capital accounts of the partnership recording the dissolution ad sale.
c) Calculate the agreed value of an ordinary share in ABC Ltd and explain why it may be different from the nominal value.
d) Explain why the partners may have accepted shares in ABC Ltd rather than insisting on a full cash settlement.
e) What was the premium on the issue of shares.

CHAPTER 16

ISSUE AND REDEMPTION OF SHARES, CAPITAL RECONSTRUCTIONS AND REDUCTIONS

16.1 Chapter objectives

After studying this chapter *the student should* be able to:

1. *Explain the differences between public issue, right issue and bonus issue.*
2. *Draw up the journal entries to record the issue of shares through public issue, right issue and bonus issue.*
3. *State the reasons why a company buys back its shares.*
4. *Give reasons why there is legislation to govern redemption of shares.*
5. *Distinguish between capital redemption and capital reconstruction.*
6. *Open, post and balance the capital reduction and share capital amounts to record the reorganization arrangements.*
7. *Prepare the Statement of Financial Position of the company immediately after the reorganization has been effected.*

16.2 Introduction

A Company raises capital by issuing shares by means of

a) Public issue
b) Rights issue and
c) Bonus issue.

The shares can be issued at par or at a premium. It may also issue its shares at a discount but this requires court approval. The shares whether offered for subscription at par or at a premium, may be payable either in full on application or by installment.

The accounting entries where shares are payable in full on application are: (for both public and rights issue)

DR -Bank
CR. -Applicant account with amount of application money (including premium if any received.)

No. of applications received multiplied by issue price per share

DR -Application Account
CR. -Share capital account with nominal value of the shares allotted.

No of Shares the company wants to issue x par value per share

<u>Where shares are issued at a premium further entry is required:-</u>

DR-Application account
CR. -Share premium account with the amount of the premium on the share allotted.

No. of shares the company proposes to issue x premium per share

<u>Where an applicant is unsuccessful and the applicants are not allotted any shares and the application money is refunded.</u>

The entry is:

DR -Application account
CR. -Bank

Nº of shares in excess x issue price

Being the amount of the application money (including premium if any) refunded.

16.3 Issue of shares at par, Payable in full

Shares that are issued at par are issued at the same price as their nominal value i.e. if a share with a nominal value of $1 is issued at par, the company receives $1.

<u>Illustration</u>
A new company is to issue 60 000 $1 ordinary shares payable in full on application. Applications were received for 70 000 shares.

<u>Required</u>
Show the Journal and Ledger entries to record the share issue including the return of excess application moneys.

		Dr	Cr.
1.	DR Bank	70 000	
	CR. Ordinary share applicants		70 000
	Application monies received on issue of 60 000 ordinary shares.		
2.	DR Ordinary share applicants	10 000	
	Cr. Bank		10 000
	Being the refund of excess application moneys		
3.	DR ordinary share applicants	60 000	
	CR. ordinary share capital		60 000
	Issue of 60 000 $1 ordinary shares		

Bank a/c

	$		$
Ordinary share applicant	70 000	Ordinary share applicants	10 000
Bal. c/d	60 000		
	70 000		**70 000**
Bal. b/d	60 000		

Ordinary share applicants' a/c

Bank	10 000	Bank	70 000
Ordinary Share Capital	60 000		
	70 000		**70 000**

Ordinary share capital A/C

		Ordinary share applicants	60 000

Statement of Financial Position*(extract)*

<u>Assets</u>	
Bank	60 000
	60 000
600 000 $1 ordinary share capital	60 000
	60 000

16.4 Issue of shares at a premium payable in full on application

Companies that have been operating profitably for some years may issue additional shares at a premium. For example a company with ordinary shares of $1 each may offer them for sale for $1.50. The $1 represents the nominal value and the 50 cents represent the premium. The Companies Act provides that when shares are issued at a premium, the premium should be transferred to a share premium account.

Illustration

A company has already issued 80 000 $1 ordinary shares. It now proposes to issue 20 000 additional $1 ordinary share at a premium of 20%. Applications for 30 000 shares are received.

Required:

Prepare the relevant ledger accounts to record the above transactions.

Bank account

Ordinary Shares applicants	36 000	Ordinary Share applicants	12 000
		Bal. c/d	24 000
	36 000		**36 000**
Bal. b/d	24 000		

Ordinary Share Applicants A/C

Bank	12 000	Bank	36 000
Ordinary Share capital	20 000		
Share Premium	4 000		
	36 000		**36 000**

Ordinary Share Capital A/C

Bal. C/d	100 000	Bal. b/d	80 000
		Application account	20 000
	100 000		**100 000**
		Bal. B/d	100 000

Share Premium Account

		Ordinary Share applicants	4 000

16.5 Bonus and right issue

Bonus issue is the issue of additional shares to existing shareholders in proportion to their current shareholding for free of charge by the utilization of capital reserves.

Rights issue – is the issue of shares to existing shareholders in proportion to their current holdings at a lower price than the market value of shares.

EXAMPLE

The summarised Statement of Financial Position of Mudzingwa (Pvt) Ltd. as at 31 December 2000 is as follows:

Property, plant and equipment	**Cost**	**Dep.**	**C.A.**
Property	70 000	-	70 000
Motor vehicles	50 000	10 000	40 000
	120 000	10 000	110 000
Net Current assets (excluding bank)			40 000
Bank			10 000
			160 000
Equity and Liabilities			
Ordinary Share Capital			60 000
Share premium			40 000
Retained income			60 000
			160 000

Additional information

The directors proposed to:

1. Revalue property upwards by $30 000
2. A bonus issue was made on 1 January 2001 on the basis of one bonus share for every six shares held on 31 December 2000 utilising the share premium account.
3. On 30 March 2001, a right issue of 2 shares for every 5 shares held on 31 January 2001 was made.

Required

Prepare the Statement of Financial Position after the above transactions as on 31 December 2001 assuming that there are no other transaction that took place.

Statement of Financial Position as at 31 December 2001

	$
Property *(70 000 + 30 000)*	100 000
Motor vehicle	40 000
	140 000
Net Current Assets (excluding bank)	40 000
Bank *(10 000 + 28 000)*	38 000
Total Assets	**218 000**
Equity and Liabilities	
Capital Reserves	
Share Capital *(60 000 + 10 000 + 28 000)*	98 000
Share premium *(40 000 – 10 000)*	30 000
Revaluation reserve	30 000
Retained income	60 000
Total equity and liabilities	**218 000**

Notes

1. When we revalue an asset upwards, we make the following entry

DR	Property, plant and equipment	(With an increase only)
CR.	Revaluation Reserve	

2. When we issue bonus shares the entry is as follows:

   DR Capital Reserve
   DR Revenue reserve — made only if capital reserves are insufficient
   CR. Bonus/ scrip issue

3. Dr. Bonus issue account
   Cr. Ordinary share capital account

16.6 Redemption and Purchases by a company of its Shares

Redemption means buying back its shares, which were issued as redeemable while purchase is buying back, shares, which were not issued as redeemable.

Reasons why a company buys back its shares

1. It may have a contractual obligation to do so e.g. debenture or redeemable shares may have a redemption date.
2. It may provide an efficient means of using surplus cash resources.
3. It may be a convenient method of buying out a dissented shareholder.
4. To reduce the gearing ratio of an enterprise when it is the preference shares or debentures being redeemed.

The reason why there is legislation to govern redemption

Redemption of shares reduces the resources available to meet the claims of the creditors. Cash leaves the company to repay shareholders who in the event of liquidation would be paid after the creditors. This safeguard is to ensure that funds are available for creditors are not reduced by the redemption.

The law *[Companies Act]* only permits a company to redeem its shares as follows:

1. Out of proceeds from a fresh issue of shares or debentures for that purpose (of redemption) including any premium received. There is no problem with this method as the money paid out is replaced by money coming in from the new issue. With this method, the nominal value of the shares redeemed must be covered by the proceeds of the fresh issue (including any premium on that issue) .The idea is that cash coming in should be enough to pay the nominal value of the shares to be redeemed.

2. A Company can also redeem its shares by the use of internal resources e.g. by utilising general reserves. If this method is used to redeem shares, the company must transfer profit from the accumulated profits enough to cover the nominal value of the shares to be redeemed to a capital reserve known as capital redemption reserve. The effect of the transfer is to reduce profit that could have been used to pay a dividend. This is sometimes referred to as the capitalization of profits.

3. Or by a combination of the above two methods

Method 2 above is sometimes referred to as the capitalisation of profits. If the redemption is by the capitalisation of profits, this requires the creation of a capital redemption reserve; this reserve is created by transferring an amount equal to the nominal value shares being redeemed to this reserve from a suitable distributable reserve like profit & loss account.

Shares can be redeemed at a premium and the premium on redemption can be charged to the share premium account only if any of the following conditions are present:

1. The shares being redeemed were originally issued at a premium or

2. The redemption is financed by proceeds from a fresh issue of shares or debentures, for that purpose.

If any of the above conditions are not met, a premium on redemption should be financed by a suitable distributable reserve. Any amount that can be charged to the share premium is limited to the following:

1. The amount of premium received when the shares were originally issued.
2. The amount of premium presently standing on the credit side of the share premium account including any premium receivable from new issue of shares, for that purpose.

Redemption/Purchases involves basically three things.

1. Provide finance for redemption
2. Cancel shares being redeemed
3. Pay the shareholders whose shares have been redeemed.

Illustration 1: Redemption plus new issue of shares.

The following is a summarised Statement of Financial Position of Mlambo Ltd. as at 31 March 2002

	$
Sundry assets	180 000
Bank	120 000
	300 000
Ordinary share capital of $1 each	200 000
7% Redeemable preference shares of $1 each	60 000
Share premium	10 000
Retained profits	30 000
	300 000

The company decided to redeem all of the 7% preference shares at $1.10. In order to provide for redemption finance the company issued 50 000 ordinary shares at $1.20 per share. The preference shares were originally issued at a premium.

Required: -

Show the Statement of Financial Position, as it would appear immediately after the above transactions.

Solution

Statement of Financial Position as at 31 March 2002

	$
Sundry assets	180 000
Bank (120 000 – 66 000 + 60 000)	114 000
	294 000
Ordinary share capital (200 000+50 000)	250 000
Share premium (10 000 +10 000 – 6 000)	14 000
Retained profit	30 000
	294 000

Illustration 2: Redemption when there is no new issue of shares

The facts are the same as in illustration 1. Assume that the company redeemed the shares using distributable profit and redeems only 20 000 of the 7% preference shares at par.

Solution

Statement of Financial Position as at 31 March 2002

	$
Sundry assets	180 000
Bank (120 000-20 000)	100 000
	280 000
Ordinary share capital	200 000
7% preference share	40 000
Capital redemption reserve	20 000
Share premium	10 000
Retained profits (30 000 – 20 000)	10 000
	280 000

Illustration: redemption of shares

Below is the Statement of Financial Position of Makuweza Ltd. As at 31 December 2000

	$
Property, plant and equipment	270 000
Current Assets	80 000
	350 000
Equity and Liabilities	
Ordinary share capital of $0.50 each	130 000
9% redeemable preference of $1.00 each	80 000
Share premium	10 000
General reserve	22 000
Profit & loss	78 000
Current liabilities	30 000
	350 000

Additonal information

1. The preference shares were redeemed at $1.25 prior to the issue of 40 000 Ordinary shares at a premium of 25c each. The preference shares were originally issued at a premium of 20c per share.
2. An item of plant with a book value of $50 000 was revalued to $60 000.
3. The directors proposed an ordinary dividend of 5 cents per share. The new shares do not rank for this dividend.

Required:
Prepare the Statement of Financial Position of Makuweza Ltd. soon after these transactions assuming that they all took place on the 31st of December 2000.

Solution

Statement of Financial Position of Makuweza Ltd. as at 31 December 2000

	$
Property, plant and equipment (270 000 + 10 000)	280 000
Current Assets (80 000 + 30 000-100 000)	10 000
	290 000
Equity and liabilities	
Ordinary share capital of $0.50 each	150 000
Capital redemption reserve	50 000
Share premium (10 000 – 16 000 + 10 000)	4 000
Revaluation reserve (60 000 – 50 000)	10 000
General reserve	22 000
Profit & loss (78 000 – 13 000-50 000 – 4 000)	11 000
Current liabilities (30 000 + 13 000)	43 000
	290 000

Transfer to capital redemption reserve this way:
Nominal value of the shares to be redeemed minus proceeds of issue (less $80 000 – ($40 000 x 0,75) the premium to be partly covered by the share premium account.
The maximum share premium to be used

(a) $80 000 x 0,20	=	$16 000
And		
$10 000 + ($40 000 x 0,25)	=	$20 000

The lesser is 16 000

The required or redeemed amount is more than the amount we are required by law, the balance has been taken from the profit and loss account.

16.7 CAPITAL REDUCTIONS AND RECONSTRUCTIONS

16.8 Reorganization

- involves carrying out an internal reconstruction of the company. A special resolution is passed which is confirmed by the High Court.

Possible option schemes:

(i) Paying off paid- up share capital held surplus to the company's requirements.
(ii) Cancelling paid- up share capital not represented by assets.
(iii) Reducing the liability on share capital not paid-up.

16.9 Capital Reduction

There are cases where the reorganization scheme cannot suffice. A company with a different capital structure is formed through capital reduction. A special resolution is passed which is confirmed by the High Court.

A capital reduction usually occurs where losses have been incurred and the share capital is no longer represented by available assets. It may also occur if

(a) The company finds it has surplus cash funds and wishes to repay part of the capital to the members.
(b) The company has issued shares as party paid up and does not intend to call up the uncalled capital.

16.10 Reasons for reduction

(i) When substantial trading losses have accumulated.
(ii) When the company is over- capitalized, it being impossible to remunerate adequately all the existing capital.
(iii) When the whole of the paid – up capital is not represented by valuable assets for example inventory in-trade depreciated by market conditions or property, plant and equipment may have become absolute.

16.11 Legal aspects

Zimbabwean Companies Act, Chapter 24:03 require the following:

(i) Authority in the articles
(ii) Special resolution
(iii) Approval of the court

16.12 Double entry – Journal Entries

A special account, called a capital reduction account is opened through which are passed the amounts written off assets and share capital, accumulated losses as shown by the following journal of entries.

