Course Name	: Financial & Management Accounting
Course Code	: BIRD 113
Course level	: Level 2
Credit Units	: 4 CU
Contact Hours	: 60 Hrs

Course Description

The Course explores different forms of Managerial accounting, and concepts, understanding and interpretation of financial statements, reading probability ratios, liquidity ratios, activity ratios, debt ratios, market ratios, fundamentals analysis, understanding business and book keeping as well as illustrating different cash balance sheets for business.

Course Objectives

- To help students recognize the importance of management accounting in several business transactions.
- To enhance the students' knowledge on preparation of financial statements for organizations.
- To help students get exposed to different forms of analyses this equips them with skills in interpreting different accounts.

Course Content

Introduction to Managerial Accounting

- Definition of Management accounting
- Contrast between financial accountancy and management accounting
- Aims of management accounting
- Traditional Vs Innovative management accounting practices
- Role of management accounting within the corporation
- An alternative view of management accounting

Specific Concepts

- Lean Accounting
- Resource Consumption Accounting
- Throughput Accounting
- Transfer pricing
- Resource and continuous learning

Financial Analysis

- Definition of Financial analysis
- Goals of financial analysis
- Methods of Financial analysis
- Financial ratios
- Sources of data for financial ratios
- Purpose and types of ratios
- Accounting methods and principles
- Abbreviations and terminology

Profitability ratios

- Gross margin
- Return on equity (ROE)
- Return on investment (ROI ratio0
- Return on assets (ROA)
- Risk adjusted return on capital (RAROC)
- Return on capital employed (ROCE)

Liquidity ratios

- Current ratio
- Acid-test ratio (Quick ratio)
- Operation cash flow ratio

Activity ratios (Efficiency ratios)

- Average collection period
- DSO ratio
- Average payment ratio
- Stock turn over
- Receivables turnover ratio
- Inventory conversion ratio
- Payables conversion period

Debt ratios (Leveraging ratios)

- Debt to equity ratio
- Long-term Debt to equity
- Times interest-earned ratio
- Debt service coverage ratio

Market ratios

- Earnings per share (EPS)
- Payout ratio
- Cash flow ratio
- Price to book value ratio
- PEG ratio

Fundamental analysis

- Description of fundamental analysis
- Objectives of fundamental analysis
- Analytical models of Fundamental analysis
- Different portfolio management styles

Business Valuation

- Definition of business valuation
- Standard and premise of value
- Elements of business valuation
- Normalization of financial statements
- Income, asset and market approaches
- Capital asset pricing model (CAPM)

Business

- Definition of a business
- Basic forms of ownership
- Classifications of businesses
- Factors that affect how a business is organized
- Factors to consider in deciding how to operate a business

Book keeping

- Definition of book keeping
- Who is a book keeper
- Book keeping systems ie single-entry system, double-entry system
- Petty cash books
- Ledgers
- Computerized book keeping

Debits and credits

- Description of debits and credits
- Origin of the terms debit and credit
- Principles of debit and credit
- Accounting methods of cost of goods sold,
- Comparison of cash method and Accrual method of accounting

Financial statements

- Definition of financial statements
- Four basic financial statements
- Purpose of financial statements
- Audit and legal implications
- Inclusion in annual reports

Balance sheet

- Definition of a balance sheet or statement of financial position
- Types of balance sheets
- Income statements
- Usefulness and limitations of income statements
- Items on income statement
- Cash flow statements
- Operating activities
- Inviting activities

Other related topics; equity (Finance), equity investments, shareholder's equity, market value of shares, statement of retained earnings, owner's equity statement

Mode of delivery, Face to face lectures

Assessment

Course work 40%

Exams 60%

Total Mark 100%

Introduction

Accounting:
It comprises two elements.

1. Recording of the transactions of a business to provide information of for the day-to-day management.
2. Summarising: the transactions of a period to provide information about the performance and position of a business to interested parties.

The principal statements being the balance sheet and the profit and loss account. The principle business forms are

- sole traders
- partnerships and
- companies or any body corporate.

Money input by the individual, partners or shareholders is capital.

Availability of accounting information:

Financial statements of sole traders and partnerships are completely private and any third parties get access with the consent of these owners. Such third parties may be bankers or insurance companies.
However, financial statements of any body corporate, public or private, can be published. Every shareholder is entitled to a copy, and they are lodged with the Registrar of Companies who maintains of file for each company, which is open to public inspection.

Groups who make use of financial reports primarily for decision making purposes:

Financial reports comprise the balance sheet, the profit and loss account and other types of financial and non-financial information. A classification of users into user groups with a summary of their needs could be as follows.

1. **Management:**
   - Interested in the analysis of revenues and expenses which will provide information which is useful when plans one formulated and decisions made.
   - Comparison of the budgeted and actual figures to get the variances, investigate these and decide on future action.
   - Know the cost consequences of a particular course of action to aid decision making.

2. **Shareholders and potential shareholders.**
   - To know the manner in which management has used their funds which have been invested in the business.
   - To know the future performance of the business and use past figures as a guide to the future decisions such as disinvesting.

3. **Employees and their trade union representatives**
   - To assess the potential performance of the business.
   - To know whether the company can offer them safe employment, and promotion through growth over a period of years.
   - To use past profits and potential profits in calculations and claims for higher wages or better conditions.
   - To assess the viability of the different divisions of a company.

4. **Lenders:**
   This includes existing lenders, short term creditors and potential lenders whose interests are as follows:
   - The security of their loan0 so they look at an accounting statement to ensure that the company will be able to repay on the due date and meet the interest requirements before that date.
   - The amount of cash available and the value of assets which form a security for the debt are of importance to this group.

5. **Government agencies:**
   - Use accounting information when collecting statistical information to reveal trends within the economy as a whole.

- To assess the profit on which the company's tax liability is to be computed.

6. **The business contact group:**
   - Customers and suppliers would want to assess the viability of a company if a long-term contract is soon to be placed.
   - Competitors will use accounts for comparisons.

7. **The public:**
   - Members of a local community who assess contribution by the business.
   - Environmental pressure groups who want to ensure that there is no pollution.

The users that refer to financial statements from time to time are:

a) **Shareholders and potential shareholders** who may want to assess on a continuing basis whether it is viable to hold their investment in the company or to make an investment in the company.

b) **Management:** who make decisions as stewards.

The groups who make use of financial accounting primarily for stewardship purposes:
Stewardship is the responsibility of management to act in the best interests of the owners in running the business. Employees, lenders, government agencies, customers and the public primarily use financial information for stewardship purposes. All these groups need to satisfy themselves that the business is being run on a sound basis.

The purpose of the main financial statements available to users:
Balance sheet: To record the assets owned by the business and the liabilities owed by the business at a particular point in time. It satisfies the stewardship needs of users rather than their decision making needs.

The profit and loss account:
Its primary purpose is to show the amount of profit or loss made in an accounting period. Generally a business exists to make profits for its owners who make decisions about the future direction of the business based on its current ability to make profits.

None-financial statements:
Company law and accounting standards require detailed notes to the profit and loss account and balance sheet. Two statements which accompany financial statements in a company's corporate report are:

a- A chairman's statement

b- A Directors Report.

A DIRECTORS REPORT:
The company's Act requires that it be included in the corporate report. Topics to be covered are

i) Principal activities together with any damages in those activities during the financial year.

ii) Business review being a review of the activities of the entity during the year and the position at the end of it.

iii) Post balance sheet events: being material events which have occurred since the balance sheet date but before the approval of financial statements by the board of directors.

iv) Future developments: if any should be indicated.

A Chairman's statement:
This is not required by law but is generally included in the report of quoted companies. Much of the general information about the business is contained in this statement. It provides an opportunity to the company, through the chairman to explain what has been happening to the business during the year and what the prospects are next year.

Conclusion:
A company's financial report contains:

- the financial statements: the balance sheet and the profit and loss account.
- Non-financial information : the chairman's statement and the director's report.

Whilst the financial statements give historical information, the non-financial information can provide users with an indication of the future plans for the company.

DESIRABLE QUALITIES OF ACCOUNTING INFORMATION:
Some criteria for identifying useful information for the users are:

1. Relevance:
The financial information should help the user to evaluate the financial performance of the business and to draw conclusions from it. Problem – to identify these needs, given the variety of users.

2. Understandability:
The information should be in a form understable by the user. It should be communicated in the way intended.
Problem – users have very different levels of financial sophistication. Business transactions may be very complex that is difficult to provide adequate disclosure whilst maintaining simplicity.

3. Reliability:
The information should be of a standard that can be relied upon by external users considering its nature ad source.
Problem – It is not possible to get information that is reliable in all cases i.e. reliability may be compromised.

4. Completeness:
Accounting statements should show necessary to give the user insight (the whole picture).
Problem: This may mean that the volume of the information is bulky.

5. Objectivity:
The accounting information should not be biased to the needs of one user. It should present facts to all and should not attempt to lead to any decisions.
Problem: Accounts are prepared by one user group; management. Though the external audit should remove any resultant bias, some authorities still question the effectiveness of the audit in this respect.

6. Timeliness:
Accounting information should be published early enough to enable the user take action on time.
Problem: quicker accounts mean more estimates and hence reduce reliability.

7. Comparability and consistency:
Accounts should be comparable with those of similar enterprises, from one period to the next.
Similarities and differences should be discerned and evaluated. This will result from consistent treatment and disclosure.
Problem: There are various acceptable accounting bases and each enterprise may adopt its own policies. Accounting standards have reduced but not eliminated this problem.

Characteristics that are not compatible:

a) Relevance and completeness:
If the financial statements show all aspects of the business there will be much information that is not relevant to the needs of individual users.

b) Reliability and timeliness:
If the financial statements are to be produced quickly they may not be totally reliable as there are many estimates.

c) Relevance and timeliness:
If financial statements are tailored to the needs of individual users they may take long to prepare.

d) Understandability and completeness:
If all aspects of the business are to be shown this may make the financial statements less comprehensible.

Conclusion:
It is impossible to fully satisfy all the desirable qualities in the preparation of financial statements due to their conflicting requirements and the diversity of users' needs.

THE USE OF THESE QUALITIES FOR DECISION MAKING AND STEWARDSHIP:

The investor's perspective:

Financial statements are prepared for the shareholders of a company so that they can see how well their company is performing for stewardship purposes and for making decisions such as whether to keep or sell their shares. The needs of most users will be satisfied by the information provided for investors.

Decision-making: when the information has the ability to influence the decisions of users, it has the quality of relevance. Users can predict what may happen to the company in future and will confirm the outcome of past predictions. To aid decision-making comparisons are made between companies. This is made possible by consistency application of accounting policies. Decisions also need to be made on time.
When investors are convinced that the investment is worthwhile, the lenders can decide whether to advance a loan, employees can decide whether a pay claim will be favourably treated and the public can decide whether the company will bring benefits on their region.

Stewardship:
Owners are able to tell whether or not the company is well-managed and decide on any necessary action. To determine company performance, they may compare with other companies considering the prevailing economic circumstances.

HISTORICAL COST ACCOUNTING: (HCA)

Historical cost is the original acquisition cost of an asset, unadjusted for any subsequent changes in price or value. The traditional approach to accounting is to record transactions at their original monetary cost. However, in periods in which prices change significantly, historical cost accounts do have deficiencies.

Advantages of historical cost accounting:
1. It is simple and cheap.
2. The profit concept is well understood.

   The transactions recorded are material, so that the income generated by the company is matched against the costs involved in getting that income.
3. The records are based on objectively verifiable amounts; their historical cost. When money is paid over, this money value will e recorded in the books of the business. The final accounts will reflect the transactions at historical cost.
4. Lack of competition – No acceptable alternative has been developed.
5. With limits, historical cost figures provide a basis for comparison with the results of other companies for the same period or similar periods, with the results of the same company for previous periods and with budgets.

Disadvantages of Historical Cost Accounting:
1. It overstates profits when prices are rising through inflation.
2. It maintains financial capital but does not maintain physical capital.
3. The balance sheet does not show value of the business. Fixed asset values are unrealistic.
4. It provides a poor basis for assessing performance. Comparisons over time are unrealistic.
5. It does not recognize the loss suffered through holding monetary assets while prices are rising. Inflationary periods, the purchasing power and thus the value of money falls. Therefore investments in money will have a lower real value at the end of a period of time than it did at the beginning.