	DR	CR
Capital Reduction	xxx	
Individual Asset accounts		xxx
Being amounts written off assets on revaluation		
Share capital account	xxx	
Capital reduction account		xxx
Being amount written off share capital		
Share premium account	xxx	
Capital reduction account		xxx
Being amount written of share premium		
Individual property, plant and equipment accounts	xxx	
Capital reduction account		xxx
Being surplus on revaluation of property, plant and equipment		
Debenture account	xxx	
Capital reduction account		xxx
Being amount written off debentures		
Capital reduction account	xxx	
Statement of comprehensive income		xxx
Being debit balance on profit and loss account written off		
Capital reduction account	xxx	
Share capital account		xxx
Being replacement of one class of shares by shares of a different class		
Capital reduction account	xxx	
Share capital / loan account		xxx
Being waiver of preference dividend arrears by an issue of shares/ loan capital		

Individual liabilities accounts	xxx	
Share capital / share premium account		xxx

Being settlement of liabilities by an issue of shares

Example

The financial position of ABC Ltd was as follows:

Statement of Financial Position as at 30 September 2002

		$	$	
Property, plant and equipment				
Freehold property			61 800	
Equipment			48 350	
Vehicles			23 600	
			133 750	
Current assets				
Inventory		41 150		
Receivable		22 250		
Bank and cash		6 200	69 600	
			203 350	
Equity and liabilities				
Capital and reserves		authorised	issued and fully paid	
7% preference share of $1 per share		50 000		50 000
Ordinary shares of $1 per share	250 000	175 000		
	300 000		225 000	
Reserves				
Retained profit				(39 200)
				185 800
Current liabilities				
Accounts payables				17 550
				203 350

Additional Notes

The preference dividends are two years in arrears. A reorganization scheme had been devised which had secured the necessary approval and contained the following provisions which were to become operative on 1 October 2002.

1. The ordinary shares are to be written down to $0.4 per share and then to be converted into new ordinary shares of $1.00 per share fully paid.
2. The preference shareholders are to receive 25 000 new ordinary shares of $1.00 per share, fully paid at par, in exchange for the preference shares.
3. The preference shareholders have also agreed to waive their rights to the dividend in arrears and to accept 4 000 new ordinary shares of $1.00 per share, fully paid, in all settlement.
4. The creditors have agreed to accept 10 000 new ordinary shares of $1.00 per share, fully paid at par in part satisfaction of the sums due to them.
5. The debit balance on Statement of comprehensive income is to be written off.
6. Certain costs are to be revalued at the under noted amounts.

	$
freehold property	51 300
equipment	32 200
vehicles	15 350
inventory	23 800
accounts receivables	20 800

Required

(a) Open, post and balance the capital reduction and share capital amounts to record the reorganization arrangements.

(b) Prepare the Statement of Financial Position of ABC Ltd on 1 October 2002 immediately after the reorganization has been effected.

Solution

Freehold property account

	$		$
Balance b/d	61 800	Capital reduction	10 500
		Balance c/d	51 300
	61 800		61 800
Balance b/d	51 300		

Equipment account

	$		$
Balance b/d	48 350	Capital reduction	16 150
		Balance c/d	32 200
	48 350		48 350
Balance b/d	32 200		

Motor vehicle account

	$		$
Balance b/d	23 600	Capital reduction	8 250
		Balance c/d	15 350
	23 600		23 600
Balance b/d	15 350		

Inventory account

	$		$
Balance b/d	41 150	Capital reduction	17 350
		Balance c/d	23 800
	41 150		41 150
Balance b/d	23 800		

Accounts receivable account

	$		$
Balance b/d	22 250	Capital reduction	1 450
		Balance c/d	20 500
	22 250		22 250
Balance b/d	20 500		

Accounts payable account

	$		$
Ordinary share capital	10 000	Balance b/d	17 750
Balance c/d	7 750		
	17 750		17 750
		Balance b/d	7 750

7% Preference share capital account

	$		$
Capital reduction	50 000	Balance b/d	50 000
	50 000		50 000

Ordinary share capital account

	$		$
Capital reduction	105 000	Balance b/d	175 000
Balance c/d	109 000	Capital reduction	25 000
		Capital reduction	4 000
		Accounts payable	10 000
	214 000		214 000
		Balance b/d	109 000

Capital reduction account

	$		$
Freehold property	10 500	7% preference shares	50 000
Equipment	16 150	Ordinary shares *(Working 1)*	105 000
Motor vehicles	8 250		
Inventory	17 350		
Accounts receivable	1 450		
Ordinary share capital	25 000		
Statement of comprehensive income	39 200		
Ordinary share capital	4 000		
Share premium *(Working 2)*	3 000		
Capital reserve *(balancing figure)*	30 100		
	155 000		155 000

Working 1

Ordinary shares = $175 000 x (1 – 0.4) = $105 000

Working 2

Share premium = $7 000 - $4 000 = $3 000

ABC Ltd's Statement of Financial Position at 1 October 2002

Property, plant and equipment

		$
Freehold property		51 300
Equipment		32 200
Vehicles		15 350
		98 850
Current assets		
Inventory		23 800
Receivables		20 800
Bank & cash		6 200
	149 650	
Equity and liabilities		
	Authorised	Issued & fully paid
7% pref shares & $1	50 000	-
Ord. Share at $1 per share	250 000	109 000
	300 000	109 000
Reserves		
Capital reserve		30 100
Share premium		3 000
Current liabilities		
Payables		7 550
Total equity and liabilities		149 650

16.13 Examination type questions

16.14 Multiple choice

1. A company with an existing issued capital of $800 000 of $2 ordinary shares made a 1-for –5 bonus issue. This was later followed by a 1-for –3 right issue. What will be the balance on the share capital account after these transactions?

   A. $800 000
   B. $960 000
   C. $1 226 666
   D. $1 280 000

2. A company which had initially issued 20 000 $5 redeemable preference shares at par has now redeemed those shares at a premium of $1.50. There is no issue of shares to finance the redemption. What are the effects on the profit and loss Account and the Capital Redemption Reserve?

Profit and loss account	**Capital redemption reserve**
A. Decrease $130 000	Increase $100 000
B. Decrease $130 000	Increase $130 000
C. Increase $100 000	Decrease $100 000
D. Increase $130 000	Decrease $100 000

3. The share capital of a company consists of 150 000 ordinary shares of $150 each. It makes a rights issue of 1 ordinary share for every 3 already held at $3.60 per share. It then makes a bonus issue of 1 share for every 5 held. Which amount will be shown in the Statement of Financial Position for share capital?

   A. $360 000
   B. $435 000
   C. $465 000
   D. $495 000

4. From which of the following to revenue reserves arise.

   A. The issue of new shares by a company
   B. The revaluation of property, plant and equipment
   C. The share premium received on shares issued by the company.
   D. The trading activities of a company

5. When may a company issue redeemable preference shares?

   A. When it has already issued non- redeemable preference
   B. When it has already issued non- redeemable shares

C. When it has already redeemed its debentures
D. When it has sufficient reserves to fund the issue

6. A company may repay part of its share capital when

A. its cash reserves exceed its requirement for the foreseeable future.
B. its shareholders need cash
C. its shares are valued below their nominal value on the open market.
D. it wishes to decrease its gearing.

7. When a company redeems shares, it may create a capital redemption reserve. Why does it create this reserve?

A. to make the Statement of Financial Position balance
B. to protect the creditors' rights
C. to provide cash for the redemption
D. to replace the cash used in the redemption

8. A company Statement of Financial Position extract is given

	$
<u>Share capital and reserves</u>	
Ordinary share capital (shares of $500)	5 000 000
Profit and loss account	(1 500 000)
	3 500 000

It has been decided to write off the debit balance on the profit and Loss account together with goodwill of $500 000. The shareholders agreed to exchange their shares for new ordinary shares of $2.50. How many shares would the directors have to issue to the shareholders?

A. 600 000
B. 700 000
C. 1 200 000
D. 1 400 000

9. A company regularly pays a dividend. It has converted $60 million 10% loan inventory into ordinary shares. Which describes the likely effect of the conversion on its financial statements?

	Dividend	**Interest**	**Gearing**
A.	Decrease	Increase	Decrease
B.	Decrease	Increase	Increase
C.	Increase	Decrease	Decrease
D.	Increase	Decrease	Increase

16.15 Structured questions

Question 1

The chief accountant of Baswells Ltd prepared the following Statement of Financial Position as at 1 July 2005.

	$'000	$'000
Property, plant and equipment		
Freehold property		600
Other property, plant and equipment		2 880
		3 480
Current Assets (including bank)	2 640	
Less current Liabilities	1 200	1 440
		4 920
Financed by		
Issued and paid up share capital		
400 000 ordinary shares of $6 each		2 400
150 000 8% redeemable preference shares of $6 each		900
		3 300
Reserves		
Capital redemption	600	
Share premium account	300	
General reserve	270	
Profit and loss account	450	1 620
		4 920

The directors decided to carry out the following transactions during July and August 2005.

1. **3 July 2005.** A rights issue of one ordinary share for every four held was made at $7.20 per share. All shareholders took up their rights.
2. **1 August 2005.** A bonus issue of one ordinary share for every ten held, based on the revised ordinary share capital was made. This was carried out by utilising equal amounts from the revenue reserves.

3. **August 2005.** 40 000-preference shares were redeemed at a premium of $0.30 per share. This was achieved out of profits with the exception of the premium, which was covered up by the share premium account.
4. **21 August 2005.** The freehold property was revalued at $780 000.
5. **28 August 2005.** Property, plant and equipment costing $60 000 were purchased on credit.

<u>You are required to</u>

a) Prepare a Statement of Financial Position as at 28 August 2005 after the completion of all transactions indicated above.
b) Describe the features of:
   i. A rights issue
   ii. A bonus issue
c) Explain the difference between capital and revenue reserves.

Question 2

The following is the Statement of Financial Position of P. Panther Ltd as at 30 April 2007.

	$'000	$'000
Goodwill		200
Tangible property, plant and equipment		2 600
		2 800
Current assets		
Inventory	128	
Debtors	320	
Bank	24	
	472	
Less creditors	168	304
		3 104
Share capital and reserves		
Ordinary shares of $4 each		4 000
Profit & loss		(896)
		3 104

For the past five years, P. Panther Ltd has traded at a loss and no dividends have been paid to the shareholders during that time. An extra- ordinary meeting has been held with the shareholders who have agreed to the director's proposals to effect a capital reduction scheme where the following matters have to be taken into account.

1. Goodwill is now valueless.
2. Tangible property, plant and equipment are now overvalued by $600 000
3. Inventory which cost $40 000 is now valueless.
4. Included in debtors is an amount of $64 000 from a customer who has now become insolvent.

The directors have expressed confidence that as a result of improved efficiency and the introduction of new products which is planned for the coming financial year the company can look forward to annual net profits of $200 000. In the proposed scheme of capital reduction, the nominal value of each ordinary share already held will be reduced by $1.80. This will enable the debit balance on the Profit and Loss Account to be eliminated.

<u>REQUIRED</u>:

a) Prepare a capital reduction account.
b) Prepare the Statement of Financial Position as it will appear immediately after the capital reduction.

Question 3

The financial position of Amigos PLC as at 30th September 2007 was as follows:

	Cost	Depr.	CA
Property, plant and equipment	$000	$000	$000
Freehold premises	200	40	160
Plant & equipment	500	120	380
Vehicles	90	30	60
	790	190	600
Current assets			
Inventory		80	
Debtors		60	
Bank		20	
		160	
LessCurrent liabilities			
Creditors		280	(120)
			480
Share Capital & Reserves			
Authorized Share Capital			
150 000 7% Preference Shares of $2 each			300
400 000 Ordinary shares of $2 per share			800
			1 100
Issued and fully paid share capital			
100 000 7% Preference Shares of $2 each			200
400 000 Ordinary shares of $2 each, $1,50 paid			600
			800
Reserves			
Profit and loss (debit balance)			(320)
			480

Additional Information

The 7% preference dividends are two years in arrears. The company has formulated an approved scheme of capital reduction/ reorganization to take effect on 1 October 2007 which contained the following:

1. The ordinary shares are to be written down to $0.50 per share and then to be converted into new ordinary share of $2.00 per share fully paid.
2. The preference shareholders are to receive 50 000 ordinary shares of $2.00 per share, fully paid at par, in exchange for their preference shares.
3. In consideration for waiving their rights to arrears of preference dividend, the preference shareholders have agreed to accept 10 000 new ordinary shares of $2.00 per share, fully paid, in full and final settlement.
4. The creditors have agreed to take 100 000 new ordinary shares of $2.00 per share, fully paid at par, in part satisfaction of the sums due to them.
5. The debit balance on the profit and loss account is to be written off.
6. The following revaluations are to be incorporated into the accounts.

	$
Freehold premises	200 000
Plant and equipment	210 000
Vehicles	50 000
Inventory	72 000

7. A Provision for credit loses is to be created at $2000.

REQUIRED:

a) Prepare journal entries to effect the capital reduction.
b) Prepare a capital reduction account.
c) Prepare the Statement of Financial Position of Amigos PLC immediately after the capital reduction scheme.

CHAPTER 17

STATEMENT OF CASH FLOWS

17.1 Chapter objectives

After studying this chapter *the student should* be able to:

By the end of this chapter you should be able to:

1. *Define the term, 'cash flow'*
2. *Explain the essence of drawing up the Statement of cash flow to all stakeholders.*
3. *Identify the International Accounting Standard applied in the preparation of the Statement of cash flow.*
4. *Distinguish between the direct method and indirect method of preparing the Statement of cash flow.*
5. *Prepare the sales ledger control account and the purchases ledger control account to determine the receipt from debtors and payments to trade payables.*
6. *Draw up the disposal account to determine the profit of loss on the sale of property, plant and equipment.*
7. *Prepare the Statement of cash flow form the given information.*
8. *Draw up the statement of financial position using information from the Statement of cash flow.*

17.2 Introduction

A Statement of cash flow is a summary of a business's cash receipts and cash payments during an accounting period.