THE PROBLEMS OF CHANGING PRICES:

Depreciation:
Under the HCA system the original cost is simply allocated over the estimated useful life of fixed assets. The charge through the profits and loss account results in funds being retained rather than distributed as dividends. When time for replacement is due, management must avail them in a sufficiently liquid form.
With inflation:

a- the charge to the profit and loss account based on original cost are measured against revenues stated in current terms. The profit figure is not meaningful as it ignores price changes which have taken place since the asset was purchased.

b- Although the concept of depreciation ensures that the capital of the business is maintained intact in money terms, it does not ensure that the capital of the business is maintained intact in real terms.

c- The depreciation provision at the end of the asset's useful life will fall short of its replacement cost.

Stock and cost of sales:
During a period of high inflation the monetary value of stocks held may increase significantly while they are being processed. The conventions of historical cost accounting lead to the realized part of this holding gain (known as stock appreciation) being included in profit for the year.

Example:
At the beginning of the year, a company has 100 units of stock and no other assets. Its trading accounts for the year is as follows:

The trading account:

	Units	£		Units	£
Opening stock	100	200	Sales (made 31 Dec.)	100	500
Purchase (made 31. December)	100	400			
	200	600			
Closing stock (FIFO basis)	100	400			
	100	200			
Gross profit	-	300			
	100	500		100	500

Apparently the company made a gross profit of £300, but at the beginning of the year the company owned 100 units of stock and at the end of the year it owned 100 units of stock and £100 (sales £500 purchases £400). From this it would seem that a profit of £100 is more reasonable. The remaining £200 is stock appreciation arising as the purchase price increased from £2 to £4.

Comparability of data over time
There will be an exaggeration of growth. For example, if a company's profit in 1991 was £100,000 and in 1999 £500,000, a shareholder's initial reaction might be that the company has done rather well. If, however, it was then realized that with £100,000 in 1991 he could buy exactly the same goods as with £590,000 In 1991, the apparent growth would seem less impressive.

Systems of accounting for price changes
They fall into one of three categories as follows:
a- General price changes and in particular, current purchasing power (CPP).
b- Current value bases. The basic principles of all these are:
   i) to show balance sheet items at some form of current value rather than historical cost.
   ii) To compute profits by matching the current value of costs at the date of consumption against revenue.
   The current value of an item will normally be based on replacement cost, net realizable value or economic value.
c- A combination of these two systems:

Why modified historical cost accounting is still used:
1. Resistance to change in the conservative accounting profession.
2. Modified HCA are easy to prepare, easy to read and easy to understand. While they do not reflect current values, the revaluation of fixed assets in seen as one of the most important items requiring such as adjustment, and therefore the value of the accounts is improved enormously by such revaluations taking place.
3. In periods of low inflation, historical cost accounts are seen as a reasonable reflection on the reality of the given situation.

4. The ASB's recent discussion paper on valuation proposed to carry on with modified HCA, but the intention was stated to clear up some of the anomalies in the current system.

SPECIFIC AND GENERAL PRICE CHANGES:

A- Specific price inflation measures price changes over time for a specific asset or group of assets.
b- General price inflation is the average rate of inflation, which reduces the general purchasing power of money.

HOW THE SHORT COMINGS OF HCA MIGHT BE OVERCOME:

Alternatives to historical cost accounting:

Current purchasing power:

CPP involves adjusting the historical cost accounts using a general price index (the retail price index) so that all items are expressed in £s of year-end purchasing power.

Advantages:

a) The restatement of asset values in terms of a stable money value provides a more meaningful basis of comparison with other companies.
b) Profit is measured in "real" terms and excludes "inflationary" value increments. This enables better forecasts of future prospects to be made.
c) CPP avoids the subjective valuations of current value accounting, because a single price index is applied to all non-monetary assets.
d) CPP provides a stable monetary unit with which to value profit and capital, £c.
e) Since it is based on historical cost accounting, raw data is easily verified, and measurements of value can be readily audited.

Disadvantages of CPP:

1. Generalised purchasing power has no relevance to any person or entity because no such thing exists in reality, except as a statistician's computation.
2. The use of indices inevitably involves approximations in the measurements of value.
3. The value of assets in a CPP balance sheet has less meaning than a current value balance sheet. It cannot be supposed that the CPP value of net assets reflects:
   i) the general goods and services that could be bought if the assets were released; nor
   ii) the consumption of general goods and services that would have to be foregone to replace those assets.

The advantages of current cost accounting:

a) By excluding holding gains from profit, CCA can be used to indicate whether the dividends paid to shareholders will reduce the operating capability of the business.

b) Assets are valued after management has considered the opportunity cost of holding them, and the expected benefits from their future use. CCA is therefore a useful guide for management in deciding whether to hold or sell assets.

c) It is relevant to the needs of information users in;
   i) Assessing the stability of the business entity.
   ii) Assessing the vulnerability of the business (perhaps to a take over), or the liquidity of the business, although it is not as accurate in this respect as current exit value accounting.
   iii) Evaluating the performance of management in maintaining and increasing business substance.
   iv) Judging future prospects.

d) It can be implemented fairly easily in practice by making simple adjustments to the HCA profits. CC balance sheet can also be prepared with reasonable simplicity.

Disadvantages

1. It is impossible to make valuations of EU or NRU without subjective judgements. The measurements used are therefore not objective.

2. The mixed value approach to valuation means that some assets will be valued at replacement cost, but others will be valued at net realizable value or economic value.

3. CCA aims to maintain no more and no less than the facilities that are available at the accounting date….. despite the fact that the fixed assets which provide those facilities might never be replaced in their existing or currently available form ….. in simple language, this meaning changing depreciation on the basis of the current replacement cost of the assets at the time the facilities are used.

FRS1 CASH FLOW STATEMENTS

It has been argued that "profit" does not always give a useful or meaningful picture of a company's operations:

- Shareholders might believe that if a company makes a profit after tax of, say, $100,000 then this is the amount, which it could afford to pay as a dividend. Unless the company has **sufficient cash** available to stay in business and also to pay a dividend, the shareholders' expectations would be wrong.
- Employees might believe that if a company makes profits, it can afford to pay higher wages next year. The ability to pay wages depends on the availability of cash.
- Survival of a business entity depends not so much on profits as on its ability to pay its debts when they fall due.

A cash flow statement provides information which is additional to that provided in the rest of the accounts. It also describes the cash flows of an organization by activity and not by balance sheet classification.
FRS 1 sets out the structure of a cash flow statement and it also sets the minimum level of disclosure.

Objective of the FRS:

To ensure that reporting entities falling within its scope:

a) report their cash generation and cash absorption for a period by highlighting the significant components of cash flow in a way that facilities comparison of the cash flow performance of different businesses; and

b) Provide information that assists in the assessment of their liquidity, solvency and financial adaptability.

Scope:

The FRS applies to all financial statements intended to give a time and fair view of the financial position and profit or loss (or income and expenditure), except those of various exempt bodies in group accounts situations or where the content of the financial statements is governed by other statutes or regulatory regimes.

Format of the cash flow statement: (single company).

The cash flow statement should list its cash flows for the period classified under the following standard headings:

a) Operating activities (using either the direct or indirect method).
b) Returns on investments and servicing of finance.
c) Taxation.
d) Capital expenditure and financial investment.
e) Acquisitions and disposals.
f) Equity dividends paid.
g) Management of liquid resources.
h) Financing.

Individual categories of inflows and outflows under the standard headings should be disclosed separately either in the cash flow statements or in a note to it unless they are allowed to be shown net.

Links to other primary statements:

Because the information given by a cash flow statement is best appreciated in the context of the information given by the other primary statements, the FRS requires two reconciliation's, between:

a) operating profit and net cash flow from operating activities; and

b) the movement in cash in the period and the movement in net debt.

Neither reconciliation forms part of the cash flow statement but each may be given either adjoining the statement or in a separate note.

Movement in net debt
Should identify the following components and reconcile these to the opening and closing balance sheet amount;
a) The cash flows of the entity
b) Other non-cash changes
c) The recognition of changes in market value and exchange rate movements.

Important definitions included in the FRS:

a) An active market:
Is a market o sufficient depth to absorb the investment held without a significant effect on the price.

b) Cash
Is the cash in hand and deposits payable on demand with any qualifying financial institution, less overdrafts from any qualifying financial institution repayable on demand. Deposits are payable on demand, if they can be withdrawn at any time without notice and without penalty or if a maturity or period of notice of not more than 24 hours or one working day has been agreed. Cash also includes deposits denominated in foreign currencies.

c) Cash flow: is an increase or decrease in an amount of cash.

d) Liquid resources:
Are current asset investments held as readily disposable stores of value. A readily disposable investment is one that:
   i) is disposable by the reporting entity without curtailing or disrupting its business; and
   ii) is either
      1. Readily convertible into known amounts of cash at or close to its carrying amount, or
      2. traded in an active market.

e) Net debt:
is the borrowings of the reporting entity less cash and liquid resources. Where cash and liquid resources exceed the borrowing of the entity reference should be to "net funds" rather than to "net debt".

f) Overdraft:
is a borrowing facility repayable on demand that is used by drawing on a current account with a qualifying financial institution.

Classification of cash flows by standard headings:

1. **Operating activities.**
Cash flows from operating activities are in general the cash effects of transactions and other events relating to operating or trading activities, normally shown in the profit and loss account in aiming at operating items relating to provisions, whether or not the provisions was included in operating profit.

If the reconciliation between the operating profit in the profit and loss account and the net cash flows from operating activities is adjoining the cash flow statement, it should be clearly labeled and kept separate. The reconciliation should disclose separately the movement in stocks, debtors and creditors related to operating activities.

2. **Returns on investment and servicing of finance:**
These are receipts resulting from the ownership of an investment and payments to providers of finance and non-equity share holders. (e.g. the holders of preference shares).
   - Cash flows from returns on investment and servicing of finance include:
      a) Interest received and interest paid (even if capitalized) including any relevant tax recovered or paid.
      b) Dividends received (net of any tax credits) and dividends paid on non-equity shares of the entity.
      c) Finance costs i.e. issue costs on debt and non-equity share capital.
      d) The interest element of finance lease rental payment.

3. **Taxation:**

These are cash flows to or from taxation authorities in respect of the reporting entity's revenue and capital profits. Cash receipts of tax rebates, claims or returns of over payments are included as well as cash payments of tax.

4. **Capital expenditure and financial investment:**
   These are cash flows related to the acquisition or disposal of any fixed assets (intangible, tangible and investments). If no cash flows relating to financial investment fall to be included under this heading, the caption may be reduced to "capital expenditure". Cash flows here include:
   a) Receipts from sales or disposals of property, plant or equipment and payments to acquire property, plant or equipments.
   b) Receipts from realization of a fixed asset investment or payments made as investments in other entities.
   c) Acquisition or realization of an intangible asset.

5. **Acquisitions and disposals:**
   These are cash flows related to the acquisition or disposal of any trade or business, or of an investment in an entity that is either an associate, joint venture, or a subsidiary undertaking. Cash inflows are receipts from sales of trades or businesses while cash outflows are payments to acquire trades or businesses.

6. **Equity dividends paid:**
   The cash outflows are dividends paid on the reporting entity's equity shares, excluding any advance corporation tax.

7. **Management of liquid resources:**
   Each entity should explain what it includes as liquid resources and any changes in its policy. The cash flows in this section can be shown in a single section with those under financing provided that separate subtotals for each are given. They include:
   a) withdraws from or payments into short-term deposits not qualifying as cash; and
   b) inflows or outflows from disposal or redemption of any other investments held as liquid resources.

8. **Financing:**
   Financing cash flows comprise receipts or payments of principal from or to external providers of finance. They include:
   a) Receipts from issuing shares or other equity instruments.
   b) Receipts from issuing debentures, loans and from other long-term borrowings.
   c) Repayments of amounts borrowed
   d) The capital element of finance lease rental payment.
   e) Payment to reacquire or redeem the entity's shares.
   f) Payments of expenses or commission on any issue of equity shares.