17.3 The importance of a Statement of cash flow.

IAS 7 (*Statement of cash flows*) requires companies to include a Statement of cash flow alongside with the Statement of comprehensive income and Statement of Financial Position in their published financial statements.

The benefits and uses of a Statement of cash flow are:

1. It shows which types or part of the business used more cash, or (put in other words)-what was most of the cash used for. How did the business raise most of its cash.(NB we can make a loss but still increase our bank balance) e.g. we sell idle machinery for twice the loss.

2. The liquidity of the business can be evaluated.

3. Helps users see how much cash did the day-to-day operations raise.(besides other means like issuing shares or borrowing loans).

4. It shows the manner in which the capital expenditure, additions on property, plant and equipment has been financed. (e.g. we raised enough money through (trading) operating activities or we borrow a lot of money or we issued more shares or debentures).

5. It can be used to project future cash flows, assess the future ability of the business to pay debts, dividends and interests.

17.4 IAS 7 – Statement of cash flows

This deals with Statement of cash flow.

The standard requires a Statement of cash flow to be reported under the following standard headings.

Operating activities

This refers to the net increase/decrease in cash, and cash equivalents that results from the Company `s trading activities.

Investing activities

This is the cash paid or received from the acquisition and disposal of property, plant and equipment.

Financing

This refers to cash received or paid to providers of Finance when shares and debentures are being issued or redeemed.

International Accounting Standards (IAS) 7 cash-flow statement is presented under the following three standard headings. All the 3 headings should be shown in this sequence and the final total/net of the three subtotals represent the net cash increase/decrease during a period.

Cash flows from operating activities
Cash flows from investing activities
Cash flows from financing activities

17.5 Direct and indirect methods

In accordance with IAS 7, there are two ways of presenting a Statement of cash flow. We have the direct and the indirect method, and the standard however emphasises that Statement of cash flows should be presented using the direct method. The difference between the two methods is the presentation of the first section i.e. cash flows from operating activities.

17.6 Direct Method

This method should be used when we are provided with the bank and cash summary. The student should prepare this summary if it is not provided. The following is a pro forma of a Statement of cash flow presented under the direct method utilising information from the bank summary.

Cash flows from operating activities		
Cash sales	xxx	
Cash received from customers	xxx	
<u>*Less* cash paid for: -</u>		
Payments to creditors	(xxx)	
Cash purchases	(xxx)	
Payments for operating expenses (rent + Electricity + Insurance paid etc.)	(xxx)	
Cash paid to employees (wages + salaries paid)	(xxx)	
Cash (used) or generated from operations	(xxx)	
Less Interest paid	(xxx)	
Less preference dividend paid	(xxx)	
Less debenture interest paid	(xxx)	
Less Cash drawings (in case of sole trader or partnership)	(xxx)	
Less Tax paid	<u>(xxx)</u>	
Net cash in/(out) flow from operating activities		xxx
Cash flows from investing activities		
Less cash paid for purchase of non – current assets /fixed investments	(xxx)	
Add loan Interest received and other investment income	xxx	
Add disposal proceeds (the actual cash received)	<u>xxx</u>	
Net Cash in/(outflow) from investing activities		xxx
Cash flows from financing activities		
Add loan acquired or addition to capital	xxx	
Add issue of shares and debentures (including premium)	xxx	
Less cash paid for redemption of share (including premium)	(xxx)	
Less loan repayment	(xxx)	
Less Equity interim (this year) dividend	xxx	
Less Final dividend (last year's dividend)	<u>xxx</u>	
Net Cash in /(outflow) from financing activities		<u>xxx</u>
Net cash increase/(decrease) during the year		**xxx**
Add opening balance of cash & cash equivalents		<u>xxx</u>
Closing balance of cash & cash		x**xx**

The common problem is to find receipts from debtors and payments to creditors. We overcome this by using control accounts.

<u>Receipt from debtors</u>

Debtors Control A/C

Bal. b/d	xxx	Bank *(as a balance figure)*	xxx
Credit sales	<u>xxx</u>	Bal. c/d	<u>xxx</u>
	xxx		**xxx**
Bal. b/d	xxx		

Payment to creditors

Creditors Control A/C

Bank *(as a balancing Figure)*	xxx	Bal. b/d	xxx
Bal. c/d	xxx	Credit Purchases	xxx
	xxx		**xxx**

Balancing figure

If debtors are shown less Provision for credit loses these should be treated separately. Increase or decrease in debtors should be determined by using the figure before Provision for credit loses and bad debts written off.

17.7 Indirect Method

This is the common method with examiners and here you take the Net profit before Interest and tax then adjusts it for non-cash items that are charged in the Statement of comprehensive income. You also adjust for working capital movements. An increase in inventory might mean we used more money to purchase more inventories, thus is a cash outflow. A decrease in accounts receivable might mean we received more cash when our accounts receivable paid up more of their bills, thus a cash inflow.

The opposite happens for liabilities e.g. a decrease in accounts payables means we made more payments to our creditors and thus cash outflow

There are basically two approaches that examiners can use, you may be required you to prepare a Statement of cash flow where you are given **two Statement of Financial Positions and a part of an Statement of comprehensive income or two Statement of Financial Positions only**. As explained earlier, the difference between the direct and the indirect is on the presentation of the first section. The following is a pro forma of the cash flows from operating activities under the indirect method. The other sections are just the same as if the cash flow is prepared under the direct method.

Cash flows from operating activities.

Net profit after tax	xxx
Add back tax	xxx
Add back interest charged	xxx
Net profit before interest and tax	xxx
Adjustments to profit	
Add back loss on disposal (it was initially deducted from profit)	xxx
Add back depreciation charged during the period	xxx
Add back bad debts written off	xxx
Add back Increase in Provision for credit loses	xxx
Add back amount of goodwill written off	xxx
Add back preliminary costs (*initially capitalised now written off*)	xxx
Add back research development cost (*initially capitalised now written off)*	xxx
Less decrease in Provision for credit loses	(xxx)
Less profit on disposal of property, plant and equipment	(xxx)
Less investment income (interest and dividend received)	(xxx)
Net cash in/outflow before working capital adjustment	xxx
Working capital Adjustments	
Add decrease /(less increase) in current assets	xxx/(xxx)
Add increase /(less decrease) current liabilities	xxx/(xxx)
Cash (used) or generated from operations	xxx
Less interest paid	(xxx)
Less preference dividend paid	(xxx)
Less debenture interest paid	(xxx)
Less cash drawings (in case of trader or partnership)	(xxx)
Less tax paid	(xxx)

Net cash in/(out) flow from operating activities **xxx**

Notes:

1. Where you are given only two balances sheets without an Statement of comprehensive income, we determine the profit and loss or the year by the use of profit and loss appropriation account as shown:

Profit and loss appropriation account

Transfer to reserve	xxx	Bal. b/d	xxx
Tax Current Year	xxx	Profit for the year *(as a balance figure)*	xxx
Interim Dividend	xxx		
Final Dividends current year	xxx		
Capital redemption reserve	xxx		
Balance c/d	xxx		
xxx		**xxx**	

The problem with the Statement of cash flow is in finding figures to be used in its preparation.

How to find items for the operating section.

2. Calculation of depreciation for the year (if not given)

Provision for depreciation account

Disposal (if any)	xxx	Balance b/d	xxx
Bal. c/d	xxx	P & L *(as a balancing figure)*	xxx
	xxx		xxx

Asset account *(at net book value)*

Balance b/d	xxx	Disposal	xxx
Bank - additions	xxx	Depreciation *(difference)*	xxx
		Balance c/d	xxx
	xxx		xxx

3. Changes in working capital items

With these, you simple take the difference between the two Statement of Financial Positions. **An increase in a current asset is an outflow** and **a decrease in is an inflow. An increase in a current liabilities is an inflow** whilst **their reduction is an outflow** because we would have used some money to pay liabilities. However there are some items which require special care e.g. when bad debts are written off you do not simply take the difference, you derive the bank figure through a T account. *See below:*

Debtors account

Bal. b/d	xxx	Bad debt written off	xxx
Payable sales	xxx	**Bank** (balancing fig.)*	xxx
		Bal. c/d	xxx
	xxx		**xxx**

*The cash in/(out) flow is represented by the bank figure.

The following items should not be used in the determination of changes in working capital because they are considered somewhere else in the Statement of cash flow.

1. Cash and cash equivalents

2. Taxation
3. Proposed dividends

4. Profit and loss on sale of property, plant and equipment

If it is not given on the question it is determined by the use of asset disposal account.

Disposal A/C

Property, plant and equipment	xxx	Dep.	xxx
		Proceed of sales	xxx
Profit	xxx	Loss	xxx
	xxx		**xxx**

The profit or loss is determined as a balancing figure, if on the right it is profit and if it is on the left it is a loss.

4. Investing activities

The problem is to determine property, plant and equipment purchased during the year. If property, plant and equipment account are stated at cost we use property, plant and equipment T. A/C

Property, plant and equipment A/C

Bal. b/d (at cost)	xxx	Disposal (at cost)	xxx
Purchases	xxx	Bal. c/d (at cost)	xxx
xxx		xxx	

If stated at CA

Property, plant and equipment A/C

Bal. b/d at CA	xxx	Disposal at CA	xxx
Asset Purchased *(as a balancing figure)*	xxx	Depreciation for the year	xxx
		Balance c/d at CA	xxx
	xxx		xxx
Balance b/d	xxx		

If property, plant and equipment are revalued we use the T account for property, plant and equipment at cost (except when figures are given only at CA) as follows:

Property, plant and equipment A/c

Bal. b/d	xxx	Disposal	xxx
Revaluation	xxx	Bal. c/d	xxx
Asset purchased (balancing fig.)	xxx		
	xxx		xxx

5. Equity dividends paid during the period

This is ordinary dividend **paid**. This is normally the **final dividend** for last year and **interim dividend** for this year. This is determined as follows: -

Dividend account

Dividend paid *(as a bal. figure)*	xxx	Bal. b/d	xxx
Bal. c/d	xxx	Profit & Loss	xxx
	xxx		**xxx**

Financing

To find capital issued during the year when there is bonus issue, we draw up the ordinary share capital account:

Share Capital A/C

Redemption (if any)	xxx	Bal. b/d	xxx
Bonus issue	xxx		
Bal. c/d	xxx	Bank *(bal. figure)*	xxx
	xxx		**xxx**

Example 1

17.8 Cash flow of a limited Company

The following information relates to the business of Qualitex Pvt Ltd.

Statement of Financial Position as at

	28/02/06	**28/02/05**
Issued share capital	420 000	360 000
Share premium	42 000	36 000
Retained profits	17 400	17 400
Long- term loan (Cr)	100 800	240 000
Trade creditors	9 000	6 900
Bank	(Cr) 1 500	(Dr) 4 500
Land and buildings at cost	450 000	450 000
Machinery at cost	180 000	180 000
Furniture and equipment at cost	12 000	9 000
Listed investments at cost	56 100	51 600
Trade debtors	7 020	8 400
Inventory – merchandise	24 000	24 000
Shareholders for dividends		9 000
Tax payable	-	39 000
Provision for bade debts	702	-
Accumulated depreciation:		
Machinery	36 000	18 000
Furniture and equipment	2 400	1 200

The following balances were extracted from the Statement of comprehensive income before any adjustments had been effected the year ended 28 February 2006.

	$
Sales	426 000
Purchases	247 500
Administrative expenses	49 200
Dividends earned on investments	7 500
Interest expense re- long – term loan	36 000
Bad debts	1 482

Additional Information

(i) Depreciation on machinery $18 000 and on furniture and fittings $1 200, were mistakenly debited to administrative expenses.

(ii) On 28 February 2006, a dividend of $18 000 was declared and it was calculated that the company tax for the year will be $48 000.

(iii) On 28 February 2006, the inventory of merchandise amounted to $27 000.

(iv) No property, plant and equipment were sold or scrapped during the financial year. All additions were paid for in cash.

(v) All purchases were on credit

<u>REQUIRED</u>

Prepare a Statement of cash flow of Qualitex Pvt Ltd for the year ended 28 February 2006.

Solution

Qualitex Pvt Ltd: Statement of cash flow for the year ended 28 February 2006.

Cash flow operating activities	$	$
Cash receipts from customers (a)		426 600
Cash paid to suppliers and employees (b)		(275 400)
Cash generalized from operations		151 200
Interest paid		(36 000)
Dividends received		7 500
Dividends paid (c)		(9 000)
Tax paid (d)		<u>(39 000)</u>
Net cash inflow from operating activities		74 700

Cash flows from investing activities		
Acquisition of investments (56 100 – 51 600)	(4 500)	
Additions to furniture & equipment		
(12 000 – 9 000)	(3 000)	
Net cash outflows from investing activities		(7 500)
Cash flows from financing activities		
Proceeds from issue of share capital (e)	66 000	
Repayment of long – term loan ($240 000-		
100 800)	(139 200)	
Net cash outflow from financing activities		(73 200)
Net decrease in cash and cash equivalents		(6 000)
Cash & cash equivalents at start of yr		4 500
Cash & cash equivalents at year end		(1 500)

Notes

1. Reconciliation of profit before tax with cash generated from operations.

	$
Profit before tax	102 318
Adjustments for	
Interest expense	36 000
Dividends earned	(7 500)
Bad debts	1 482
Depreciation	19 200
Operating profit before working capital changes	151 500
Working capital changes:	
Increase in inventory (27 000 – 24 000)	(3 000)
Increase in debtors (g)	600
Increase in creditors (9 000 – 6 900)	2 100
Cash generated from operations	151 200

Workings

a) Cash receipts from customers

	$
sales	426 000
add debtors (opening balance)	8 400
less bad debts (1 482 – 702)	(780)
debtors (closing balance)	7 020

DEBTORS A/C

Balance b/d	8 400	Bad debts	780
Sales	426 000	Bank	426 600
		Balance c/d	7 020
	434 400		434 400
Balance b/d	7 020		

b)	Cash paid to suppliers and employees	$
	Purchases	(247 500)
	Creditors: opening balance	(6 900)
	Creditors: closing balance	9 000
	Payments to creditors	(245 400)
	Administrative expenses (49 200 – 19 200)	(30 000)
		(275 400)
c)	Dividends paid	
	Balance at 28/02/05	(9 000)
	Dividends declared	(18 000)
	Dividends payable	(27 000)
	Balance at 28/02/06	(18 000)
	Dividends paid	(9 000)
d)	Tax paid	$
	Balance at 28/02/05	(39 000)
	Tax expense for the year	(48 000)
	Tax payable	87 000
	Balance at 28/02/06	48 000
	Tax paid	(39 000)
e)	Proceeds from shares issued	$
	Ordinary share capital (28/02/06)	420 000
	Share premium (28/02/06)	42 000
		462 000
	Ordinary share capital (28/02/05)	(360 000
	Share premium (28/02/05)	(36 000)
	Proceeds from share issue	66 000

f)	Profit before tax	$	$
	Turnover		426 000
	less Cost of Sales		
	Opening inventory	24 000	
	± Purchases	247 500	
	- Closing Inventory	27 000	244 500
	Gross profit		181 500
	Less administrative expenses		
	(49 200 – 19 200)	30 000	
	Depreciation	19 200	
	Bad debts	1 482	50 682
	Net operating profit		130 818
	Add investments income (dividends recd)		7 500
	Less finance costs: interest payable		(36 000)
	Net profit for the year		102 318

g) Both the increase in Provision for credit loses and actual bad debts are non- cash items which must not be taken into account. Therefore bade debts of $1 482 must be added back to profits and must be omitted in the calculating changes in the debtors.