Interpretation of cash flow statements:
Some of the main areas where FRS 1 should provide information not found else where in the accounts are as follows:

1. The relationships between profit and cash can be seen clearly and analysed accordingly.
2. Management of liquid resources is highlighted, giving a better picture of the liquidity of the company.
3. Financing inflows are shown rather than simply passed through reserves.

Important:
It is wrong to try to assess the health or predict the death of a reporting entity solely on the basis of a single indicator. When a analyzing cash flow data, the comparison should not just be between cash flows and profit, but also between cash flows over a period of time (say 3-5 years).

- Profit is smoothed out through accruals, prepayments, provisions and other accounting conventions and this does not apply to cash.

- Healthy companies do not always have reported profits exceeding operating cash flows, and unhealthy companies can have operating cash flows well in excess of reported profit. The value of company profit and cash flows is to determine the extent to which earned profits are being converted into the necessary cash flows.

The extent to which a company can convert its profits into cash on a continuing basis should be judged over a longer period than one year.

- Cash flow figures should also be considered in terms of their specific relationships with each other over time. A form of "cash flow gearing" can be determined by comparing operating cash flows and financing cash flows, particularly borrowing, to establish the extent of dependence of the reporting entity on external funding.

Other relationships:

a) operating cash flows and investment flows can be related to match cash recovery from
b) Investment can be compared to distribution to indicate the proportion of total cash outflow designated specifically to investor return and reinstatement.

The "ratios" mentioned above can be monitored inter – and intra – firm and the analyses can be undertaken in monetary, general price-level adjusted, or percentage terms.

The advantages of cash flow accounting:

1. Survival in business depends on the ability to generate cash. Cash flow accounting directs attention towards this critical issue.
2. Cash flow is more comprehensive than profit which is dependent on accounting conventions and concepts.
3. Creditors are more interested in an entity's ability to repay them than in its profitability. Whereas "profits" might indicate that cash is likely to be available, cash flow accounting is more direct with its message.
4. Cash flow reporting provides a better means of comparing the results of different companies than traditional profit reporting.
5. Cash flow reporting satisfies the needs of all users better.
   i) For management, it provides the sort of information on which decisions should be taken – "relevant costs" to a decision are future cash flows. Traditional profit accounting does not help with decision-making.
   ii) For shareholders and auditors, cash flow accounting can provide a satisfactory basis for stewardship accounting.
   iii) The information needs of creditors and employees will be better served by cash flow accounting.
6. Cash flow forecasts are easier to prepare, as well as more useful, than profit forecasts.
7. They can in some respects be audited more easily than accounts based on the accruals concept.

Example:

KANE LTD

Profit and loss account for the year ended 31.12.x2

		£'000		£'000
Sales				720
Raw material consumed	70			
Staff costs		94		
Depreciation		118		
Loss of disposal	18			
				300
Operating profit			420	
Interest payable			28	
Profit before tax				392

Taxation		124
		268
Dividends		72
Retained profit for year	196	
Balance brought forward		490
Balance carried forward	686	

KANE LTD BALANCE SHEET AS AT 31.12 X2

	X2		X1	
Fixed assets:	£'000	£'000	£'000	£'000
Cost		1596		1560
Depreciation		318		224
		1278		1336
Current assets:				
Stock	24		20	
Trade debtors	66		50	
Prepayments	10		8	
Bank	48		56	
	148		134	
Current liabilities:				
Trade creditors	12		6	
Taxation	102		86	
Proposed dividend	30		24	
	144		116	
Net current assets		4		18
Total assets less current liabilities		1282		1354
Long-term liabilities				
Loans		200		500
		1082		854
Share capital		360		340
Share premium		36		24
Profit and loss		686		490
		1082		854

During the year, the company paid £90,000 for a new piece of machinery.

Required:
Prepare a cash flow statement for Kane Ltd for the year ended 31.12.x2 in accordance with the requirements of FRS 1 (Revised).

Solution
Steps

1. Set out the proforma cash flow statement with all the headings required, leaving plenty of space, for the main statement, for notes to the cash flow statement and workings.

2. Complete the reconciliation of operating profit to net cash in flows as far as possible.
3. Calculate the figures for tax paid, dividends paid, purchase of fixed assets, issue of shares, repayments of loans, if not given – from their individual accounts.
4. If you are not given the profit figure, work it out using the opening and closing balances on the balance sheets and incorporating the taxation charge, dividends proposed and paid and transfers to reserves of the current period and working backwards.
5. Complete note one after calculating the depreciation charge and the charge to provisions of current year.

Workings:

Fixed assets account

	£'000		£'000
Balance b/d	1560	Balance c/d	1596
Bank	***90***	Disposal a/c	54
	1650		1650
Balance b/d	1596		

Fixed assets disposal a/c

	£'000		£'000
Fixed assets a/c	54	Bank	12
		Profit and loss	18
		Depreciation	24
	54		54

Fixed assets depreciation a/c

	£'000		£'000
Balance c/d	318	Balance b/d	224
Disposal	24	P/L a/C	118
	342		342
		Balance b/d	318

Taxation payable a/c

	£'000		£'000
Balance c/d	102	Balance b/d	86
Bank	108	P/L a/c	124
	210		210
		Balance c/d	102

Dividends payable account

	£'000		£'000
Balance c/d	30	Balance b/d	24
Bank	66	Profit and loss a/c	72
	96		96
		Balance c/d	66

Loan account

	£'000		£'000
Balance c/d	200	Balance b/d	500
Bank	300		
	500		500

Share capital account

	£'000		£'000
Balance c/d	360	Balance b/d	340
		Bank	***20***
	360		360
		Balance b/d	360

	£'000		£'000
Balance c/d	36	Balance b/d	24
		Bank	12
	36		36
		Balance c/d	36

Reconciliation of operating profit to net cash flows from operating activities.

	£'000
Operating profit	420
Depreciation	118
Loss on sale of tangible fixed assets	18
Increase in stocks	(4)
Increase in debtors	(16)
Increase in prepayments	(2)
Increase in creditors	6
Net cash inflow from operating activities	540

KANE LTD'S CASH FLOW STATEMENT FOR YEAR ENDED 31.12.X2

	£'000	£'000
Net cash flow from operating activities		540
Returns on investments and servicing of finance:		
Interest paid		(28)
Taxation paid		(108)
Capital expenditure		
Payments to acquire tangible fixed assets	(90)	
Receipts from disposal of tangible fixed assets	12	
Net cash outflow from capital expenditure		(78)
		326
Equity dividends paid		(66)
Financing:		
Issue of share capital at a premium	32	
Repayment of long-term loan	(300)	
Net cash outflow from financing		(268)
Decrease in cash		(8)

Note 2. Analysis of net debt.

	At 1.1.x2	Cash flows	At
		£'000	31.12.x2
	£'000		£'000
Cash in hand, at bank	56	(8)	48
Debt due after 1 year	(500)	300	(200)
Total	444	292	152

Exercise:

1. Rene plc Balance sheet as at 31.12.x8

	X8		X7	
Fixed assets	£'000	£'000	£'000	£'00
Tangible assets		628		514
Current assets:				
Stocks	214		210	
Debtors	168		147	
Cash	7		-	
	389		357	
Current liabilities:				
Trade creditors	136		121	
Tax payable	39		28	
Dividends payable	18		16	
Overdraft	-		14	
	193		179	
Net current assets		196		178
Total assets less current liabilities		824		692
Long term liabilities:				
10% debentures		(80)		(50)
		744		642
Capital and reserves				
Ordinary share capital (£1 shares)		250		200
Share premium a/c		70		60
Revaluation reserve		110		100
Profit and loss a/c		314		282
		744		642

Rene plc profit and loss a/c for the year ended 31.12.x8

	£'000
Sales	600
Cost of sales	(319)
Gross profit	281
Other expenses (including depreciation of £42,000)	(194)
Profit before tax	87
Tax	(31)
Profit after tax	56
Dividends	(24)
Retained profit for the year	32

You are additionally informed that there have been no disposals of fixed assets during the year. New debentures were issued on 1 January 19x8. wages for the year amounted to £86,000.

Required:

Produce a cash flow statement using the direct method suitable for inclusion in the financial statements as per FRS 1.

TANGIBLE ASSETS ACQUISITION, DEPRECIATION AND DISPOSAL

Learning Outcomes for ATC(U)

- Record transactions using double entry booking system
- Classify/Categorise non-current assets
- Prepare ledger accounts for non-current assets
- Record depreciation and disposal of non-current assets

Definitions of Terms

Assets

The future economic benefit embodied in an economic resource. An economic resource is an asset if it has the potential to contribute directly or indirectly to the flow of cash and cash equivalents to the entity. The potential may be a productive one or mere convertibility into cash or cash equivalents, or capability to reduce cash outflows.

Cash

Comprises cash on hand and demand deposits

Cash Equivalent

Highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value.

Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, the amount attributable to that asset when initially recognized.

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

Useful Life is the period over which an asset is expected to be available for use by an entity; or the number of production or similar units expected to be obtained from the asset by an entity.

Depreciable Amount is the cost of an asset, or other amount substituted for cost, less its residual value.

Residual Value of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Property, Plant and Equipment are tangible items that are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes and are expected to be used for more than one financial reporting period.

Carrying Amount is the amount at which an asset is recognized after deducting any accumulated depreciation and accumulated impairment losses.

Fair Value is the amount for which an asset could bee exchanged between knowledgeable willing parties in an arm's length transaction.

ASSET ACQUISITION PROCESS

There should have been a need for the asset as approved in the original budget for the year, or any subsequent budget approval.

A Requisition Form is completed and approved by the Head of the Department/Unit or authorised officer.

Asset Identification

In general, assets are to be recognised and valued on an individual item basis. However, there will be instances where it is more appropriate to account for assets on a group basis, or account for material segments of an asset separately. These 'grouped assets' are generally accounted for as one asset.

Certain items that have values below the asset recognition threshold are, by their nature, susceptible to theft or loss. Such items, termed portable and attractive, may include personal computers, programmable calculators, cameras, power tools, ladders and like items.

The cost of the item being purchased

The cost of an item of property, plant and equipment shall be recognized as an asset if and only if;

(a) it is probable that future economic benefits will flow to the entity; and

(b) the cost of the item can be measured reliably.

These costs include costs incurred initially to acquire or construct an item of property plant and equipment and cost incurred subsequently to add to, replace part of or service it.

Initial Cost

To include item of property, plant and equipment acquired for safety reasons and not directly increasing the future economic benefits of any particular existing item of property, plant and equipment but is necessary for an entity to obtain future economic benefits from its other assets in excess of what could be derived had those items not been acquired.

To include the cost of its dismantlement, removal, or restoration, the obligation for which an entity incurs as a consequence of installing the item.

Subsequent Recognition

The cost of major replacement, repair and renovations are recognized in the carrying amount of the item of property plant and equipment.

In this case, any remaining carrying amount of the previous renovations or repairs (as distinct from physical parts) is derecognized.

Measurement at Recognition

An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost.

Elements of Cost

The cost of an item of property, plant and equipment comprises:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

(b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

(c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

The cost of a self constructed asset is determined using the same principles as for an acquired asset.

If an entity makes similar assets for sale in the normal course of business, the cost of the asset is the same as the cost of constructing an asset for sale (after eliminating any internal profits).

Examples of directly attributable costs are:

(a) costs of employee benefits arising directly from the construction or acquisition of the item of property, plant and equipment;

(b) costs of site preparation;

(c) initial delivery and handling costs;

(d) installation and assembly costs;

(e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and

(f) professional fees.

Examples of costs that are not costs of an item of property, plant and equipment are:

(a) costs of opening a new facility;

(b) costs of introducing a new product or service (including advertising and promotion);

(c) cost of conducting business in a new location or with a new class of customer (includes staff training costs)

(d) administration and other general overhead costs.

Recognition of costs of the carrying amount of an item of property, plant and equipment ceases when the item is in the location and condition necessary for it to be operating in the manner intended by management.

Measurement of Cost

The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date.

Trade-In (Asset Exchange Transactions). Where trade-in of an existing item is included in the acquisition of a new item, the Requisition form and purchase order must separately show details of the item being acquired and its cost, details of the item being traded in, the trade-in (fair) value and the net amount of the order. The non-monetary assets exchanged will be ignored if they lack commercial substance. If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

Example
Carrying amount of item A is Ushs 400,000=
Consideration for item B is as follows:

i) Pay a cheque of Ushs 900,000=
ii) The supplier of item B takes over item A

Therefore, the cost of item B is (400,000+900,000) = Ushs 1,300,000=

Measurement after Recognition

a) Cost Model

After recognition as an asset, an item of property, plant and equipment shall be carried at its cost less accumulated depreciation and any accumulated impairment losses.

b) Revaluation model

After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount being its fair value at the date of revaluation less any subsequent accumulated depreciation and subsequent impairment losses.

Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from the fair value determined at the end of the reporting period.

If there is no market-based evidence of fair value, an entity estimates fair value using an income or a depreciated replacement cost approach.

If an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued.

A class of property, plant and equipment is a grouping of assets of a similar nature and use in an entity's operation

Depreciation at the date of Revaluation

This is treated in one of the following ways:

i) Restated proportionately with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount.
ii) Eliminated against the gross carrying amount of the asset and the net amount restated to the revalued to the revalued amount of the asset.

Example

Property, Plant & Equipment Ushs
Cost as at 8 May 2009 50,000

Depreciation
Accum Depn as at 8 May 2009 30,000

Net Book Value
As at 8 May 2009 20,000

Revalued amount at 8 May 2009Ushs 40,000=

i) To Restate Depreciation:

Property, Plant & Equipment Ushs
Cost as at 8 May 2009 50,000

Depreciation

Accum Depn as at 8 May 2009	30,000	
Revaluation Surplus		(20,000)
Restated as at 8 May 2009		10,000

Net Book Value

As at 8 May 2009		40,000

ii) To Eliminate Depreciation

Property, Plant & Equipment	Ushs	
Cost as at 8 May 2009		50,000
Revaluation Surplus		20,000
As at 8 May 2009		70,000

Depreciation

Accum Depn as at 8 May 2009	30,000	

Net Book Value

As at 8 May 2009		40,000

Treatment for Changes in Asset Carrying Amount

1. If an asset's carrying amount is increased as a result of a revaluation, the increase shall be recognized in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the increase shall be recognized in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognized in profit and loss.

2. If an asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognized in profit or loss. However, the decrease shall be recognized in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognized in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.

Depreciation

Depreciation of an asset begins when it is available for use (ie when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.
Depreciation is recognised even if the fair value of the asset exceeds its carrying amount, as long as the asset's residual value does not exceed its carrying amount.
Depreciation of an asset ceases at the earlier of the date that the asset is classified as held for sale and the date that the asset is derecognized.

Depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated.

Depreciable amount = acquisition cost minus the residual value of the asset
The depreciable amount is allocated on a systematic basis over its useful life

Factors Considered in Determining Useful Life of an Asset:
The future economic benefits embodied in an asset are consumed by an entity principally through its use. However, other factors, such as technical or commercial obsolescence and wear and tear while an asset remains idle, often result in the diminution of the economics benefits that might have been obtained from the asset. Consequently, all the following factors are considered in determining the useful life of an asset:

(a) expected usage of the asset. Usage is assessed by reference to the asset's expected capacity or physical output.
(b) expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle.

(c) technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset.

(d) legal or similar limits on the use of the asset, such as the expiry dates of related leases.

The useful life of an asset is defined in terms of the asset's expected utility to the entity, therefore, the useful life may be shorter than its economic life.

Depreciation Method

The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

The depreciation method applied to an asset shall be reviewed at least at each financial year-end, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method shall be changed to reflect the changed pattern.

Straight Line depreciation

Assumes uniform consumption pattern of economic benefits

The depreciation expense:

$$\frac{\text{Depreciable amount}}{\text{Estimated useful life}} = \text{Depreciation expense}$$

Diminished balance method

Allocates a high proportion of expense to the early years of the asset's useful life

Depreciation expense is calculated as percentage of the asset value after deduction of previous years' accumulated depreciation ('the balance of the asset')

Depreciation rate can be mathematically derived, but will usually be approximated

Units of production method

Depletion method

Asset is expensed according to physical capacity usage referents

Estimates of resource capacity and utilization are critical

Components approach

Asset components with different useful lives or with different benefit consumption patterns should be recognised separately

Each component will follow proper depreciation rules

Subsequent expenditure to replace or renew an asset component will be treated as the acquisition of a new asset

Depreciation accounts

- Financial position accounts: the net value of the asset (carrying amount or book value of the asset) is preserved through two accounts:
  - Gross (acquisition) cost
  - Accumulated depreciation
- Comprehensive income statement account:
  - Depreciation expense of the current year
- Balances and details of these accounts are used in supplementary disclosures in the notes to the financial statements (ie Property, plant and Equipment/Non-Current Assets schedule).

Disposal or retirement of a non-current asset

- The carrying amount of an item of property, plant and equipment shall be derecognized:
  - On disposal, or
  - When future economic benefits are no longer expected
- Accounting effect of asset derecognition:
  - Net book value of asset is eliminated in the balance sheet
  - A gain or loss on disposal is recognised in the other comprehensive income
- Gain or loss on disposal = difference between the net disposal proceeds and the net book value of the asset at disposal date

- The revaluation surplus included in equity in respect of an item of property, plant and equipment retired or disposed of shall be transferred to retained earnings.

Disclosure

The financial statements shall disclose, for each class of property, plant and equipment:

(a) the measurement bases used for determining the gross carrying amount;

(b) the depreciation methods used;

(c) the useful lives or the depreciation rates used;

(d) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and

(e) A reconciliation of the carrying amount at the beginning and end of the period showing:

i) additions;
ii) assets classified as held for sale
iii) Increase or decrease resulting from revaluation and from impairment
iv) Depreciation method adopted and depreciation rates used or estimated useful life
v) Accumulated depreciation at the end of the period

Where items of property, plant and equipment are stated at revalued amounts, the following shall be disclosed;

(a) the effective date of the revaluation;

(b) whether an independent valuer was involved;

(c) methods and significant assumptions applied in the estimating the items' fair values;

(d) for each revalued class of property, plant and equipment, the carrying amount that would have been recognized had the assets been carried under the cost model; and

(e) the revaluation surplus indicating the change for the period.

Other disclosures relevant to users

(a) the carrying amount of temporarily idle property, plant and equipment;

(b) the gross carrying amount of any fully depreciated property, plant and equipmentthat is still in use;

(c) the carrying amount of property, plant and equipment retired from active use and not classified as held for sale ;

(d) when the cost model is used, the fair value of property, plant and equipment when this is materially different from the carrying amount;

Examples of disclosures

PROPERTIES, PLANT & EQUIPMENT	**Leasehold Land**	**Buildings**	**Equipment**	TOTAL
COST/VALUATION	**Ushs**	**Ushs**	**Ushs**	**Ushs**
As at 1/1/2008	481,035,982	330,000,000	498,000,000	2,309,035,982
Additions for the year	10,000	0	100,000,000	100,010,000
Disposals	(20,000)	0	(50,000,000)	(50,020,000)
Revaluation Surplus	300,000	0	0	300,000
As at 31/12/2008	481,345, 982	330,000,000	548,000,000	2,359,325,982
DEPRECIATION				
As at 1/1/2008	100,000,000	50,000,000	220,000,000	370,000,000
Charge for the year	20,000,000	10,000,000	30,000,000	60,000,000
Disposals	0	0	(50,000,000)	(50,000,000)
Revaluation Surplus	0	0	0	0
As at 31/12/2008	120,000,000	60,000,000	200,000,000	380,000,000
NET BOOK VALUE				
As at 31/12/2008	361,345,982	270,000,000	348,000,000	979,345,982
As at 31/12/2007	381,035,982	280,000,000	278,000,000	939,035,982

- Depreciation is calculated to write off the cost of Non- current Assets over their estimated useful lives using the reducing balance method, basing on the following rates:
  Leasehold Land and Buildings Leasehold period of 35 years.
  Equipment 12.5% reducing balance
- Etc.

INTERPRETATION OF ACCOUNTING INFORMATION

The business performance is measured to determine the financial soundness and growth rate of a company. For this purpose, the financial statements are analysed and interpreted. The analysis of financial statements indicates the strengths and weaknesses of a company and it also show the underlying trends in its activities. The statement of financial position shows the financial position of a concern at a particular date. The statement of income discloses the performance of a concern for a given period.

Analysis of financial statements
The process of critically examining in detail the accounting information given in the financial statements. It is largely a study of relationship among the various financial factors in a business as disclosed by a single set of statements and a study of the trend of these factors as shown in a series of statements.

Interpretation of financial statements
Means the drawing of inference and stating what the figures in the financial statements really mean. Interpretation is not possible without analysis and without interpretation, analysis has no value.

The main objectives of analysis of financial statements are to assess the following:-

i- The present and future earning capacity or profitability of the concern
ii- The operational efficiency of the concern as a whole and of its various parts or departments.
iii- The short-term and long-term solvency of the concern for the benefit of the debenture holders trade creditors
iv- The comparative study in regard to one firm with another firm or one department with another department.
v- The possibility of developments in the future by making forecasts and preparing budgets
vi- The financial stability of a business concern
vii- The long –term liquidity of its funds.

What information is particularly relevant to each user group?
The information needs of user group depends on the decisions made by that group. This can be summarised as below;-

User	**Required for;-**
Management	Control of costs, improved profits changes in assets and liabilities
Lender	Borrowing and credit purposes i.e liquidity and sound financial position of the company to determine ability of repayment.
Shareholders and investment	Investment decisions;- buying and selling shares analyst
Government and Inland Revenue	Statistics and taxation

FACTORS THAT NEED TO BE CONSIDERED

1- Markets in which the business operates. Growth opportunities i.e is it a new and expanding market or is there an expectation that market is contracting?
2- General economic conditions- When the economy is in a recession, it will be harder for a business to sell goods to the public at a profit
3- Size of the business in relation to competitors;- in some markets it is necessary to be large in order to benefit from economies of scale such as advertising branded products.

Caution

- When calculating ratios, calculate <u>only</u> those ratios that are relevant to the needs of the user.
- State the definitions used

- Some ratios can be calculated in alternative ways and therefore it is important to define the terms used.
- In the analysis of ratios consider the following;-
  - if a ratio has been computed over a number of time periods, does it show a worsening or an improving situation?
  - Can the ratio be compared on an objective standard? i.e can it be compared with an 'ideal' ratio?
  - Do all the ratios when taken together support the conclusions drawn from each individual ratio?

Comparisons

The information gathered by calculating ratios will allow comparisons with;-

1- The performance of the business in previous years
2- The budgeted or planned performance in the current year
3- The performance of similar businesses.

Emphasis

Accounting ratios are only a means to an end. By comparing relationships between figures, they merely highlight significant features or trends in the accounts. Ratios do not tell one what to do, but they do help to point one in the right direction therefore making it easier to make decisions.

Interpreting accounts lies in defining the reasons for the features and fluctuations disclosed and one should bear in mind the following;-

a- The date at which the accounts are drawn. The figures need to be up-to-date. Any seasonal variations should be taken into account
b- The accuracy of the position shown in the balance sheet, window dressing may be misleading ordering goods to be delivered just after the year end so that stocks and creditors can be kept as low as possible.
c- Interim accounts;- A clearer picture of the trends and fluctuations will emerge from these than form the annual financial statements.
d- Accounting ratios are based on accounting information and are, therefore, only as accurate as the underlying accounting information.
e- Accounting ratios of one company must be compared with those of another similar company in order to draw meaningful conclusions. These conclusions will only be so if that other company's trade is similar.

Principal techniques used in the analysis and interpretation of financial statements are;-

1- accounting ratios or ratio analysis
2- easy flow statements

Types of ratios

A ratio is an expression of one item in terms of another in a mathematical problem. The expression may be percentage, fraction or stated as a comparison between two things.