The effect is that the closing balance of the debtors increases with $780 which is bad debts written off against trade debtors = $7 020 + 780 = $7 800.

Example 2

17.9 Cash flow of a Sole Trader

The following information relates to the business of Angela, a sole trader.

Statement of comprehensive income for the year ended 31 December 1999

	$	$
Sales		400 000
Less cost of sales		
Opening inventory	90 000	
Add purchases	240 000	
	330 000	
Less closing inventory	70 000	260 000
Gross profit		140 000
Add Profit on disposal of machinery		2 000
		142 000
Less expenses		
Loan interest paid	6 000	
Depreciation of property, plant and equipment	14 000	
Other expenses	130 000	150 000
Net loss		(8 000)

Statement of Financial Position as at 31 December:

	1998		1999	
	$	$	$	$
Property, plant and equipment				
Land and buildings		400 000		400 000
Machinery		120 000		200 000
		520 000		600 000
Current assets				
Inventory	90 000		70 000	
Debtors	50 000		90 000	
Cash at bank	30 000		33 000	
	170 000		193 000	
Less creditors	40 000	130 000	83 000	110 000
		650 000		710 000
Less long- term loan		100 000		80 000
		550 000		630 000
Financed by:				
Capital		520 000		550 000
Additional capital		-		98 000
				648 000
Add net profit/ (Loss)		70 000		(8 000)
		590 000		640 000
Less drawings		(40 000)		(10 000)
		550 000		630 000

Additional information

i. All sales and purchases were on credit
ii. An item of machinery with a written down value of $5 000 was disposed of during the year.

Required:

1) Prepare a Statement of cash flow using the following methods for the year ended 31 December 1999.
   a) The direct method.
   b) The indirect method.
2) Comment on the liquidity and profitability of Angela's business.

<u>Solution</u>
<u>The direct method</u>
If a Statement of cash flow is to be prepared using this method, a summary of the bank transactions should be prepared as part of workings if not supplied. A summary of bank transactions is the cash book. A Statement of cash flow can then be prepared by utilising all the figures in the summary of bank transactions. Other necessary workings are to be shown as we go on.

Workings

The bank summary

	$		$
Bal. b/d	30 000	Loan interest	6 000
Receipts from debtors	360 000	Other expenses	130 000
Disposal of machinery	7 000	Loan repayment	20 000
Additional capital	98 000	Drawings	10 000
		Machinery	99 000
		Payments to creditors	197 000
		Bal. c/d	33 000
	495 000		495 000
Bal. b/d	33 000		

Sales ledger control account

	$		$
Bal. b/d	50 000	Bank *(difference)*	360 000
Sales	400 000	Bal. c/d	90 000
	450 000		450 000
Bal. b/d	90 000		

Machinery account *(at CA)*

	$		$
Bal. b/d	120 000	Depreciation	14 000
Additional machinery	99 000	Disposal	5 000
		Bal. c/d	200 000
	219 000		219 000
Bal. b/d	200 000		

Purchases ledger control account

	$		$
Payments	197 000	Bal. b/d	40 000
Bal. c/d	83 000	Purchases	240 000
	280 000		280 000
		Bal. b/d	83 000

Statement of cash flow for the year ended 31 December 1999

	$	$
Cash flows from operating activities		
Receipts from debtors	360 000	
Payments to suppliers	(197 000)	
Payments for operational expenses	(130000)	
Cash generated from operations	33 000	
Loan interest paid	(6 000)	
Net cash inflow from operating activities		27 000
Cash flows from investment activities		
Disposal of machinery	7 000	
Purchase of machinery	(99 000)	
Net cash outflow from investment activities		(92 000)
Net cash outflow before financing		(75 000)
Cash flows from financing		
Capital introduced	98 000	
Drawings	(10 000)	
Loan repayment	(20 000)	
Net cash inflow from financing		68 000
Increase in cash and cash equivalents during the year		3 000
Cash & cash equivalents (1 Jan. 1999		30 000
Cash & cash equivalents (31 Dec. 1999)		33 000

The indirect method

Statement of cash flow for the year ended 31 December 1999

	$	$
Cash flows from operating activities		
Net profit /loss before interest (-8 000 +6 000)	(2 000)	
Adjustment for: - Depreciation	14 000	
Profit on disposal of machinery	(2 000)	
Decrease in inventory	20 000	
Increase in debtors	(40 000)	
Increase in creditors	43 000	
Cash generated from operations	33 000	
Loan interest paid	(6 000)	
Net cash inflow from operating activities		27 000
Cash flows from investment activities		
Disposal of machinery	7 000	
Purchases of machinery	(99 000)	
Net cash outflow from investment activities		(92 000)
Net cash outflow before financing		(75 000)
Cash flows from financing		
Capital introduced	98 000	
Drawings	(10 000)	
Loan repayment	(20 000)	
Net cash inflow from financing		68 000
Increase in cash and cash equivalents during the year		3 000
Cash & cash equivalents (1 Jan. 1999		30 000
Cash & cash equivalents (31 Dec. 1999)		33 000

Comments on the Statement of cash flow

- A Statement of cash flow measures the liquidity of the business, whilst a Statement of comprehensive income shows the profitability of the business. Profitability does not necessarily mean that cash is available. The answers are explained in a Statement of cash flow as below in relation to the business of Angela.
- During the year, there was a significance decrease in net trading profit contrary to an increase in cash and cash equivalents of $3 000. This was caused partly by cash and non-cash operating expenses that were provided for during the year.
- Cash flows from operating activities, which are the principal revenue producing activities of the business amounted to $33 000. This amount was too little to meet purchase of machinery.
- In a bid to improve the liquidity of the business, Angela brought in additional capital of $98 000. Part of the money was used to repay a long-term loan.

17.10 STATEMENT OF CASH FLOW FOR A PARTNERSHIP BUSINESS

The following information pertains to the partnership of Water and Oil as at 31 December 2005.

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2005

	$	$
Turnover		1 001 200
Less Cost of Sales		
Opening inventory	200 800	
+ purchases	383 920	
Cost of goods available for sale	584 720	
Less Closing inventory	192 000	392 720
Gross profit		608 480
Add other income		
Profit on disposal of buildings		20 000
Rent receivable		9 600
		638 080
Less expenses		
Administrative expenses (wages included)	140 000	
Depreciation	2 400	142 400
Net trading profit		495 680

Extract from the ledger –

CAPITAL A/C

	Water	Oil		Water	Oil
2005			**2005**		
Dec 31 Balance c/d	440 000	440 000	Jan 1 Balance b/d	387 600	3 876
			Dec 31 Bank	52 400	52 400
	440 000	440 000		440 000	440 00
			2006		
			Jan 1 Balance b/d	440 000	440 000

CURRENT A/C

	Water	Oil		Water	Oil
2005			**2005**		
Jan 1 Balance b/d	-	800	Jan 1 Balance b/d	100 800	-
Dec 31 Int. on current a/c	-	80	Dec 31 Int. on cap	26 400	26 400
Int. on drawings	26 880	23 440	Int. on current a/c	10 080	-
Drawings	268 800	234 400	Share of profit	241 600	241 600
Balance c/d	83 200	9 280			
	378 880	268 000		378 880	268 000
			2006 Jan Balance b/d	83 200	9 280

THE FOLLOWING INFORMATION WAS EXTRACTED FROM THE STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER.

	2005 $	2004 $
Capital accounts (fixed): Water	440 000	387 600
: Oil	440 000	387 600
Current accounts : Water	83 200 (cr)	100 800 (cr)
: Oil	9 280 (cr)	800 (dr)
Land and Buildings at cost	480 000	720 000
Furniture and equipment at cost	25 600	24 000
Accumulated depr: - furniture & equip	6 400	4 000
Inventory	192 000	200 800
Bank	134 480	(20 000)
Debtors	293 200	148 000
Trade creditors	224 800	194 400
Accrued rent receivable	800	1 600
Accrued wages	2 400	800
Investment at fair value	80 000	-

Additional information

1. The investment was made on 31 December 2005
2. No land and buildings were purchased during the year 50% of the selling price of the land and buildings was received in cash and the balance will be received during the next financial year.
3. No furniture or equipment was sold or scrapped during the year. All purchases were paid for in cash.
4. All purchases of inventory were made on credit. All of the other expenses, except the accrued expenses, were paid in full.
5. Drawings of the partners were made in cash.
6. Inventory is recorded at cost.
7. Debtors in the book on 31 December 2004 were trade debtors and those in the books on 31 December 2005 pertained to trade debtors and the debtor in respect of the sale of land and buildings.

REQUIRED:

Prepare a Statement of cash flow of Water and Oil for the year ended 31 December 2005

Statement of cash flow for the year ended 31 December 2005

	$	$
<u>Cash flow from operating activities</u>		
Cash receipts from customers **(W1)**	996 400	
Cash paid to suppliers and employees **(W2)**	491 920	
Cash generated from operations	504 480	
Drawings (268 800 + 234 400)	<u>(503 200)</u>	
Net cash inflow from operating activities		1 280
<u>Cash flows from investing activities</u>		
Payments to acquire furniture & equipment	(1 600)	
Proceeds from the sale of land & buildings	130 000	
Payments to acquire investments	<u>(80 000)</u>	
Net cash inflow from investing activities		48 400
<u>Cash flows from financing activities</u>		
Proceeds from capital contributions	<u>104 800</u>	
Net cash inflow from financing		104 800
Net increase in cash and cash equivalents		154 480
Cash & cash equivalent at the beginning of year		<u>(20 000)</u>
Cash & cash equivalent at year end		<u>134 480</u>

WORKINGS:

(W1) Sales	1 001 200
<u>Add</u> opening debtors	148 000
<u>Less</u> closing debtors (193 200 – 130 000)	<u>163 200</u>
Cash receipts in respect of sales revenue	<u>986 000</u>
Rental income	9 600
<u>Add</u> opening rent income accrued	1 600

Less closing rent income accrued	(800)
	10 400

Cash received from customers:

Cash from sales + cash from rent

= $986 000 + 10 400

= $996 400

(W2) Purchase of inventory	383 920
Add opening trade creditors	194 400
Less closing trade creditors	(224 800)
Payments made to trade creditors	353 520

Administrative expenses including wages	140 000
Add opening wages accrued	800
Less closing wages accrued	(2 400)
Administrative expenses (including wages) paid	138 400

Cash paid to suppliers and employees:

Payments to creditors + admin expenses (including wages) paid

= $353 520 + $138 400

= $491 920

17.11 PREPARATION OF A STATEMENT OF FINANCIAL POSITION FROM A STATEMENT OF CASH FLOW

Rio Ltd's Statement of Financial Position at 31 May 2005 is as follows:

Property, plant and equipment		Cost/ Valuation	Depr	CA
	$000		$000	$000
Intangible assets				
Goodwill	-		-	-
Tangible Property, plant and equipment				
Freehold land & Buildings	2 400		-	2 400
Plant and Machinery	1 200		540	660
Motor vehicles	360		270	90
	3 960		810	315
Current assets				
Inventory			588	
Debtors			243	
			831	
Creditors: amounts falling due within one year				
Bank overdraft		54		
Trade creditors		159		
Ordinary dividend		60	273	558
				3 708
Share Capital and Reserves				
Ordinary shares of $3				1 500
Share premium				540
Revaluation reserve				1 020
General reserve				360
Retained profit				48
				3 468

EXTRACT FROM PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31 MAY 2005

	$000	$000
Operating profit		195
Less debenture interest		36
		159
Transfer to General Reserve	60	
Ordinary dividends	90	150
Retained Profit for the year		9

STATEMENT OF CASHFLOW FOR THE YEAR ENDED 31 MAY 2005

	$000	$000
Cash inflow from operating activities		324
Debenture interest paid		(36)
Net cash inflow from operating activities		288
Cash flows from investing activities		
Payments to acquire tangible property, plant and equipment		
Plant & Machinery	(540)	
Motor vehicle	(180)	
Receipts from sale of tangible property, plant and equipment		
Plant & machinery	135	
Motor vehicles	15	
Net cash used in investing activities		(570)
Cash flows from financing activities		
Issue of 100 00 ordinary shares (including premium)	600	
Preference share dividend paid	(12)	
Redemption of preference shares at par	(300)	
Ordinary share dividends paid	(90)	
Redemption of debentures at par	(150)	
Net cash received from financing		48
Decrease in cash and cash equivalents		(234)

RECONCILIATION OF OPERATING PROFIT WITH NET CASH INFLOW FROM OPERATING ACTIVITIES

	$000
Operating profit	195
Goodwill written off	150
Depreciation: plant & machinery	120
Motor vehicles	108
Loss on disposal of vehicles	18
Profit on disposal of plant and machinery	(30)
Increase in inventory	(108)
Increase in debtors	(75)
Decrease in creditors	(54)
Net cash inflow from operations	(324)

Further information relevant to the year ended 31 May 2005

1. Motor vehicles which had cost $120 000 were sold for $15 000.
2. Plant and Machinery which had cost $300 000 was sold for $135 000.
3. The Freehold land and buildings were purchased in 2001 for $1 800 000.
4. $150 000 debentures had been redeemed at par on 31 Mat 2005.
5. The company redeemed its 6% preference shares on 1 June 2004.

REQUIRED:

Prepare Rio Ltd's Statement of Financial Position as at 31 May 2004

Rio Ltd Statement of Financial Position as at May 2004

		Cost		**Dpr**		**CA**
		$000		$000		$000
Intangible property, plant and equipment						
Goodwill					150	
Tangible property, plant and equipment						
Freehold land and buildings **(W1)**		1 800		420		1 380
Plant and Machinery **(W2)**		960		615		345
Motor Vehicles **(W3)**		300		249		51
		3 060		1 284		1 776
Total Property, plant and equipment					1 926	
Current Assets						
Inventory (588 – 108)				480		
Debtors (243 – 75)			168			
Bank (234 – 54)				180		
				828		
Creditor's amounts falling due within one year						
Traded creditors (159 + 54)	213					
Preference dividend		12				
Ordinary dividend **(W4)**		60		285		543
						2 469
Creditors: amounts falling due after more than one year						
10% debentures (2003/ 2006) (240 + 150)						390
					2 079	
Share Capital and Reserves						
Ordinary shares of $3 each (1 500 – 300)						1 200
6% preference shares of $3 each						300
Share premium a/c (540 – 300)						240
(Revaluation Reserve) (W5)					-	
General Reserve (360 - 60)					300	
Retained profit (48 -9)						2 079

WORKINGS:

(W1) Freehold land & buildings at cost (given) $1 800 000

Revaluation Reserve has been made up as follows

- Increase in freehold land & buildings @ cost $600 000
- Depreciation at 31 May 2004 $420

W2) Plant and machinery:	**at cost**		**Depreciation**
	$000		$000
At 31 May 2005	1 200	At 31 May 2005	540
Less additions in 2005	(540)	Provided in 2005	(120)
Add disposals in 2005	300	On disposals	195
At 31 May 2004	960	At 31 May 2004	615

Disposals of Plant & Machinery

	$000
Cost	300
Proceeds	(135)
Profit on disposal	30
Depreciation on date of sale	195

(W3) Motor Vehicles:	**at cost**		**Depreciation**
		$000	$000
At 31 May 2005	360	At 31 May 2005	270
Less additions in 2005	(180)	Provided in 2005	(108)
Add disposals in 2005	120	On disposal	87
At 31 May 2004	300	At 31 May 2004	249

Disposals of Motor Vehicles

	$000
Cost	120
Proceeds	(15)
Loss on sale	(18)
Depreciation on date of sale	87

(W4) Ordinary dividends

	$000
Accrued at 31 May 2005	60
Paid in 2005	90
Debited in P & L a/c	(90)
Accrued at 31 May 2004	60

(W5) Revaluation Reserve should be included in the Statement of Financial Position of 31 May 2004 although it did not exist at that date. Examiners require a positive response if a mark is to be awarded for correct recognition of the situation. Omission of the item from the answer could suggest that the candidate had overlooked it or had not understood how to deal with it.

17.12 Examination type questions

Multiple choice questions

1. When preparing a Statement of cash flow, which of the following would be classified as an investing activity.

   A. dividends paid
   B. a new long – term loan taken out to finance the purchase of property, plant and equipment
   C. interest paid on a long- term bank loan
   D. the cost of purchasing a patent

2. The data given relates to the business of Bingo Ltd for the year ended 31 December 2006

	$
Operating profit	1 000
Depreciation charges	60
Profit on sale of vehicle	10
Receipts from sale of vehicle	50
Interest paid	100
Increase in inventory	150
Increase in debtors	35
Increase in creditors	50
Dividend paid	25

What is the net cash inflow from operating activities?

A. $915 B. $935 C. $1015 D. $1090

3. A company wishes to prepare a Statement of cash flow. The following information is known concerning dividends.

Proposed dividends owing year 1	$75 000
Proposed dividends owing year 2	$120 000
Dividends paid and proposed in year 2	$170 000

What is the amount paid as dividends by the company to be included in the Statement of cash flow?

A. $25 000
B. $215 000
C. $125 000
D. $170 000

4. The following information concerning tax, is extracted from the books of Springles Ltd.

	2005 $	2006 $
Current liabilities		
Taxation	180 000	172 000

The profit and loss extract for the year ended 2006, includes a tax liability of $160 000.

What is the amount of tax paid to be included in the Statement of cash flow of 2006?

A $160 000

B $168 000

C $180 000

D $182 000

17.13 Structured questions

Question 1

The following information pertains to the business of Jane White, a general dealer.

	31 August 2002	**31 August 2001**
	$	**$**
Equipment at cost	216 000	180 000
Land and Buildings at cost	300 000	270 000
Inventory at cost	60 000	48 000
Trade debtors	51 000	57 000
Cash at Bank	6 000	-
Creditors	57 000	60 000
Bank overdraft	-	18 000
Long – term loan (Cr)	240 000	225 000
Capital – Jane White	252 600	175 200
Accumulated depr- equipment	36 000	29 400

Additional Information

1. No property, plant or equipment was sold or scrapped during the year ended 31 August 2002. Equipment costing $21 000 was purchased on credit during the year. This amount is included in creditors' figures and no payments for the equipment had been made by year end. All other additions to property, plant and equipment were paid for.
2. Interest paid on the long- term loan during the year amounted to $36 000.
3. Cash drawings which have been deducted from the capital a/c during the year ended 31 August 2002 amounted to $30 600.
4. Profit for the year amounted to $78 000 and has already been added to the capital a/c.
5. Creditor's in respect of 31 August 2002 pertain to trade creditors and a creditor in respect of an investment activity.

REQUIRED

PREPARE THE STATEMENT OF CASH FLOW OF JANE WHITE FOR THE YEAR ENDED 31 AUGUST 2002.

Question 2

The following information is available from XYZ Ltd

2003	**Balances at 31 December**	**2004**
$		$
3 304 000	Turnover for the year	2 875 200
1 944 800	Cost of Sales	1 690 400
2 200 000	Issued 10% Redeemable preference shares of $2 each	1 800 000
1 840 000	Issued ordinary shares of $2 each	2 440 000
368 000	Share Premium	116 000
112 000	Other revenue reserves	132 000
3 938 400	Property, plant and equipment at book value	3 976 000
168 400	Inventory	147 200
194 560	Trade debtors	384 560
218 320	Bank (dr. balance)	58 120
509 680	Creditors	466 880
240 000	9% Debenture Inventory	168 000
900 000	Long-term investments	840 000
150 000	Profit and loss account	283 000

Additional information

1. Depreciation of property, plant and equipment for 2004 was $146 400
2. Creditors include dividends proposed of $404 000 for 2003 and $375 200 for 2004.
3. During 2004, investments were sold at a profit of $10 000, which has been deducted from the administration costs for the year.
4. At 1 January 2003 there was a Provision for credit loses of $12 800. This provision was reduced in December 2003 to $10 240 and was increased in December 2004 to 5% of the debtors. The debtors shown in the accounts are net of this provision.
5. In May 2004 a bonus issue of shares was made of 2 new $2 Ordinary shares for every 10 held.
6. New $2 ordinary shares had been issued at a premium of $1.00 each in October 2004.
7. No property, plant and equipment had been sold during the year.

Prepare a Statement of cash flow for the year ending 31 December 2004.

CHAPTER 18

ACCOUNTING RATIOS

18.1 Chapter objectives

After studying this chapter *the student should* be able to:

1. *State and explain the users of accounting ratios.*
2. *Explain the importance of liquidity ratios, profitability ratios, efficiency ratios, capital structure ratios and investment ratios.*
3. *Describe the factors that may lead to a low gross/net profit percentage.*
4. *Calculate liquidity ratios, profitability ratios, efficiency ratios, capital structure ratios and investment ratios.*
5. *Comment briefly on the comparison of each ratio as between the two companies.*
6. *State which company appears to be more efficient, giving what you consider to be possible reasons?*
7. *Prepare the Statement of comprehensive income using information from the ratios calculated.*
8. *Prepare Statement of Financial Position using information from the ratios calculate.*
9. *Give five reasons why making a profit does not necessarily mean having cash.*
10. *Explain the limitation of accounting ratios.*

18.2 Introduction

The purpose of accounting is to convey information. The Statement of comprehensive income will indicate the profit or loss made by an organisation in a period, while the Statement of Financial Position will provide a summary of its assets and liabilities at a given date.

Ratios enable users of accounting information and management to gain better understanding of how an organisation has performed. However the calculation of ratios is not in itself adequate. Comparisons must be made.

Common bases of Comparisons are:
1) an industrial average
2) other businesses in the same line of business
3) trends in the same business over a number of years
4) management forecasts or anticipated results

18.3 Users of ratios

Management: -
1) to analyse results of their companies
2) to plan for the future
3) to control their business
4) to facilitate management by exception

Investors

1) to compare their investments with alternative forms of investment in terms of share price growth
2) ability of business to maintain or increase their current dividend
3) make informed decisions when investing in a particular company
4) bankers and finance houses, to assess credit worthiness of businesses
5) government statistics for national statistics compilations
6) financial Analysts working for trade unions to enable them negotiate salary rises, conditions and so on

18.4 Commonly used ratios

1) Liquidity
2) Profitability
3) Use of Assets/efficiency ratios
4) Capital Structure
5) Return to investors

Example:

Growth ratios.

Financial statement analysis

The following are financial statements of Enzo Ltd. for the trading period ended 31 December 2001

FINANCIAL STATEMENT FOR ENZO LTD AS AT 31 DECEMBER

		2000		**2001**
	$	$	$	$
Turnover	-	1 000	-	1 300
Less Cost of sales	-	650	-	800
Gross Profit		350		500
Selling and Distribution cost	50		80	
Administration cost	100	150	120	200
Operating profit before interest & Tax	-	200	-	300
Interest payable		4	-	10
Profit before tax	-	196	-	290
Taxation	-	40	-	60
Profit after tax	-	156	-	230
Preference dividend	5	-	5	-
Ordinary dividend	30	35	60	65
Retained income – For the year		121		165
- Beginning of the year		(21)		100
- At the end of the year		**100**		**265**

Statement of Financial Position for Enzo Ltd. as at 31 December

		2000			**2001**	
		$		**$**	**$**	
Property, plant and equipment (N B V)		300			730	
Current Assets						
Inventory		60			70	
Receivables		80			120	
Bank		80	220		55	245
			520			**975**
Equity & liabilities						
Ordinary share $1 each			160			300
10% preference shares			50			50
General reserves			25			25
Retained Income			100			265
			335			640
Liabilities						
Payables	70			110		
Taxation	40			60		
Dividends unpaid	35		145	65		235
10% Debentures			40			100
			520			**975**

Additional information

1.	Average inventory	$65 000	$70 000
2.	Market price of ordinary shares	120 cents	190 cents
3.	Opening inventory was as follows:	Yr. 2000 = 65 000	Yr. 2001 = 60 000

REQUIRED

Calculate (a) liquidity ratios

(b) Profitability, efficiency and investments ratios and comment on the results.

18.5 Liquidity ratios

Liquidity ratios measure the ability of a business to meet its short-term financial commitments using its current assets.

The Importance of liquidity ratios

1. Before new suppliers may extend credit to a customer, the liquidity situation of the customer is considered to assess the risk for non-payment.
2. For management, liquidity ratios may help identify working capital items, which are poorly, managed e.g. Capital being tied up in inventory, Receivables or cash lying idle in the bank instead of being invested to achieve profit.

Current ratio or working capital ratio

Shows the number of times current liabilities are covered by current assets.

Current ratio	=	Current Assets / Current Liabilities	
		2000	**2001**
Current ratio	=	220 / 145	245 / 235
		1,52: 1 times	**1,042: 1 times**

<u>Tutorial note</u>:

A mere mention that a ratio has decreased or increased is not obvious but meaningless. Students are advised to give explanations that should suit the question being considered.

<u>Comment</u>

The liquidity position of the business seems barely satisfactory in 2000 and has fallen to a very low level in 2001. This has been caused by an overly increase in the investment on receivables. It is generally accepted that a current ratio of between 1.5:1 and 2:1 is reasonable.

<u>Factors that influence the current ratio</u>

1. The nature of the business. A business may require large inventories to be carried.
2. Or where sales are mainly on credit, a large amount of Receivables is carried in the Statement of Financial Position.
3. Where sales are seasonal, working capital will also fluctuate.

Acidity test ratio

Sometimes referred to as liquidity ratio that measures the ability of the business's current assets other than inventory to meet current liabilities. Inventory includes work in progress, materials and finished goods. The rationale of inventory is that it is the least liquid working capital assets. In other words it cannot be readily converted into cash.

=		Current assets – inventory / Current liabilities	
		2000	**2001**
Quick ratio	=	220 – 60	245 – 70
145		235	
	=	**1,10: 1 times**	**0,74: 1 times**

<u>Comment</u>

A quick ratio of 1:1 is generally considered satisfactory while Enzo Ltd`s quick ratio for 2 000 is satisfactory. It has been allowed to fall too low in 2001. The situation in 2001 can be blamed on the large dividend declared in 2001.

18.6 Profitability ratios

These ratios indicate the performance of a business. Investors are interested in knowing whether or not to invest in a business based on the return to their capital. For management, they need to assess their efficiency in terms of their ability to control expenses.

a) Gross Profit / Sales or Margin

It expresses the gross profit as a percentage of total sales.

Gross profit percentage = $\frac{\text{Gross profit x 100\%}}{\text{Sales}}$

		2000	2001
	=	$\frac{350 \times 100}{1\ 000}$	$\frac{500 \times 100}{1\ 300}$
	=	**35%**	**38%**

Comment
The business has achieved a higher margin in 2001. It is likely that the business factors that may lead to a low gross profit percentage. However, such an increase should not be a satisfactory measure of the performance of the business without relating it to other targets set by management and or other similar business in the same line.