Accounting ratios can be classified into the following groups

1. Profitability ratios/return ratios
2. Revenue ratios
3. Liquidity ratios
4. Capital structure/gearing ratios
5. Coverage ratios or stability ratios
6. Activity ratios
7. Stock market ratios

Profitability ratios

This is considered as main indicator of a successful business. The real test of success or failure is to evaluate profits earnings capacity in relation to capital employed. The measure the ability of the business to convert sales into profits and earn profits on assets employed. They are expressed as a percentage. They are; -

1. Return on capital employed (ROCE)

Formula

$$\text{ROCE} = \frac{\text{Profits before interest and taxation}}{\text{Capital employed}} \times 100$$

Capital employed = Total share capital + reserves + loan capital

This can alternatively be expressed as;-

Capital employed = fixed assets + current assets - current liabilities.

Other variations

Capital employed may mean

1- fixed assets plus current assets (gross capital employed)
2- fixed assets plus current assets minus current liabilities (net-capital employed)
3- fixed assets plus current assets minus current liabilities and long-term liabilities (Shareholders capital employed/net worth).

Which particular convention to adopt depends on the purpose for which the return is being calculated. If it is to assess the earnings for the shareholders, the return on share capital and reserves would be most appropriate. In assessing the efficiency of an organisation, as a whole, the return on gross or net capital employed would be more appropriate.

2. Return on investment (ROI)

To measure the return on shareholder's investment, in the company, being their total share capital plus the reserves that they indirectly own.

i) $\text{ROI} = \dfrac{\text{Profits after tax}}{\text{Total share capital plus reserves}} \times 100$

ii) Return on owner's equity ratio (ROOE)

$\text{ROOE} = \dfrac{\text{Net profit after tax}}{\text{Owner's equity}} \times 100$

iii) Profit margin;-

$\dfrac{\text{Profit before interest and taxation}}{\text{Sales}} \times 100$

iv) Assets turnover

$\text{Assets turnover} = \dfrac{\text{sales}}{\text{Capital employed}} \times 100$

REVENUE RATIOS

These are obtained by comparing figures in the trading and profit and loss account with other revenue items

They measure the cost and profit structure of the company in relation to sales revenue. They are

a- Gross profit ratios

$\dfrac{\text{Gross profit}}{\text{Sales}} \times 100$

b- Net profit ratio;-

$\dfrac{\text{Net profit}}{\text{Sales}} \times 100$

c- Cost ratios

i) $\dfrac{\text{cost of sales}}{\text{sales}} \times 100$

ii) $\dfrac{\text{Selling and distribution expenses}}{\text{Sales}} \times 100$

iii) $\dfrac{\text{Administrative expenses}}{\text{sales}} \times 100$

LIQUIDITY RATIOS

They measure the ability of a company to meet its current liabilities as they fall due. These ratios help in ascertaining the effectiveness of the working capital management. If a company has insufficient current assets in relation to its current liabilities, it might be unable to meet its commitments and be forced into liquidation.

The important liquidity ratios are;-

a- Current ratio

It measures current assets against current liabilities

It is given by $\frac{\text{current assets}}{\text{Current liabilities}}$

The industry norm is 2:1

b- Quick or acid test ratio:

For purpose of raising quick cash, stock should not be regarded as a liquid asset. The ratio of 1:1 is usually considered ideal and satisfactory. It is given by $\frac{\text{current assets - stock}}{\text{Current liabilities}}$

Capital structure/Gearing ratio

This measures the contribution of financing by owners compared with the financing provided by the firm's creditors who include preference shareholders, debenture holders and other long-term creditors. The important ratios include;-

a- Debt – equity ratio;

Given by $\frac{\text{Total Debt}}{\text{Total owners equity}}$

OR

$\frac{\text{Fixed interest capital}}{\text{Total capital}}$ = capital gearing ratio

The larger the portion of funds provided by owners, the less risk is assumed by creditors.

Implications:-

- When a company is heavily in debt, banks and other potential lenders may be unwilling to advance further funds
- When a company is earning only a modest profit before interest and tax, and has a heavy debt burden

There will be very little profit left over for shareholders after the interest charges have been paid. And so if interest rates were to go up, or the company were to borrow even move, it might soon be incurring interest charges in excess of PBIT. This might eventually lead to the liquidation of the company. There is no absolute guide to the maximum safe debt ratio, but so a very general guide, you might regard 50% as a safe limit to debt.

Coverage ratios/stability ratios

Claims on the profits from operations include
- interest on loans
- preference dividend
- repayment of loans
- redemption of preference shares on maturity

The stability or soundness of a company lies in its ability to service the claims of long-term creditors.

a- Interest coverage ratio;-

This measures how may times a company could pay its interest expenses. It shows whether a company is earning enough profits before interest and tax to pay its interest costs comfortably, or whether its interest costs are high in relation to the size of its profits; so that a fall in PBIT would then have a significant effect on profits available for ordinary shareholders.

It is given by $\frac{\text{profits before interest and tax}}{\text{Interest charges}}$

Norm

An interest cover of 2 times or less would be low and should really exceed 3 times before the company's interest costs are to be considered within acceptable limits.

b- **Preference dividend coverage ratios**;-

Measures the ability of a firm to pay dividends on preference shares, which carry a fixed rate return. It is expressed as $\frac{\text{Net profit after tax}}{\text{Preference dividend}}$

It reveals the safety margin available to the preference shareholders. The higher the coverage, the better it is from the point of view of preference shareholders.

c- Total coverage ratio/fixed charge coverage;-

It takes into account all the fixed obligations of a company e.g interest on loan, preference dividend and the repayment off the principal .

It is expressed as $\frac{\text{Net profit before interest and taxation}}{\text{Total fixed charges}}$

The higher the coverage, the better the ability of the firm to discharge its outside liabilities.

Efficiency/activity ratios;-

They are also known as turnover ratios; they measure the efficiency of a firm in employing the available resources i.e. the ratios reflect the degree of effectiveness of asset utilization in the business activities. A rise in these ratios indicates that the company is expanding too quickly and a fall indicates the decline in efficiency. They include;-

a- Stock turnover ratio;

Measures how vigorously a business is trading. A lengthening stock turnover period indicates

- a slow down in trading; or
- a build up in stock levels (excessive investment in stocks)

It is expressed as $\frac{\text{Cost of sales}}{\text{Average stock}}$

Stock turnover period /stock days;

This indicates the average number of those items of stock are held for

It is expressed as $\frac{\text{average stock}}{\text{Cost of sales}} \times 366 \text{ days}$

b- Debtors payments period;-

Measures the average length of time it takes for a company's debtors to pay what they owe.

It is expressed as $\frac{\text{trade debtors}}{\text{Credit sales}} \times 366 \text{ days}$

This ratio depends on the particular trade or industry

c- Creditors ratio

Creditors are divided by credit purchases to give the average credit period for creditors.

Thus $\frac{\text{Creditors}}{\text{Purchases}} \times 366 \text{ days}$

d- Sales/fixed assets ratio

This ratio shows whether the trading value of a company is large enough to justify its investment in fixed assets.

It is given by

$$= \frac{\text{Sales}}{\text{Fixed asset}}$$

Total assets ratio;-

This ratio measures the overall performance and activity of the business organization. Sales/total assets give it.

STOCK MARKET RATIOS

These help investors choose specific investments; These ratios are concerned about market value of the securities. They are used to measure the return on investment and determine the future prospects. They are;-

1- Dividend per share (DPS)

The earnings distributed to ordinary shareholders divided by the number of ordinary shares. Thus

$$\frac{\text{Earnings distributed to shareholders}}{\text{Number of ordinary shares in issue}}$$

2. Dividend pay out ratio;

Dividends are expressed as a percentage of earnings per share. It shows an entity's retention policy. It is given as $\frac{\text{Dividends per share}}{\text{Earnings per share}} \times 100$

3. Earnings per shares (EPS)

This ratio shows total earnings per share attributes to ordinary shareholders. It shows the profitability of the firm. It is given by

$$\frac{\text{Net profit after tax and preference dividends}}{\text{Number of ordinary shares in issue and ranking for dividends}} \times 1000$$

E.P.S over years indicates the growth in the profitability of an entity

4- Price/earnings ratio (P/E)

This is the most important yardstick for assessing the relative worth of a share. It relates the market price of a share and earnings per share. It is given by $\frac{\text{market price per share}}{\text{Earnings per share}} \times 100$

If this ratio is low, it shows that a potential shareholder will get back his investment back in a relatively short period provided there are no retentions with a low P/E ratio, the market price of the shares raises.

5- Dividend yield

This indicates the return of shareholders in relation to the market value of the shares. This is then compared with returns on other investments.

It is given as $\frac{\text{Dividend per share}}{\text{Market price per share}} \times 100$

or

$$\frac{\text{Gross dividend on all shares}}{\text{Market price of all shares}} \times 100$$

6- Dividend cover;-

Also known as times covered is the number of times the actual dividend could be paid out of the current dividend. It is more than one if there are any retentions. It is given by;-

$$\frac{\text{Net profit after tax and preference dividend}}{\text{Ordinary dividend}}$$

Or

$$\frac{\text{Earnings per share}}{\text{Dividends per share}}$$

A high dividend cover is an assurance to shareholders that the return on their shareholdings is adequate.

7- Earnings yield

Earnings are expressed as a percentage to the market price of shares. The ratio is favourable when high

It is given by $\frac{\text{earnings per share}}{\text{Market price pars share}} \times 100$

Or

$$\frac{\text{Total earnings attributable to ordinary shareholders}}{\text{Total market price of shares issued.}} \times 100$$

INTERPREATION OF RATIOS

The analyst should have enough skills, insight and experience in the analysis and interpretation of financial statements. Other factors that should be considered are;-

- general economic condition of the firm
- risk acceptance
- future expectations
- future opportunities
- accounting system of the industry

Ratio are interpreted by comparing them with

- previous figures- trend analysis
- similar firms – inter-firm comparisons
- targets – individual ratio set to meet the objective

Advantages of ratio analysis

1. Guides management in formulating future financial planning and policies
2. It permits comparison of ht firms figure with data for similar firms, and possibly with industry-wise-data. And it permits the data to be measured against yard-sticks of performance or of sound financial conditions.
3. It ensures effective cost control
4. It measures profitability and solvency of a concern
5. It permits monetary figures of many digits to be condensed to tax or three digits which enhances the managerial investment decisions.

Limitations of ratio analysis

1. It lacks standard values for the ratio, therefore scientific analysis is not possible
2. It gives only the relationship between different variables and then actual magnitudes are not known through ratios.
3. Ratios are derived from the financial statements and naturally reflect their drawbacks
4. Seasonal factors can upset ratio analysis
5. The basis of asset valuation can be misleading
6. A set of accounts never shows a complete picture of a company's activities
7. Ratios vary enormously between different industries.

Qn. The directors of Hawk Ltd wish to compare the company's financial statements are given below.

Hawk Limited
Profit and loss accounts

	Year ended 31.3.99 £'000	Year ended 31.3.2000 £'000
Sales revenue (80% credit, 20% cash)	1,800	2,500
Cost of sales (see note)	(1,200)	(1,800)
Gross profit	600	700
Distribution costs	(160)	(250)
Administrative expenses	(200)	(200)
Operating profit	240	250
Interest payable	(50)	(50)
Profit before tax	190	200
Taxation	(44)	(46)
	146	154

Note: Cost of sales figure are made up as follows:

	Year ended 31.3.99 £'000	Year ended 31.3.2000 £'000
Opening stock	180	200
Purchases (all on credit)	1,220	1,960
	1,400	2,160
Less: closing stock	(200)	(360)
Cost of sales	1,200	1,800

Balance sheet As at

	31.3.99		31.3.2000	
	£'000	£'000	£'000	£'000
Fixed assets - cost	3,100		3,674	
Less: accumulated depreciation	1,214		1,422	
		1,886		2,252
Current assets				
Stock	200		360	

Trade debtors	400		750	
Bank balance	100		120	
	700		1,230	
Less: current liabilities:				
Trade creditors	(210)		(380)	
Sunday creditors	(260)		(430)	
Taxation	(48)		(50)	
	518		860	
Net current assets		182		370
Total assets less current liabilities		2,068		2,622
10% debentures		500		500
		1,568		2,122
Capital and reserves				
Issued ordinary share capital*	1,000		1,200	
Share premium a/c*	400		600	
Profit and loss a/c	168		322	
		1,568		2,122
		1,568		2,122

The additional share capital was issued on 1 April 1999.