Factors that may lead to a low gross profit percentage

1. An increase in the cost of sales not passed to customers.
2. Reductions in selling price to dispose of slow moving, damaged or obsolete inventory.
3. Stolen inventory not identified
4. A price cutting policy usually as a measure to combat competition.
5. Bulk discounts being given to major customers.
6. The owner may have taken goods for private consumption.
7. Opening inventory overstated
8. Closing inventory understated
9. Sales being understated
10. Purchases being understated.
11. Changes in product mix resulting in selling more of low margin products than the previous period.

b) Net Profit Percentage

This expresses an organisation's net profit as a percentage of total sales.

Net Profit % = $\frac{\text{Net profit before interest \& tax}}{\text{Sales}}$

		2000	2001
Net profit %	=	$\frac{200}{1\ 000}$	$\frac{300}{1\ 300}$
	=	**20%**	**23%**

Comment
The net profit to sales ratio has improved in 2001. Possible explanations could have been:

1. A deliberate reduction of costs
2. An increase in the selling price without a corresponding increase in costs.

Notes:
A significant decrease in the net profit percentage that is not accompanied by a similar change in the gross margin might indicate that an organisation needs to improve control of its expenses.

c) Return on Capital Employed
Measures the return or profit made by the total assets employed in the business

ROCE = $\frac{\text{Profit before interest \& tax}}{\text{Total capital employed}}$

OR **=** Margin x turnover

$$\frac{\text{Net profit before interest \& tax x 100\%}}{\text{Sales}} \quad x \quad \frac{\text{Sales}}{\text{Capital}}$$

The second method is more detailed and may assist users to analyse how well the assets are being utilised (turnover) and the general profitability (margin).

Enzo Ltd.

Method 1		**2000**	**2001**
ROCE	=	$\frac{200 \times 100\%}{(335 + 40)}$	$\frac{300 \times 100\%}{(640 + 100)}$
	=	**53%**	**40%**
Method 2	=	Margin x turnover	
	=	$\frac{200}{1\,000} \times \frac{1000}{375}$	$\frac{300}{1\,300} \times \frac{1\,300}{740}$
	=	20% x 2,67 times	23% x 1,76 times
	=	**53%**	**40%**

Comment

The ratio indicates a falling return on capital. Method 2 will indicate that more capital has been employed but have failed to raise reasonable sales to support it. There is need to dispose of excess property, plant and equipment.

Importance

- Investors can assess in percentage terms, the level of profit that can be generated by every dollar that they invest, use ROCE.
- Investors would be satisfied with a return that is higher than what they expect to be compensated for the capital they would contribute in the business.
- Investors & management can apply it to evaluate alternative forms of investment.

What does a low or declining ROCE means?

- An increase in the cost of borrowing may turn the business into a loss making company.
- Additional borrowings may have an adverse effect on profitability.
- Can be used as a base of evaluating investment projects, those with low ROCE would certainly be undesirable.

Tutorial Notes

A common pitfall for students is when asked to distinguish between liquidity and profitability. A business may be profitable but having liquidity problems, the following may contribute to such a situation.

1. too large a balance for accounts receivable due to slow paying debtors
2. A poor inventory control policy due to inventory held in excess of requirements.
3. Use of short-term loans and overdrafts to finance the acquisition of assets.
4. Where long – term debt was used to finance the acquisition of inventory this results in serious problems, as the business may find itself without money to pay off its long-term debt. Companies are required to match short – term debt with short – term assets, long-term debt with long term

assets. Capital is a long term fund normally used to finance the acquisition of property, plant and equipment or to repay long term debt now due.

5. Over trading – occurs where a business expands too quickly without adequate working capital to support the expansion. To support the high demand for its products, the business builds up inventories, sales increase so do receivables, there is an overly dependence on payables to finance acquisition of inventory. Without a comprehensive policy a business may find itself failing to meet its running costs.

18.7 Assets utilisation

These ratios are used to measure the efficiency with which the resources have been used.

a) Sales to property, plant and equipment ratio

- Measures how effectively an organisation utilises its property, plant and equipment to generate sales.
- It measures how much each dollar invested in property, plant and equipment generates sales.

Sales / property, plant and equipment ratio = $\frac{\text{sales}}{\text{Property, plant and equipment}}$

	2000	2001
Sales/Property, plant and equipment ratio =	$\frac{1000}{300}$	$\frac{1\ 300}{730}$
=	**3,3 times**	**1,78 times**

<u>Comment</u>

There has been a fall in the sales / property, plant and equipment ratio a testimony of poor property, plant and equipment utilisation. It is probably that the business has non-property, plant and equipment in excess of requirements.

b) Sales/ Total assets

Model = $\frac{\text{Sales}}{\text{Total assets}}$

Where total assets is non-current plus current assets.

Enzo Ltd.

2000	2001
$\frac{1\ 000}{520}$	$\frac{1\ 300}{975}$
1.92 times	**1.33 times**

<u>Comment</u>

This ratio confirms merely investment the business has made in assets, which seem to be failing to generate adequate sales to justify the level of investment made. However, care should be taken as an investment in assets made part-way in the year may not be expected to yield the same results as an investment in assets made at the beginning of the year.

c) Inventory turnover ratios

Holding unnecessary high levels of inventory may be expensive for a business in terms of storage and security costs and the greater the risk that goods would perish or become obsolete. Furthermore there could be pilferage going on in the business.

Inventory turnover = $\frac{\text{cost of sales}}{\text{Average inventory}}$

This ratio measures the number of times, in a year a business sells its average inventory. The higher the figure the better to the business.

Enzo Ltd.

	2000	**2001**
	$\frac{650}{62.5}$	$\frac{800}{65}$
=	**10.4 times**	**= 12.3 times**

Comment

There has been a slight improvement in the inventory turnover. A meaningful comparison of this ratio should be made with the average inventory turnover in the industry; business in the retail industry should be expected to have a very high inventory turnover. Business in electrical appliances, hardware and furniture are expected to have lower turnover ratios as inventory will be converted into amounts receivable and ultimately cash.

Rate of inventory turnover is also called ROST

Inventory turnover (in days) = $\frac{\text{Average inventory}}{\text{Cost of sales}} \times 365$

Inventory turnover (in weeks) = $\frac{\text{Average inventory} \times 52}{\text{Cost of sales}}$

Measures in days the length of time a business holds inventory. The shorter the period the better as less money is tied up in inventory and inventory will be converted into cash more quickly.

Enzo Ltd.

ROST =

	2000	**2001**
	$\frac{62.50 \times 365}{650}$	$\frac{65 \times 365}{800}$
=	**35 days**	**and 30 days**

<u>Comment</u>

The business is now taking less time to sell inventory. Inventory turnover can also be calculated on months and the model is adjudged as follows:

*Inventory turnover (months) = $\frac{\text{average inventory} \times 12}{\text{Cost of sales}}$

*Inventory turnover (weeks) = $\frac{\text{Average inventory} \times 52}{\text{Cost of sales}}$

d) Debtors Collection period

Measures the period taken on average by debtors to pay. It can be calculated in days, weeks and months like the inventory turnover ratio. The shorter the period the better. It means business collects the money quite early from debtors and hence it becomes easy to pay its debts and other commitments (wages, bills and accounts payables).

Enzo Ltd.

		2000	**2001**
Receivables collection (in days)		$\frac{\text{Receivables x 365}}{\text{Credit sales}}$	
(in weeks)	=	$\frac{\text{Receivables x 52}}{\text{Credit sales}}$	
(months)	=	$\frac{\text{Receivables x 12}}{\text{Credit sales}}$	
Collection in days	=	$\frac{80 \text{ x } 365}{1\,000}$	$\frac{120 \text{ x } 365}{1\,300}$
	=	**29,2 days**	**33,9 days**
In weeks	=	$\frac{80 \text{ x } 52}{1\,000}$	$\frac{120 \text{ x } 52}{1\,300}$
	=	4,16 weeks	4,8 weeks
In months	=	$\frac{80 \text{ x } 12}{1\,000}$	$\frac{120 \text{ x } 12}{1\,300}$
	=	**0,96**	**1,1 months**

Comment
The collection period of the business has been extended in year 2001 from the year 2000 levels. Perhaps the business extended its credit period to increase its sales. However the business may need to critically analyse the credit period offered to it by its creditors and to assess whether or not there are no pressures for quick availability of cash.

In general, it is good for a business to have as short as possible a debtor's collection period. It is not surprising for a business to find itself technically in solvent with money tied up in debtors who pay very late. Wages will need to be paid as well as creditors. it is an imprudent practice to source short – term loans and overdrafts to finance receivables. A comprehensive credit policy is very necessary, as it would:

- establish the maximum credit period perceived in the industry or by the company as best suited to its environment.
– establish who should be given credit based on the calibre of customers attracted.

e) Creditors payment period

Measures the period a business takes before paying its creditors. The average for the creditors for the period is used. Where the discount is not meaningful, it is better to avail the full credit period. This will certainly help boost the business's cash flow position.

Payables turnover (in days)	=	$\frac{\text{Payables x 365}}{\text{Credit purchases}}$
(In weeks	=	$\frac{\text{Payables x 52}}{\text{Credit purchases}}$
(In months)	=	$\frac{\text{Payables x 12}}{\text{Credit purchases}}$

Enzo Ltd.

			2000	2001
Payables turnover (days)		=	70 x 365 / 645	110 x 365 / 810
		=	39.6 days	49,56 days
	(Weeks)	=	70 x 52 / 645	110 x 52 / 810
		=	**5,6 weeks**	**7,06 weeks**
(Months)		=	70 x 12 / 645	110 x 12 / 810
		=	**1,3 months**	**1,6 months**

Comment

The business is now taking longer to pay its creditors. This assists the cash flow position of the business. However it is only hoped that the delay to pay is within the period given otherwise, this indicates a potential problem for the business.

Note:

Where a business fails to pay on time its credit lines may be cancelled and may result into forced liquidation.

18.8 Capital Structure

Investors, lenders and potential investors are interested in an organisation's capital structure or long – term funding arrangements. The higher the ratio of debt to equity the more dependent an organisation is on borrowed funds, and the greater the risk that it may be unable to meet interest payments on these funds when they fall due.

Note:

This could cause serious liquidity problems for an organisation.

Gearing Ratio

Means the relation between long – term loan (or fixed cost capital) and total capital. In other words, it indicates the level of borrowing in the business.

$$\text{Gearing ratio} = \frac{\text{Fixed cost capital}}{\text{Total capital}}$$

Fixed cost capital - includes preference shares, debentures and any long term loans

Enzo Ltd.

	2000	2001
	50 + 40 x 100% / 335 + 40	100 + 50 x 100% / 640 + 100
=	**24 %**	**20%**

Comment

1. There has been a slight decrease in debt financing. The company is still low geared. A company whose gearing exceed 50% may be said to be highly geared and this can be risky.
2. As profit increases, the rate of return to equity (ordinary) shareholders also increases. Certainly the vice versa is true. A decrease in profits also means the return to equity shareholders goes down.
3. Investors and bankers are usually reluctant to support highly geared companies because the risk of failure is quite high.

Debt/Equity

Measures the relationship between debt and equity.
Model

$$\text{Debt / equity} = \frac{\text{Debt x 100\%}}{\text{Equity}}$$

Where equity refers to shareholders` funds.

– Ordinary share capital
– Plus all reserves

Enzo Ltd.

		2000	**2001**
D/E	=	$\frac{40 + 50}{335 – 50}$	$\frac{100 + 50}{640 – 50}$
	=	**31,57%**	**25.42%**

Comment
In proportion to total equity funds there has been a decrease in the level of borrowing. This is a good sign for the debenture holders who should feel better placed and less exposed to the risk of default.

18.9 Investors' ratios

This group of ratios is commonly used by listed Companies to assist investors with more information.

18.10 IAS 33 - Earnings per share

Earnings per share is an important ratio. It was issued to spell out its calculation, presentation and disclosure. It applies to entities that are listed on the stock market.

This is commonly used measure to assess the success of a business. It indicates the profits, in cents each share has earned in a given accounting period. This is the profit available to ordinary shareholders after the payment of interest, tax and preference dividend.
Investors are usually interested in a steady growth in the EPS
Basic EPS
This should be calculated by dividing the net profit or loss for the period attributable to ordinary shareholders by the weighted average number of ordinary shares during the period.

The model is: $$\frac{\text{Net profit after tax and preference share dividends}}{\text{Number of ordinary shares ranking for dividend}}$$

If a company has any preference shares in issue then it should be dealt with as follows

The cumulative preference dividend should be deducted even if it is not paid or proposed. The cumulative preference dividend should always be deducted before anything is available to ordinary shareholders. If preference shares are non-cumulative, it should only be deducted from net profit after tax if declared or proposed. If the question does not specify whether preference shares are cumulative or non-cumulative always assume that they are cumulative.

Example 1

H Ltd. made a profit after tax of $1.6m and it had in issue the following on 1 January 2000:

8% cumulative preference shares of $1 each	$100 000
Ordinary share of $1 each	$300 000

The company's year end is 31 December

<u>Required</u>
Calculate the basic EPS

<u>Solution</u>

Net profit after tax	1 600 000
Less preference dividend 8% x 100 000	8 000
	1592 000

EPS $\dfrac{\$1592\ 000}{300\ 000}$

$5,31 per share

531 cents

Note: EPS is to be expressed in cents per share.

Example 2

Ndlovu Ltd. made a profit of $1 800 000 after tax for the year ended 31 December 2000. It has issued the following:

6% non-cumulative Preference shares	= 200 000
Ordinary share of 50c each	=750 000

No shares were issued during the year.