Required:

a) Calculate for each of the two years, eight accounting ratios which should assist the directors in their comparison, using closing figures for balance sheet items needed.

b) Suggest possible reasons for the changes in the ratios between the two years.

QN. 2. A business associate has invited you to invest in Hester Ltd. He has watched the company steadily grow over the last three years and consider it a good investment. You have requested the following financial information so that you can draw your own conclusions.

Hester Ltd
Balances as at the end off

	1997	1998	1999
	£'000	£'000	£'000
Sales	1,000	1,250	1,500
Cost of sales	700	850	975
Gross profit	300	400	525
Distribution costs	55	75	100
Administrative expenses	100	200	300
Profit on ordinary activities before interest	145	125	125
Interest payable	10	15	30
Profit on ordinary activities before taxation	135	110	95
Taxation on profit on ordinary activities	30	25	25
Profit on ordinary activities after tax	105	85	70
Less: proposed dividends	50	35	35
	55	50	35
Debentures	100	150	300
Share capital:500,000 ordinary shares £1@	500	500	500
Share premium a/c	20	20	20
Profit and loss a/c	250	300	335
	870	970	1,155
Financial performance ratios:			
Gross profit percentage	30.0%	32.0%	35.0%
Operating profit percentage	14.5%	10.0%	8.3%
Return on capital employed	16.7%	12.9%	10.8%

Required:

a) Identify and comment on the key financial trends as indicated by the above information.

b) Calculate the following ratios for Hester Ltd for 1999 only and explain the purpose of the ratio.
   - i) Return on shareholders' capital
   - ii) Capital gearing ratio
   - iii) Earnings per share
   - iv) Dividend cover.

Qn. 3. Your company regularly publishes financial statements for its shareholders. However, the Director of Resources is aware that there may be other groups who are also interested in the company's financial statements.

Required:

You have been asked to prepare a memorandum for the Director of Resources which:

i) Outlines the objectives of producing financial statements.

ii) Identifies the main qualitative characteristics of financial information.

iii) Identifies five potential users of the company's financial statements and explains their specific information requirements.

THE REGULATORY FRAMEWORK.

Accounting standards are authoritative statements of how particular types of transactions and other events should be reflected in financial statements. There are many generally accepted methods of dealing with particular transactions and what is suitable for a given business may not be suitable for another. However, each enterprise should follow its accounting policies consistently.

Areas where variations in accounting practices are recognized:

- Depreciation of fixed assets
- Treatment of long-term contracts
- Research and development expenditure
- Hire purchase and Installment transactions
- Deferred taxation
- Stock and work-in-progress
- Translation of the accounts of foreign subsidiaries
- Consolidation policies.

Introduction of accounting standards:

ASC was set up in 1970 as a result of considerable criticism during the 1960's of the scope allowed for manipulation of published accounts by the variety of acceptable bases. From its formation the ASC attempted to build up a definitive body of rules to govern the presentation of published accounts.

Before a standard was introduced, it was first published by the ASC in the form of an Exposure Draft (ED). This was purely a discussion document. Once the discussion (exposure) period elapsed, the document, amended in the light of the results of that discussion, was issued in the form of a statement of standard Accounting practice (SSAP).
Such statements had binding effect immediately after the operative date (determined by the Consultative Committee of Accountancy Bodies (CCAB).

The Dearing Report:

In 1987 the CCAB appointed a committee under the chairmanship of Sir. Dearing to review and make recommendations on the standard setting process. The major points considered were:

a) The most appropriate form which accounting standards should take.

b) The status of standards in relation to company law.
c) procedures for the monitoring of compliance with standards and the enforcement of standards.
d) the need for, and nature of, public consultation about draft standards;
e) The funding of the cost of standard-setting; and
f) The appropriate composition and powers of any body responsible for standard-setting and the manner in which appointment to that body should be made, taking into account the interests of the users, preparers and auditors of accounts in the standard-setting process.

Summary of principal recommendations:

1. A Financial Reporting Council (FRC) should be created covering at high level a wide constituency of interests, whose chairman would be appointed jointly by the secretary of state and the governor of the Bank of England, to guide the standard setting body on work programmes and issues of public concern, to see that the work on accounting standards is properly financed; and to act as a powerful pro-active public influence for securing good accounting practice.

2. The task of devising accounting standards should be discharged by a newly constituted expert Accounting Standards Board (ASB) with a <u>full time chairman</u> and <u>Technical director</u>. Its total membership would not exceed 9. The Board would issue standards on its own authority. In the interests of clearly drawn standards avoiding compromise decisions, a majority o two thirds of the Board would suffice for approval of a standard Government would have observer status.

3. A Review Panel (FRRP) would be established to examine contentious departures from accounting standards by large companies. The review panel would be alerted to most cases for investigation by the results of the new CA 85 requirements, to give details of material departures from standards with reasons.

4. Accounting standards should be accompanied by a statement of the principles underlying them and of the reasons why alternatives were rejected.

5. The concern should be with increasing the quality and timeliness of accounting standards and reducing the permitted options and not with increasing their number.

6. On the basis of a cost-benefit test, the ASB should express a clear view on the extent to which an accounting standard, and provisions on disclosure, should apply to small companies.

7. Accounting standards should remain, as far as possible the responsibility of auditors, preparers and users of accounts and there should not be a general move towards incorporating them into law. But in discharge of its responsibility to facilitate the effective working of the systems of published financial reporting, government should introduce legislation along the following lines:

    i) In the case of all large companies, directors should be required to state in the notes to the annual accounts whether these are drawn in accordance with applicable accounting standards and to draw attention to any material departures.
    ii) There should be a new statutory power under civil law for certain authorized bodies or the secretary of state to apply to the courts for an order requiring the revision of accounts that do not give a true and fair view.
    iii) A small levy should be added to the annual fees paid by all companies to the Companies Registration Office to assist in meeting the cost of setting and monitoring standards.

APPLICATION IN THE CA 89:

Some of the proposals of the Dearing Report were implemented in the C.A. 89. In particular
i) There is power under the Act for grants to be made to the FRC.
ii) Accounts must now state that they have been prepared in accordance with applicable accounting standards. The secretary of state has power to introduce this requirement to different classes of companies, and it was introduced for plc's and large private companies.
iii) The secretary of state or other "authorized person" may apply to the courts to order the revision of defective accounts.

The role and structure of the ASB.

The current standard setting process came into effect in August 1990 and incorporates many of the recommendations of the Dearing Report.

1. The Financial Reporting Council (FRC).
   Comprises around 25 members drawn from the users and preparers of a/cs and auditors. Two bodies are under its jurisdiction – the ASB and the FRRP. FRC is responsible for guiding the ASB on its planned work programme.

2. The Accounting Standards Board (ASB)
   Issues accounting standards.

3. The Review Panel (FRRP).
   Chaired by a banister, is concerned with the examination and questioning of departures from accounting standards by large companies.

4. The Urgent Issue Task Force (UITF).
   Its function is to tackle urgent matters not covered by existing standards and for which, given the urgency, the normal standard-setting process would not be practicable.

The difference between the old and the new structure are:

a) FRC contains a much wider field of interested parties than the CCAB, which used to oversee the old ASC.

b) The ASB can issue standards on its own authority unlike the ASC.

c) Under the CA 89 the accounting standards issued by the ASB are recognized and directors of public companies are under a statutory duty to disclose whether there has been a material departure from accounting standards.
d) The Review panel has an ultimate legal backing to its review.

THE ASB – STATEMENT OF AIMS:

Issued in July 1991:

Aims:

To establish and improve standards of Financial Accounting and reporting, for the benefit of users, preparers, and auditors of financial information:

Achieving the aims:

The ASB intends to achieve its aims by

i) Developing principles to guide it in establishing standards and to provide a frame-work within which others can exercise judgement in resolving accounting issues.
ii) Issuing new accounting standards, or amending existing ones, in response to evolving business practices, new economic developments and deficiencies being identified in current practice.
iii) Addressing urgent issues promptly.

Fundamental guidelines:

ASB has the following guidelines in conducting its affairs:

1 To be objective and to ensure that the information resulting from the application of accounting standards faithfully represent the underlying commercial activity. Such information should be free

from bias (neutral) i.e. not influence users in a particular direction and should not be designed to favour any group of users or preparers.

2. To ensure that accounting standards are clearly expressed and supported by a reasoned analysis of the issues.

3. To determine what should be incorporated in accounting standards based on research, public consultation and careful deliberation about the usefulness of the resulting information.

4. To ensure that, through a process of regular communication, accounting standards are produced with due regard to International developments.

5. To ensure that there is consistency both from one accounting standard to another and between accounting standards and company law.

6. To issue accounting standards only when the expected benefits exceed the perceived costs.

7. To take account of the desire of the financial community for evolutionary rather than revolutionary change in the reporting process where this is consistent with the objectives. (aims).

The process leading to Financial Reporting Standards:

Once a topic has been identified, the ASB first commissions its own staff to undertake research in the area. A discussion paper will normally be issued to form a basis for discussing the issue involved. On the basis of the feedback received from the discussion paper, the ASB may proceed to issue a Financial Reporting Exposure Draft (FRED), which after further feedback will be developed into an FRS.

In order to avoid the confusion that might result from accounting standards having different sources of authority SSAPs are reviewed to ensure compatibility with the ASB's approach. Where SSAPs are updated, they are then issued by the ASB as FRS's.

INFLUENCE ON THE REGULATORY PROCESS:

1. Companies Act 1985

   Its influence is in two main respects.

   a) The financial statements of companies must follow prescribed formats and disclose certain information in the notes to the accounts.

   b) The accounts of public limited companies (plc's) and large private companies must state that they have been prepared with applicable accounting standards.

   The over riding requirement that financial statements show a true and fair view generally means that they must be prepared.

   - in accordance with generally accepted principles.
   - On a consistent basis.
   - So as not to be misleading.

   N.B. An accounting standard is therefore a declaration that, save in exceptional circumstances, accounts, which do not comply with the standard, will not give a true and fair view.

2. International Accounting Standards (IAS's)

   IASC come into existence in 1973 as a result of an agreement by the leading accounting bodies of several countries. Its objectives are to "formulate and publish, in the public interest, standards to be observed in the presentation of audited financial statements and to promote their world-wide acceptance and observance".

It is important to achieve harmonization because:

- It enables comparison to be made on international basis. This is particularly useful for overseas investors, suppliers and customers.
- It can help to resolve practical problems with overseas subsidiaries.
- It is useful for companies whose shares are traded internationally as it ensures that information on overseas competitors is available on a comparable basis; thus their results and position may be fairly assessed.
- Securities exchanges in some countries require foreign registered companies to reconcile their financial statements to the accounting and disclosure requirements of that country; this is a burden to the companies and an obstacle to International trading; and
- If UK standards follow International standards, then this enhances their credibility.

Forward to Accounting Standards:

In 1993 the ASB issued a forward to Accounting Standards, which states the attitude of the ASB to International Standards.
FRS's are formulated with due regard to International developments. The ASB supports the IASC in its aim to harmonize International financial reporting. As part o this support an FRS contains a section explaining how relates to the International Accounting standard (IAS) dealing with the same topic. In most cases, compliance with an FRS automatically ensures compliance with the relevant IAS.

3. European Union (EU) Directives

It is the aim of the EU that its member states will eventually become part of a single economic entity. To achieve this goal businesses must operate under the same legal and accounting requirements. The fourth Directive resulted in accounts formats and detailed disclosure requirements being contained in CA85.
The seventh Directive on group accounts has its provisions in CA89.

4. The stock exchange:

The purpose of The Listing Rules publication (yellow book) is to set out and explain requirements which apply to applicants for listing admission to the official list of stock exchange), the manner in which any proposed marketing of securities is to be conducted and the continuing obligations of issuers.
A most important condition for listing is acceptance of the continuing obligations, which apply following admission.
These obligations form the basis of the relationship between an issuer and the stock exchange, governing the disclosure of information necessary to protect investors and maintain an orderly market.

5. Generally Accepted Accounting Practice (GAAP):

GAAP is accounting practice which has substantial authoritative support amongst users of financial information.
Accounting standards will generally represent GAAP but there may be a GAAP which is not reflected in an accounting standard.
Accounting the boundaries of UK GAAP extend beyond the principles contained in accounting standards.
It includes the requirements of the CA, the stock Exchange and other acceptable accounting treatments not incorporated in legislation or quasi-legislation.

NON TRADING ORGANISATION OR NOT FOR PROFIT MAKING ORGANISATIONS.

They are organizations set up to provide certain services to their members or promote their members' cultural, social recreational, religion interests. They are called non-profit making because profit maximization is not their main objective. Such organizations include public hospitals, schools, social clubs, churches, charities like Kefa Sempangi's, Africa Foundation etc.

Non trading organisations differ from profit making under takings in nature due to the financial accounts prepared at the end of the year.

TERMS FOUND IN NON TRADING ORGANISATION

1. **Accumulated fund:**
   Trading organizations have capital invested in business to make profit, being the excess of Assets over liabilities. However, when assets of a non trading organisation exceeds the liabilities the difference is called the accumulated fund. It's treated in the same way as capital of trading organizations.

2. **Surplus:**
   Though the objective of such organizations is not to make profit, their income (got from donations fees, subscripts) may exceed their expenditure. The excess of income other expenditure is called surplus and is added to accumulated fund in the same way net profit is added to capital in the balance sheet.

3. **Deficit:**
   This is when expenditure exceeds income. It's deducted from accumulated fund in the same way net loss is deducted from capital.

4. **Legacies**: - are sums of money left to club of some one in his will.

5. Life subscriptions or life membership fees is a single large payment made by a person to become a life member of the club so that he need not pay any additional subscription in subsequent years.

ACCOUNTS OF NON TRADING ORGANISATIONS RECEIPTS AND PAYMENTS:

It's a summary of actual cash received (receipts) and cash paid during the period or a mere summary of the cash book for the period or the equipment of the cash or bank a/c of a trading organisation.

Receipts and payments a/c

Receipts		**Payments**	
Balance b/d	xx	**Payments**	**xx**
Receipts	xx	**Electricity**	**xx**
Entrance fees	xx	Purchase o a fixed asset	xx
Gate fees	xx	Rent	xx
Bar takings:		Stock purchases	xx
Sales of beer	xx	Wages	xx
Subscriptions	xx	Vehicle repairs	xx
Donations	xx	Bal c/d	xx
Life membership	xx		
Deposit account interest	xx		-----
	xx		xx

MAIN FEATURES OF THIS ACCOUNT

(I) **Items are treated in the same way the cash book;**
(ii) **The balance at the beginning at the end of the period represent the amount of cash in hand or at bank.**
(iii) **It deals with capital and revenue items.**
(iv) **It's used as a base for preparing the income and expenditure account.**
(v) **Income is debited and expenditure is credited.**

N.B: There is no distinction between capital and revenue expenditure and capital and revenue receipts. The fact that some of these receipts or payments may be meant for the previous period or following period is also immaterial e.g. subscription received in advance and rent for previous period. The balance in the receipts and payments at the end of the period represents cash in hand and at bank or overdraft. This balance appears in the balance sheet as a current asset (cash in hand and at bank) in liability in case of an overdraft. Receipts of non trading organizations are divided into two revenue receipts and capital receipts.

Revenue receipts:

- **Subscriptions from members.**
- **Interest from Investments in banks.**
- **Gross profit from Permanently run bars and restaurants.**
- **Donations (unless stated specifically stated that they are for a capital purpose).**
- **Proceeds from funding raising (unless specified capital expenditure e.g. building a swimming pool or building.**
- **Rent.**
- **Sale of tickets.**
- **Entrance fees.**
- **Membership fees.**
- **Sale of tennis balls.**

Capital receipts:

- **Proceeds from sale of fixed assets.**
- **Life membership fees or life subscription.**
- **Donations specified as capital expenditure.**
- **Fundraising for capital expenditure.**
- **Sale of tennis nets and tables.**
- **Large legacies and donations or bank Dr bank a/c Cr capital a/c.**

INCOME AND EXPENDITURE ACCOUNT

An income and expenditure account is simply the name that is given to what is effectively the profile and loss account of non trading organisation. Its preparation follows the principles of the profile and loss a/c.

FORMAT OF THE INCOME AND EXPENDITURE ACCOUNTS

F.T.C.
Income and expenditure account for the year ended 31 December 2002

	£	£
Income		
Subscriptions		**xx**
Entrance fees		**xx**
Bank interest		**xx**
Donations		**xx**
Bar profit		**xx**
Gate fees		**xx**
		xx
Expenditure		
Rent	**xx**	
Electricity	**xx**	
Vehicle repairs	**xx**	
Wages	**xx**	
Depreciation on motor vehicle	**xx**	
		(xx)
Surplus of income over expenditure for the year		**xx**

FEATURE OF THIS ACCOUNT

1 It's a summary of all items relating to income and expenditure on accruals basis.
2 It deals with only revenue item.
3 It does not deal with any capital item.
4 Income is credited while expenditure is debited.
5 The balance on this account represents surplus or deficit for the period which is added or subtracted from the accumulated fund in the balance sheet.
6 When income is earned from fundraising or social activity, discos, all associated expenses are set off and the net figures are taken to the income and expenditure e.g. the expenditure on socials are shown as a reduction from income of socials.

The income and expenditure account therefore records:

1. **Income that comes in the year and belonging to the year.**
2. **Debtors owing money which should have come into the organisation in the year (subscriptions owing).**
3. **Expenditure made in the year and relating to that year.**
4. **Creditors who should have been paid, for supplies and services actually enjoyed in the year. (accruing expenditure).**

While receipts and payments record:
1. **Receipts and payment: that do not relate to the year for which records are being committed.**
2. **receipts and payments which belong to the year but are capital nature.**
3. **receipts and payments of revenue nature which belong to the year.**

It's only number 3 above that will be recorded in the income and expenditure. On which your income due in the year under review but not yet received (debtors for subscriptions) and expenditure incurred but not yet paid for goods and services enjoyed in the period under review.

N.B. The balance is the same as for profit making organizations. But capital is referred to as Accumulated Fund or net profit (surplus).

SOURCES OF INCOME OF NON TRADING ORGANISATIONS:

We are going to base on hospitals, education institutions, religious institutions and charitable organizations as given below.

ACCOUNTS OF NON-PROFIT ORGANISATIONS

HOSPITALS, EDUCATIONAL INSTITUTIONS, RELIGIOUS INSTITUTIONS AND CHARITABLE ORGANISATIONS:

Accounts of Hospitals:

Hospitals also prepare receipts and payments a/c, income and expenditure a/c and balance sheet.

Items of income;

1 Room and bed rent

2 Food charges. (3) Medical care. (4) Operating room charge.(5). Delivery room charge. (6) Anesthesia charges (7) x-ray charges. (8) Laboratory charges

10 Physical therapy. (11) Dentistry income. (12) Donations in cash and value free items.

13 Contributed services of personnel who do not receive full salary.

14 Operating grants are income for current period where as grants for providing fixed assets are capitalized.

15 Fees from nurses getting training in the hospital.

16 Interest on investments

17 Subscriptions (if any).

18 Miscellaneous income.

Items of expenditure

-Salaries and wages -Diet expenses -Surgery and dispensary expenses
-Office expenses -Depreciation of fixed assets -Repairs and maintenance
-Laundry and linen expenses - Operation plant and x-ray plant expenses.
- Laboratory and pharmacy expenses. –Motor service expenses -Other expenses.

BOOKS

Columnar charges books, Purchases books and Cashbooks are prepared. A patient a/c is opened for each patient in the patient's a/c receivable ledger; thus:

Name …………………….. Indoor/outdoor………………… Admitted on …………….. Room/bed No……………..

Address………………….. Ward ………………………….. Discharged on ……………………

Patient's accounts receivable ledger

Date	Medical care Shs.	Operation charges	Delivery charges	Anesthesia charges Shs.	X-ray charges Shs.	Pharmacy charges Shs.	Lab charges Shs.	Other charges Shs.	Total Shs.	Concession Shs.	Amount Deposited Shs.	Balance	
												Dr Shs.	Cr Shs.

ACCOUNTS OF EDUCATIONAL INSTITUTIONS:

These may be
- Government Institutions
- Harambee Institutions
- Private Institutions.

The basic aim of an educational institution is not to earn profit but to spread education at a cheaper rate.

<u>Sources of income:</u>

1. Fees collected from students in form of admission fees, tuition fees, science fees, examination fees, registration fees, fines, etc.
2. Security deposits from students such as library security.
3. Donations from public.
4. Grants received from the government such as maintenance grant, equipment grant, building grant, etc.

A separate register should be maintained for each collection head e.g. admission fees, tuition fees, etc. A student's ledger must be maintained and an account of each student should be opened in this ledger to keep a record of the various types of fees due from him and amounts realized from him from time to time.

Fees due from a student should be debited to his account and fees received from him are credited to his account.

Fees concessions and irrecoverable fees should be sanctioned by the higher authority or managing committee and these should be noted in the accounts of students given concessions.
Periodical reconciliation's should be made for the fees which should have been collected from the students and fees which have been actually collected and fees outstanding should be ascertained.

The various types of payments:

a- Pay and allowances for teaching staff, office staff and other employees.
b- Provident fund contribution.
c- Books for library.
d- Newspapers and magazines
e- Medical Inspection
f- Examination expenses i.e. printing of question papers and supply of answer books.
g- Functions and festivals
h- Sports and games
i- Extra-curricular excursions and visits
j- Laboratory equipment
k- Audio-visual education
l- Furniture-purchases and repairs
m- Building repairs
n- Distribution of scholarships and stipends
o- Electricity and telephone charges
p- Purchase of stationery for office use
q- Other expenses.

The educational institutions prepare an income and expenditure account and balance sheet for each financial year to find out surplus or deficiency of each accounting year and financial position of their Institutions at the end of each accounting year.

RELIGIOUS INSTITUTIONS:

Established for the promotion and spread of a religion. These are several in Uganda for the various religious sects.

Items of income:

a- Subscriptions. b- Donations c- Grants. C- Contributed services of personnel.
e- Income from properties of religious Institutions.
f- Miscellaneous Income.

Items of expenditure:

a) salaries and wages. b) Books and magazines.
c) Travelling expenses c) Food expenses of religious students.
e) Other expenses.

These Institutions also prepare the Receipts and Payments account, Income and expenditure account and Balance sheet.

CHARITABLE ORGANISATIONS:

These are established to provide financial and material assistance to the poor and disabled persons. Examples are Rotary clubs, lions club, Action Aid Uganda, e.t.c.

Items of income:

a) Subscriptions from the members.
b) Donations.
c) Grants.
d) Investment income.
e) Income from charity shows and festivals
f) Contributed services of personnel
g) Miscellaneous income.

Items of expenditure:

a) Salaries and wages of the employees.
b) Monetary assistance to the needy people.
c) Material assistance to the needy people e.g. food items, blankets, clothes e.t.c.
d) Other expenses.

Example

1. The following relate to Parkland Hospital:

Receipts and payments account for the year ending 31/12/20x6

Receipts	Shs.	Payments:	Shs.
Balance b/d	142,600	Medicines	900,000
Subscriptions and fees	959,920	Doctor's Honorarium	240,000
Donations	490,000	Salaries	700,000
Interest n investment at 15%	150,000	Miscellaneous expenses	24,000
Proceeds from charity show	500,000	Equipment	300,000
		Expenses on charity show	30,000
		Balance c/d	48,520
	2,242,520		**2,242,520**

Additional information:

	1/1/20x6 shs.	31/12/20x6 shs.
Subscriptions due	48,000	56,000
Subscriptions in advance	12,800	20,000
Stock of medicines	178,000	195,000
Equipment	424,000	632,000
Buildings (cost less depreciation)	800,000	760,000

Required:

Prepare the income and expenditure account for the year ended 31/12/20x6 and a balance sheet as at that date.