<u>Required</u>

Calculate the basic EPS for the year ended 31 December 2000

<u>Solution</u>

Net profit after tax $\dfrac{\$1\ 800\ 000}{1\ 500\ 000}$

Number of shares $\dfrac{750\ 000}{0.5}$ = 1 500 00 shares

EPS = 120 cents

Note that now preference dividend has not been provided because it has not been paid or declared. The number of shares should be determined by formula which goes like

$$\frac{\text{Total value of shares}}{\text{Nominal value of each share}}$$

In the first illustration this formula was not used but because the normal value was $1.00 therefore total value of shares was the same with number of shares. To get the correct number of shares you should always use this formula.

Issue of shares during the year

When extra shares are issued during the year the basic EPS is calculated by dividing the earnings by the weighted average number of shares outstanding during the year. The weighting is on a time basis.

Example 3

A company has in issue 100 000 ordinary share of $1 each on 1 January 2002. It issued a further 20 000 shares on 1 July 2002 at par and payment was received in full on application.

Required

Calculate the weighted average number of shares by 31 December 2002

Solution

$$100\,000 \times \frac{12}{12} = 100\,000$$

$$20\,000 \times \frac{6}{12} = \underline{10\,000}$$

$$\mathbf{110\,000}$$

Therefore the weighted number of share = 110 000.

Example 4

XYZ Ltd., whose year ends on 31 December each year made a profit after tax of $900 000. It has in issue 50 000 ordinary shares of $1 each on January 2001. It issued a further 40 000 ordinary shares as follows:

1 April 2001, 30 000 shares
30 June 2001, 10 000 shares

Required

Calculate the basic EPS for the year ended 31 December 2001

Solution

Weighted number of shares

500 000 x 12/12 = 50 000
20 000 x 9/12 = 22 500
10 000 x 6/12 = 5 000
77 500

$$\text{Basic EPS} = \frac{900\,000}{77\,500}$$

= $11.61 per share
= 1 161 cents per share

Issue of shares for free

If shares are issued for free (bonus issue) during the year, there is no time apportionment. Simply add the shares to the existing ordinary shares.

ABC Ltd. made a profit after tax of $1 200 000. It had an issued 80 000 ordinary shares of $1.00 each. On January 2000 the company made a bonus issue of 2 for every 5 held on 1 July 2000. The company's year end is 31 December 2000

Required:
Calculate the basic EPS

Solution

$$80\,000 + 2/5 \times 80\,000 \qquad \frac{\$1\,200\,000}{112\,000 \text{ (weighted shares)}}$$

= $10.71 per share

= 1 071 cents per share

Earnings yield

Expresses the earnings of a Company as a percentage of the market price of its share

Enzo Ltd.

	2000	2001
Earnings Yield =	$\frac{\text{EPS}}{\text{MPS (Market price / share)}}$	
=	$\frac{94 \times 100\%}{120}$	$\frac{75 \times 100\%}{190}$
=	**78.3%**	**39.5%**

Comment

There has been a decrease in the earnings yield. It is probable that the price of the share is not properly valued or based on the strengths of management plans and future forecasts, investors could be confident of better times ahead.

Price earnings ratio (PER)
The E/P ratio relates the market price of a share to the earnings per share.

Price earnings ratio =		<u>Market Price /Share</u> Earnings per share

Enzo Ltd.

	2000	**2001**
	<u>120</u> 94	<u>190</u> 75
=	**1.28 times**	**2.53 times**

<u>Comment</u>

The E/P ratio has moved higher an indication of growing confidence in the business. The higher the P/E ratio, the higher the confidence investors have in the future of the business.

Dividend Cover

It indicates the number of times the current dividend can be paid out of the company's profit after tax. A comprehensive dividend policy must be adopted by a business to ensure that:

1. investors are satisfied with the dividend declared
2. adequate profits are retained to fund future growth of the company

Enzo Ltd.

		2000	**2001**
Dividend Cover =		<u>Profit after tax less Preference divided</u> Gross dividend on ordinary shares	
		<u>156 – 5</u> 30	<u>230 – 5</u> 60
	=	**5 times**	**3.75 times**

<u>Comment</u>

A dividend cover of 5 times could be very high and indicative of a comparative dividend policy.

<u>Dividend per share</u>

This is concerned with dividend paid in an accounting period per share

Dividend per share	=	<u>Gross dividend for the year</u> No. of ordinary shares in issue

		2000	**2001**
Dividend per share		<u>30</u> 160	<u>60</u> 300
	=	**18.75 cents**	**20 cents**

Comment

The dividend has remained unchanged at 21 cents. However investors will certainly be happier with an increase in the company dividend.

Dividend Yield

This expresses the shareholder's dividend as a percentage of the market value of the share. It shows investor's return on investment.

$$\text{Dividend Yield} = \frac{\text{Dividend/ Share x 100\%}}{\text{Market price per share}}$$

		2000	2001
Dividend Yield	=	$\frac{18.75 \times 100}{120c}$	$\frac{20 \times 100}{190\ c}$
	=	**17.63 %**	**11.53%**

Comment

There has been a sharp decrease in the dividend yield. Probably shareholders may not be happy with lack of growth in the Company's dividend. However whether this satisfies the shareholder will depend upon the yield that could be earned elsewhere.

Note

The dividend yield indicates the return that an investor earns from holding share in a particular company. The higher the dividend yield the better. A low dividend yield may convince shareholders to dispose of their shares.

Interest Cover

This measures the number of times interest payments on long –term debt can be paid out of profit before interest & tax. The higher the level of interest cover the less likely the chance that interest payments will not be met, hence the lower level of financial risk to ordinary shareholders associated with an organisation.

$$\text{Interest Cover} = \frac{\text{Profit before tax \& interest}}{\text{Interest charges}}$$

		2000	2001
Interest Cover	=	$\frac{200}{4}$	$\frac{300}{10}$
	=	**50 times**	**30 times**

18.11 Limitation of ratios

1. Ratios can only show results of carrying on a business. They do not explain what caused the ratios, hence further explanations by management is necessary.
2. Ratios are based on accounting information that may be subjective as different businesses may use different policies and accounting conventions for treating the same transaction.
3. For meaningful analysis of ratios, like should be compared with like. In other words, a company in the motor industry cannot be compared to an insurance company or a company's performance in 2001 cannot be compared to its performance in 1985.
4. Ratios ignore seasonal fluctuations.
5. Ratios may be misleading if not adjusted for inflation.
6. Ratios are snap shots; as at the end of the year, in the case of a Statement of Financial Position.

18.12 Ratios & incomplete records

If given summarised account (details and ratios), it is possible to prepare final accounts utilizing those summaries. Some of the techniques used in incomplete records should be applied. In the previous section, we have demonstrated the calculation of ratios. In this section, we have a motive of preparing final accounts from those ratios. Students should therefore have the formulae of calculating the ratios at hand.

Example 1

B. Sam plans to go into business on 1st June 2001 and has $60 000 to invest. He intends to use the money to buy the following:

	$
Premises	44 000
Furniture	5 000

The remainder will be deposited in the business bank account. Sam's projected figures for the first year of business are:

Sales	$140 000 of which 20% will be on credit
Gross profit ratio	40%
Net profit ratio	20%
Sales commission	4% of total sales
Depreciation on furniture	45% reducing balance
Discount allowed	1 ½% of total sales
Discount received	2 ½% of credit purchases
Bad debts	2 ½% of sales
Wages	$13 250
Sundry expenses	$6 600
Drawings	$5 000 plus 5% of total sales

Projected balances at 31 May 2002 are:

	$
Inventory	16 000
Receivable	6 000
Payables	5 000

No accruals or prepayments are expected at that date, and the balance at bank has not been estimated.

Required

1. Draw up a projected Statement of comprehensive income for the year ending 31 May 2002
2. Draw up a projected Statement of Financial Position as at 31 May 2002

Solution

Sales ledger Control A/c

Sales	28 000	Bank *(difference)*	19 200
		Disc. Allowed	2 100
		Bad debts	700
		Bal. c/d	6 000
	28 000		28 000
Bal. b/d	6 000		

Purchases ledger Control A/c

Bank	65 200	Purchases *(difference)*	72 000
Disc. Received	1 800		
Bal. c/d	5 000		
	72 000		72 000
		Bal. b/d	5 000

Bank Summary

Capital	11 000	Payments to creditors	65 200
Cash Sales	112 000	Sales Comm.	5 600
Receipts from debtors	19 200	Wages	13 250
		Sundry expenses	6 600
		Drawings	12 000
		Other expenses	27 300
		Bal. c/d *(difference)*	12 250
	142 200		142 200
Bal. b/d	12 250		

Projected Statement of Financial Position as at 31 May 2002

Assets			
Property, plant and equipment			
	Cost	Acc. Dep.	Net
Premises	44 000	--	44 000
Furniture	5 000	2 250	2 750
	49 000	2 250	46 750
Current Assets			
Inventory		16 000	
Receivables		6 000	
Bank		12 250	34 250
Total Assets			**81 000**
Equity & Liabilities			
Capital			60 000
Add Net profit			28 000
			88 000
Less drawings			12 000
Total equity			76 000
Current liabilities			
Accounts payable			5 000
Total equity and liabilities			**81 000**

Projected Statement of comprehensive income for the year ending 31 May 2002

Sales		140 000	
Less Cost of Sales			
Purchases	72 000		
Less Closing Inventory	16 000	56 000	
		84 000	
Add Disc. Received		1 800	
Gross Profit		85 800	
Less Expenses			
Sales Commission	5 600		
Wages	13 250		
Sundry expenses	6 600		
Disc. Allowed	2 100		
Bad debts	700		
Depreciation	2 250		
Other expenses	27 300		57 800
Net Profit			**28 000**

Example 2

R. Show is in business and at 31 December 1994 his capital was $65 000. All his sales and purchases were on credit. At 31 December 1995, Show's inventory was valued at $20 000, which was $8 000 less than at the end of the previous year.

The following ratios have been calculated from the Statement of comprehensive income for the year to 31 December 1995 and his Statement of Financial Position at that date:

1. Rate of inventory-turn : 7 times
2. Mark up : 33 1/3%
3. Selling & Distribution expenses : 8% of sales
4. All other overheads – administration : ?
5. Net profit percentage : 15%
6. Sales / property, plant and equipment : 5 times
7. Sales / current assets : 4 times
8. Average period of credit taken by receivables: 30 days
9. The only current assets are inventories, receivables and balance at bank
10. Average time taken to pay creditors : 45 days

Required

Prepare R. Show's Statement of comprehensive income for the year ended 31 December 1995 and his Statement of Financial Position as at that date (Make all calculations to the nearest $)

Workings

1. Rate of inventory-turn $= \frac{\text{Cost of Sales}}{\text{Average inventory}}$

$$\Rightarrow \frac{\text{Cost of sales}}{24\ 000} = 7$$

Cost of sales $\Rightarrow$ 24 000 x 7 = **$168 000**

2. Mark-up ⇒ $\frac{\text{Gross profit}}{\text{Cost of sales}}$ ⇒ $\frac{\text{G.P}}{168\ 000}$ = 33 1/3%

Gross Profit = **$56 000**

3. Sales ⇒ Cost of Sales + Mark –up
$224 000

4. Selling & Distribution expenses = 8% x 224 000 = **$17 920**

5. Net Profit = Sales x 15% = **$33 600**

6. All other overheads = **$4 480**

7. Property, plant and equipment = $\frac{\text{Sales}}{5}$ ⇒ $\frac{224\ 000}{5}$ = **$44 800**

8. Current assets = $\frac{\text{Sales}}{4}$ ⇒ $\frac{224\ 000}{4}$ = **$56 000**

9. Debtors period ⇒ $\frac{\text{Receivables x 360}}{\text{Sales}}$ = 30 days

Debtors = $\frac{224\ 000 \text{ x } 30}{360}$ = **$18 667**

10. Bank = Current Assets - Receivables - Inventory
Bank = 56 000 – 18 667 - 20 000 = **$17 333**

11. Creditors period = $\frac{\text{Payables x 360}}{\text{Purchases}}$ = 45 days

Creditors = $\frac{\$160\ 000 \text{ x } 45}{360}$

Creditors = **$20 000**

<u>Statement of comprehensive income for the year ended 31 December 1995</u>

	$		$
Sales			224 000
Less Cost of Sales			
Opening inventory		28 000	
Add Purchases	160 000		
	188 000		
Less Closing Inventory	20 000		168 000
Gross Profit			56 000
Less expenses			
Selling & distribution	17 920		
Administration	4 480		22 400
Net Profit			**33 600**

Statement of Financial Position as at 31 December 1995

		$
Assets		
Property, plant and equipment		44 800
Current assets –	Inventory	20 000
	Accounts Receivables	18 667
Bank		17 333
Total Assets		100 800
Equity & Liabilities		
Capital		65 000
Add Net Profit		33 600
		98 600
Less Drawings (missing figure)		17 800
Total equity		80 800
Add accounts payables		20 000
Total equity and liabilities		100 800

18.13 Examination type questions

18.14 Multiple choice questions

1. During an accounting period, a company earned a profit, after tax, of $1 440 000. Its capital was as follows:

Ordinary share capital ($3 shares)	$600 000
12% preference share capital ($ 3 shares)	$120 000
10% debentures	$180 000

The company's earnings per share for the period was:

A. $6.00
B. $7.128
C. $7.20
D. $7.50

2. A company's inventory turnover ratio is calculated using the cost of goods sold and the average of opening and closing inventory. In each of the last two financial years, closing inventory was valued at $5 000 more than the corresponding opening inventory. In both years, the rate of inventory-turn was 10 times and in the earlier year the cost of goods sold was $125 000.

What was the cost of goods sold in the second year?

A. $200 000
B. $175 000
C. $150 000
D. $125 000

3. The following information has been calculated from the accounts of a business:

Days taken to pay creditors	36
Days taken by debtors to pay	65
Inventory turnover in days	14

What is the cash operating cycle?

A. 15 days
B. 29 days
C. 43 days
D. 79 days

4. The following balances are found in the Statement of Financial Position of a business.

	$
Inventory	192 000
Debtors	378 000
Creditors	261 000
Bank (debit balance)	63 000
Bank loan (repayable in 2 years)	150 000

What is the quick (acid test) ratio?

A. 1.1:1
B. 1.2:1
C. 1.7:1
D. 2.4:1

5. The opening inventory of a business is $5 000 and the cost of sales is $100 000. Using the average figure of opening and closing inventory, what value of closing inventory is needed to give a inventory turnover of 10?

A. $5 000
B. $10 000
C. $15 000
D. $20 000

6. The following items appear on a Statement of Financial Position

	$
Inventory	30 000
Provisition for credit loses	6 000
Cash and bank	12 000
Creditors	30 000

The current ratio is 2:1

How much are the debtors?

A. $12 000
B. $18 000
C. $24 000
D. $30 000

7. A company has the following information:

Price earnings (P/E) ratio	14
Earnings per share (EPS)	$0.60
Dividend per share	$0.40

What is the market value of an ordinary share?

A. $2.80
B. $5.60
C. $8.40
D. $14.00

18.15 Structured questions

Question 1
Below are financial statements of two companies which both sell household furniture and decorative wall paper for the year ended 31 December 2006.

	Exquisite Household		Flamboyant Household	
	\$000	\$000	\$000	\$000
Statement of comprehensive income				
Sales		2 000		3 200
Less Cost of Sales				
Opening inventory	380		220	
+ Purchases	1 200		2 440	
	1 580		2 660	
- Closing inventory	440	1 140	320	2 340
Gross profit		860		860
Less expenses				
Wages & salaries	360		260	
Director's remuneration	140		240	
Other operating expenses	28	528	20	520
Net profit		332		340
Less Appropriations:				
Transfer to general reserve	60		60	
Proposed & paid dividend	280	340	224	284
Retained profit/ loss for the year		(8)		56
Add retained profit b/f		208		120
Retained profit c/d to next year		200		176

Statement of Financial Position

Property, plant and equipment				
Machinery & equip at cost	400		100	
Less depreciation to date	160	240	40	60
Vans	128		96	
Less depr. to date	52	76	32	64
		316		124
Current assets				
Inventory	440		320	
Debtors	208		58	
Bank	150		20	
	798		398	
LessCurrent liabilities				
Creditors	378	420	76	322
		736		446
Financed by:				
Issued share capital		400		200
Reserves				
General reserve		136		70
Retained profit		200		176
		736		446

a) Calculate the following ratios for both Exquisite household Ltd and Flamboyant Household Ltd for the year ended 31 December 2006.

i) Gross profit as a percentage of sales
ii) Net profit as a percentage of sales
iii) Expenses as a percentage of sales
iv) Rate of inventory turn
v) Return on capital employed

Liquidity ratios

i) Current ratio
ii) Acid test ratio
iii) Debtors/ sales ratio
iv) Creditors/ purchases ratio

b) Comment briefly on the comparison of each ratio as between the two companies. State which company appears to be more efficient, giving what you consider to be possible reasons.

Question 2

The following information relates to Electronics Unlimited Ltd Co.

Statement of Financial Position as at 30 June

		2006		**2005**
Property, plant and equipment				
Property, plant & equipment		474 000		495 000
Investments		45 000		45 000
		519 000		540 000
Current Assets				
Inventory	201 000		180 000	
Trade debtors	215 700		170 400	
Cash and bank	1 500		2 400	
	418 200		352 800	
Lesscurrent liabilities				
Trade creditors	(150 000)		(183 000)	
Short –term loan	(90 000)		-	
Working Capital		178 200		169 000
		697 200		709 000
Less Long- term liabilities				
15% $300 debentures		120 000		120 000
		577 200		589 000
Share Capital & Reserves				
Ordinary shares of $3 full paid		540 000		540 000
Retained profits		37 200		49 800
		577 200		589 800

Below is the Statement of comprehensive income for the year ended 30 June:

		2006		2005
Turnover		900 000		852 000
Less Cost of Sales				
Opening inventory	180 000		150 000	
+ Purchases	720 000		705 000	
	900 000		855 000	
- Closing inventory	201 000	699 000	180 000	675 000
Gross profit		201 000		177 000
Less expenses				
Administrative expenses	69 600		86 400	
Depreciation	21 000	90 600	24 000	110 400
Net operating profit		110 400		90 600
Add investment income		4 500		3 000
		114 900		93 600
Less interest charged		18 000		18 000
Net profit before tax		96 900		75 600
Less tax		42 000		33 000
Net profit for the year		54 900		42 600

All purchases and sales were made on credit.

a) Calculate the following profitability and liquidity ratios.
Profitability

i) Return on Ordinary equity (ROE)
ii) Return on assets (ROA)
iii) Net profit percentage
iv) Gross profit percentage

Liquidity

(i) Current ratio
(ii) Acid test ratio
(iii) Debtors collection period
(iv) Creditors payment period
(v) Rate of inventory turn

b) Comment on the performance of Electronics Unlimited over the past two years.

Question 3

An extract from a company's Profit and Loss Account for the year ended 30 April 1998 was as follows:

	$000	$000
Operating profit		3 000
Debentures interest (12½%)		750
		2 250
Ordinary dividend paid and proposed	1 050	
Preference dividend paid and proposed	360	
Transfer to general reserve	600	2 010
Retained profit for the year		240

The company's issued share capital and reserves at 30 April 1998 consisted of:

Ordinary shares of $30	$12 000
8% Preference shares of $15	$4 500
Capital and revenue reserves	$2 700

The market price of the ordinary shares at 30 April 1998 was $90.

(a) Calculate the following ratios:
(i) Interest cover
(ii) Dividend cover
(iii) Earnings per share
(iv) Price earnings ratio
(v) Dividend yield
(vi) Gearing

(b) Explain why each of these ratios above is important for investors in ordinary shares in the company.

Question 4

India Indigo is a general dealer with the data below for the year ended 30 September 2005.

Net profit percentage	15.5%
Mark-up	25%
Selling overheads	2.5% of sales
Other overheads	?
Inventory turnover	10 times
Sales: current assets	5.3:1
Sales: property, plant and equipment at net book value	5:1
Average period taken by debtors to pay	28.8 days
Average period taken to pay creditors	45 days

<u>Notes</u>

(i) Included in current assets are debtors, inventory and prepayments.
(ii) The bank account was overdrawn.
(iii) Inventory at 30 September 2004 was valued at $210 000 which was $140 000 less than that at 30 September 2005.
(iv) All sales and purchases were on credit.
(v) Capital at 30 September 2004 was $647 500
(vi) Indigo made drawings equal to 7.5% of his sales.
(vii) The shop opened for 360 days during the year.

You are required to:

(a) Prepare a Statement of comprehensive income of Indigo for the year ended 30 September 2005. Round off your calculations to the nearest $.
(b) Prepare Indigo's Statement of Financial Position at 30 September 2005. Your answers should be rounded off to the nearest $
(c) Give five reasons why making a profit does not necessarily mean having cash.
(d) What method can a company use to distribute profit if there is no cash available.

CHAPTER 19

COMPUTERSED ACCOUNTING

19.1 Chapter objectives

After studying this chapter *the student should* be able to:

1. *Explain what computerized accounting is*
2. *Distinguish between computer software and computer hardware*
3. *Give an outline of some computerized accounting packages*
4. *Explain the advantages and disadvantages of computerized accounting systems*
5. *Describe the components of a computer hardware used in a computer system.*

19.2 Introduction

With the advent of technological developments and advances, nowadays computers have common places and are commonly used in business for various purposes. Book-keeping and accounting are also now computerized in most businesses for the scope of our syllabus it is important to note that practical ‘hands-on’ experience of computers is not required. In this chapter we will therefore look at the theory which will give you an understanding of what computerized accounting systems are and how they benefit a business accounting system.

19.3 Computer systems

A complete computer system consists of two main parts, the hardware and the software

19.4 Computer hardware

These are part of the computer which you can touch and handle, as shown below. They include input devices, the central processing unit (CPU), output devices and the memory.

i) <u>Input devices</u>

These are used to enter data and instructions into the computer for the CPU to process e.g. keyboard and mouse.

ii) **The Central processing Unit (CPU)**

It is the brain and the heart of the computer. Its function is to carry out all operations and it also stores information. It contains the primary memory of the computer

iii) **Output devices**

These are used to communicate and record information after it has been processed in the CPU. Output devices include the visual display unit (VDU) also known as the monitor or screen which looks like a television set and provides output in the form of screen displays. The printer is another output device which gives a hard copy of results produced by the computer in the form of print-outs.

19.5 Computer Software

This is a set of programs which enable us to use the computer hardware by controlling the functionality of the computer. These programs are loaded into the CPU so that data can be processed. In accounting, software programs include those that are designed to enter invoices into debtors accounts, prepare payrolls i.e. wages and salaries prepare final accounts maintain stock records etc. Appropriate and relevant data must be input into the system so that appropriate output is derived otherwise if misleading data is recorded the output will also be misleading. A computer does not have an independent brain of its own. Its brain function depends on what is fed into the system thus care must be taken in data input so that reliable outcomes are achieved. A computer system uses two kinds of software, namely systems software and application software.

19.6 Operating systems/Systems software

An operating system also known as the system software is a program that controls the hardware directly, such as the memory and control devices such as printers. Without an operating system, a computer would be useless.

19.7 Applications software

This software is used to perform specific tasks. In accounting applications packages include the use of spreadsheet software such as Excel and software used for entering, invoices in debtors accounts, preparing a payroll, stock control etc.

19.8 Computerised Data Processing

Putting information into a structure in which it can be processed by the computer is called data capture. This is commonly done using the keyboard but other methods such as Magnetic ink character recognition (Mick), optical mark reading (OMR), barcode readers and optical character recognition (OCR) are used. For accounting purposes, mainly the keyboard is used. You need not worry much about the other methods of data capture at this level.

Once data is captured, it is collected in a record called a data file such as the data file for the purchases ledger which will contain the individual records of each creditor, showing the personal details such as the name address ,account number,terms of payment, balance outstanding etc. The data file is then stored either on the machine or on a memory stick or a disc, and it can then be accessed using computer applications software.

19.9 Uses of Computers in Accounting

Application of computer fall into two main categories

i) Financial accounting
ii) Management accounting

Financial Accounting

Computers and electronic data processing can be used to replace monotonous aspects of a book-keeper's job by cutting down on the amount of labour needed in manual data capture right up to the compilation of final accounts. Computers can be used with the appropriate packages, to write up the books of account with less effort and time. With a full system of computerized accounting which rates from originating source documents write up to the extraction of a trial balance a business can then be provided with an Statement of comprehensive income and a statement of financial position as frequently as required by simply using commands to perform the necessary tasks.

Management Accounting

Computerized accounting is very useful in the area of analysis and decision making. A properly run organization which is efficient desires to have up-to-date information being readily available. For decisions to be done efficient variances for instance, need to be reported timeously. In addition more specialized programs can be used to aid decision- making Computers can be used to generate frequent variance reports, to enable management to act upon adverse variances quickly and possibly averse adverse results. A spreadsheet is quite useful in managerial accounting. A spreadsheet is simply a large area of row and columns which make up a grid of cells, into which text numbers or formula may be placed via the keyboard A spreadsheet enables arithmetical and statistical operations to be performed on the contents of the cells. Managers commonly use spreadsheets for budgeting forecasting and statistical analysis of results. Spreadsheets are windy renowned for what if calculations that is sensitivity analysis this their biggest advantage i.e. if the sales price is reduced by 10% what is the effect on the budgeted profit. Charts can also be printed as a result of using spreadsheet giving a graphical view of outcomes to be included in management reports. Spreadsheet applications include functional budgets master budgets cash flow charts, capital expenditure appraisal stock, records CVP analysis etc.

19.10 Advantages of using a computerised Accounting system

1. Data is processed at a very high speed as compared to manual methods.
2. Huge volumes of data can be processed by a single computer manned by one person where several accounts clerks would be used if manual methods are employed.
3. Computers are extremely accurate and do not create errors of their own. Errors are a result of human/ use error.
4. Computers enable the compilation of financial and statistical information easy, which would be time-consuming expensive and tedious if manual methods are used
5. They make management by exception easy to implement by reporting on items which deviate from agreed standards of acceptability.

19.11 Disadvantages of using computers in accounting

1. The cost of acquiring computer systems and their installation is quite high at first
2. Training of staff in the use of computers and the software is expensive
3. As computers do not think independently of their users, an error in inputting data produces faculty unreliable results.
4. If a need arises to change a computer system, the costs are very high.

19.12 Examination type Questions

1. Define hardware and software in a computer system giving two examples of each.
2. What is exception reporting? State what accounting systems are available to enable management by exception.

3a) A small business wishes to convert its manual accounting system to a computerized accounting system. Write a brief report to the owners of the business, identifying the advantages that a computerized system would bring to the accounting functions of the business and distinguish between

i) The clerical aspects of accounting
ii) The management accounting function
iii) State three limitations of a computerized accounting system

Suggested Solutions

1. Hardware- the physical part of the computer system, e.g. keyboard, VDUs, processing unit printers etc.
2. Software-programs or set of instructions given to the computer telling it what operations to perform and how to perform them.

Example of hardware

i) Keyboard to input accounting data such as credit sales transactions
ii) VDU to display of debtors' analysis by region.

Examples of software

i) Payroll program to calculate wages and produce pay slips
ii) Sales ledger program to produce invoices and statement

2. This is whereby a report on activities which deviate adversely from the budget is compiled and management focuses its attention on those variances for corrective action to be taken.

- The use of spreadsheets enables management by exception through the use of applications such as CVP analysis, cash flow, charts records etc.

3. **Report: Computerised Accounting System**

Clerical Accounting-Advantages

A computerised accounting system enables clerical staff to become more involved in their tasks as their focus shifts from just a single aspect of the job e.g. sales clerk to a whole task approach as the computer does the bulk of the work. Likely, this will improve motivation. In addition, clerks will not have to spend a lot of time doing manual calculations as they are automatically done by the computer.

Advantages for management Accounting

Access to accounting information, with the advantage of production of exception reports becomes instant.

b) **Limitation of a computerised accounting system**

i) GIGO-garbage in, garbage out. A computer can only process data it is ed. If it is fed inaccurate data results are also inaccurate and therefore of no value in decision-making

ii) If a business operations charge significantly, it results in expensive modifications to software and at times additions to hardware

iii) A breakdown in the equipment which is not resolved timeously can leave management stranded, without information for decision-making

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