Solution:

Parkland hospital
Income and expenditure a/c for the year ended 31/12/20x6

	Shs.	Shs.
Incomes:		
Subscriptions (working 1)		960,720
Donations		490,000
Interest on investments		150,000
Proceeds from charity show (500,000 – 30,000)		470,000
		2,070,720
Expenditure:		
Medicines consumed (working 2)	883,000	
Doctor's honorarium	240,000	
Salaries	700,000	
Miscellaneous expenses	24,000	
Depreciation on equipment (working 3)	92,000	
Depreciation on buildings (working 4)	40,000	
		1,979,000
Surplus income		91,720

Parkland Hospital Balance Sheet as at 31/12/20x6

Fixed assets:	Shs.		Shs.
Buildings	760,000	Accumulated fund (w-5)	2,579,800
Equipment	632,000	Surplus income	91,720
Investments (w-6)	1,000,000	Current liabilities:	
Current assets:		Subscriptions in advance	10,000
Stock of medicines	195,000		
Subscriptions due	56,000		
Cash balance	48,520		
	2,691,520		2,691,520

Workings:

1. Annual subscriptions a/c

	Shs.		Shs.
1/1/20x6 Balance b/d	48,000	Balance b/d	12,800
31/12/20x6 Balance c/d	20,000	Receipts and payments a/c	959,920
Income and Expenditure	960,720	31/12/20x6 Balance c/d	56,000
	1,028,720		1,028,720
Balance b/d	56,000	Balance b/d	20,000

2. Stock of medicine

	Shs.		Shs.
1/1/20x6 Bal. B/d	178,000	31/12/20x6 Balance c/d	195,000
Receipts and payments	900,000	Income and expenditure a/c	883,000
	1,078,000		**1,078,000**
1/1/20x7 Balance b/d	195,000		

3. Equipment account:

	Shs.		Shs.
1/1/20x6 Balance b/d	424,000	31/12/20x6 Balance c/d	632,000
Receipts and payments	300,000	Income and expenditure (Depn)	92,000
	724,000		**724,000**
1/1/20x7 Balance b/d	632,000		

4. Depreciation on buildings:

Buildings 1/1/20x6	shs.	800,000
Less: Buildings 31/12/20x6		760,000
Depreciation charge for year		40,000

5. Accumulated fund as at 1/1/20x6: [capital = Assets – liabilities]

Assets:	Shs.	Shs.
Buildings	800,000	
Equipment	424,000	
Investments	1,000,000	
Subscriptions due	48,000	
Cash balance	142,600	
Stock of medicines	178,000	
		2,592,600
Less: Liabilities		
Subscriptions in advance		12,800
Accumulated fund at start		**2,579,800**

6. Investments:

Interest received at 15% for the year = shs. 150,000

Value of investments = $150{,}000 \times \frac{100}{15}$ = " 1,000,000

Example 2.

The trial balance of Greenhill Academy as on 31/12/20x1 is as follows:

	Dr Shs.	Cr Shs.
Furniture and fittings	250,000	
Additions to the furniture during year	64,000	
Library books	350,000	
Additions to library books during year	86,000	
Buildings	5,500,000	
General investments	3,000,000	
Investment reserve fund		300,000
Sundry debtors and creditors	100,000	290,000
Entrance fees		304,000
Examination fees		48,000
Subscriptions received		400,000
Certificate fees		10,000
Hire of school's hall		130,000
Interest realized on investments		110,000
Sundry receipts		12,000
Staff salaries	204,000	
Taxes and insurance	16,000	
Examination expenses	12,000	
Subscriptions to periodicals	24,000	
Prize Trust Fund		320,000
Prize Trust Investment	316,000	
Prize Trust income		13,000
Prizes awarded	9,000	
Prize fund bank balance	5,500	
Donations received (to be capitalized)		360,000
General expenses	7,500	
Accumulated fund		7,783,000
Bank balance	110,000	
Cash balance	6,000	
Printing and stationery	20,000	
	10,080,000	**10,080,000**

Additional information:

		Shs.
- Subscriptions to be received		90,000
- Subscriptions received in advance		10,000
- Interest on general investments accrued	9,000	
- Staff salaries outstanding		36,000
- Taxes and insurance paid in advance	10,000	

- Provide for depreciation on fixed assets including additions as follows
  - * Library books 15% p.a.
  - * Furniture and fittings 5% p.a.
  - * Buildings 1% p.a.

The market value of General Investments on 31/12/20x1 was shs.2,600,000 but you are not required to bring down the book value to this level.

Required:

Prepare the Income and expenditure a/c and balance sheet for the school.

Solution:

Greenhill Academy
Income and expenditure a/c for the year ended 31/12/20x1

	Shs.	Shs.
Incomes:		
Annual subscription (400,00 + 90,000 – 10,000)		480,000
Entrance fees		304,000
Examination fees		48,000
Certificate fees		10,000
Interest on investment (110,000 + 9,000)		119,000
Hire of school hall		130,000
Sundry receipts		12,000
		1,103,000
Expenditure:		
Staff salaries (204,000 + 36,000)	240,000	
Taxes and insurance (16,000 - 10,000)	6,000	
Examination expenses	12,000	
Subscription to periodicals	24,000	
General expenses	7,500	
Printing and stationery	20,000	
Depreciation: Library books	65,400	
Furniture and fittings	15,700	
Buildings	55,000	
		445,600
		657,400

Greenhill academy balance sheet as at 31/12/20x1

Fixed assets:		shs.		Shs.
Buildings	5,500,000		Accumulated fund b/d	7,783,000
Less: depn	55,000	5,445,000	Donations capitalized	360,000
Furniture and fittings.			Surplus income	657,400
	314,000		Investment reserve fund	300,000
Less: Depn	15,700	298,300	Prize Trust fund	
Library books	436,000		(320,000 + 13,000 – 9000)	324,000
Less: Depn	65,400	370,600		
Investments (market			Current liabilities:	
Value shs.2,600,000)		3,000,000	Creditors	290,000
Current assets:			Subscriptions in advance	10,000
Debtors		100,000	Accrued salaries	36,000
Accrued interest		9,000		
Price trust investment		316,000		
Subscriptions due		90,000		
Prepaid taxes and Insurance		10,000		
Prize fund bank balance		5,500		
Bank balance		110,000		
Cash balance		6,000		
		9,760,400		**9,760,400**

Exercise:

1. Glory Academy prepares accounts annually to 31/July. A trial balance for the academic year ended 31/7/20x4 was as follows:

	Shs.	Shs.

Estate and premises	1,215,000	
Equipment and furniture	120,000	
Teachers' salaries	338,000	
General salaries and other costs	449,000	
Capital account on 1/8/20x3		1,200,000
Provision for extensions and improvements		120,000
Catering	114,000	
Bursaries	13,000	
Short-term deposit – building fund	121,000	
Stock	14,000	
Debtors	12,000	
Bank and cash balances	211,000	
Investments at cost (Bursary fund)	110,000	
Fees collected – Boarders 1,005,000		
- Day boys 110,500		1,115,500
Contributions from staff for meals		12,000
Income and expenditure a/c 1/8/20x3		14,000
Building fund collections		121,000
Bursary Fund - capital		110,000
- Income		7,500
Creditors for supplies		17,000
	2,717,000	**2,717,000**

Before finalizing the a/cs, the following adjustments are to be effected:

i) Provision for extensions and improvements is to be increased to shs.210,000.
ii) Unpaid operating cost as at 31/7/20x4 amounted to shs.15,000.
iii) The net cost of bursaries is to be written off.

Required:

a) The income and expenditure a/c for the year ended 31/7/20x4.
b) The balance sheet as at 31/7/20x4.

2. From the following Receipts and payments account of charity Hospital, prepare the income and expenditure account for the year ending 31/12/20x0 and a balance sheet as at that date:

Receipts and payments a/c:

Receipts	Shs.	Payments	Shs.
Balance b/d	205,000	Medicines	950,000
Donations	1,380,000	Doctor's Honorarium	340,000
Receipts from dispensing	670,000	Salaries	300,000
Receipts from medical treatment	840,000	Miscellaneous expenses	620,000
		Equipment	300,000
		Balance c/d	585,000
	3,095,000		**3,095,000**
Balance b/d	585,000		

	1/1/20x0 shs.	31/12/20x0 shs.
Stock of medicines	150,000	135,000
Equipment	250,000	500,000

Buildings (less depreciation)	700,000	660,000

3. The HB tennis club was formed on 1 April 20x0 and has the following receipts and payments account for the six months ended 30 September 20x0.

	£		£
Receipts		*Payments*	
Subscriptions	12,600	Purchase of equipment	4,080
Tournament fees	465	Groundsman's wages	4,520
Bank interest	43	Rent and business rates	636
Sale of club ties	373	Heating and lighting	674
Life membership fees	4,200	Postage and stationery	41
		Court maintenance	1,000
		Tournament prizes	132
		Purchase of club ties	450
		Balance c/d	6,148
	17,681		17,681

Notes

(a) The annual subscription fee is £300. On 30 September there were still five members who had not paid their annual subscription, but this money was received on 4 October 20x0.

(b) The equipment is expected to be used by the club for five years, after which time it will need to be replaced. Its estimated scrap value at that time is £50.

(c) During the six months, the club purchased 100 ties printed with its own design. Forty of these ties remained unsold at 30 September 20x0.

(d) The club had paid business rates in advance on 30 September 20x0 of £68.

(e) The club treasurer estimates that the following amounts should e accrued for expenses.

	£
Groundsman's wages	40
Postage and stationery	12
Heating and lighting	53

(f) The life membership fees received relate to payments made by four families. The scheme allows families to pay £1,050 which entitles them to membership for life without further payment. It has been agreed that such receipts would be credited to income and expenditure in equal installments over ten years.

Required

(a) Prepare the club's income and expenditure account for the six months ended 30 September 20x0.

(b) Prepare the club's balance sheet at 30 September 20x0.

QN. 4 HAPPY TICKERS

The accounting records of the Happy Tickers Sports and Social Club are in a mess. You manage to find the following information to help you prepare the accounts for the year to 31 December 20x0.

SUMMARIZED BALANCE SHEET 31 DECEMBER 20X9

	£		£
Half-share in motorized roller	600	Insurance (3 months)	150
New sports equipment unsold	1,000	Subscriptions 20Y0	120
Used sports equipment at valuation	700	Life subscriptions	1,400
Rent (2 months)	200		1,670
Subscriptions 20x9	60	Accumulated fund	2,900
Café stocks	800		
Cash and bank	1,210		
	4,570		4,570

Receipts in year to 31 December 20Y0

	£
Subscriptions – 20x9	40
- 20Y0	1,100
- 20Y1	80
- life	200
From sales of new sports equipment	900
From sales of used sports equipment	14
Café takings	4,660

Payments in the year to 31 December 20Y0

	£
Rent (for 12 months)	1,200
Insurance (for 18 months)	900
To suppliers of sports equipment	1,000
To café supplies	1,900
Wages of café manager	2,000
Total cost of repairing motorized roller	450
	7,450

Notes

(a) Ownership and all expenses of the motorized roller are agreed to be shared equally withy the Carefree Conveyancers Sports and Social club which occupies a nearby site. The roller cost a total of £2,000 on 1 January 20x6 and had an estimated life of 10 years.

(b) Life subscriptions are brought into income equally over 10 years, in a scheme begun in 20x5. Since the scheme began the cost of £200 per person has been constant. Prior to 31 December 10x9 10 life subscriptions had been received.

(c) Four more annual subscriptions of £20 each had been promised relating to 20Y0, but not yet received. Annual subscriptions promised but unpaid are carried forward for a maximum of 12 months.

(d) New sports equipment is sold to members' at cost plus 50%. Used equipment is sold off to members at book valuation. Half the sports equipment bought in the year (all from a cash and carry supplier) has been used within the club, and half made available for sale, new, to

members. The ‘used equipment at valuation’ figure in the 31 December 20Y0 balance sheet is to remain at £700.

(e) Closing café stocks are £850, and £80 is owed to suppliers at 31 December 20Y0.

Required

(a) Calculate profit on café operations and profit on sale of sports equipment.
(b) Prepare statement of subscription income for 20Y0.
(c) Prepare income and expenditure statement for the year to 31 December 20Y0, and balance sheet as at 31 December 20Y0.
(d) Why do life subscriptions appear as a liability?

Helping hand

1 In part (a) there is an incomplete records element.

2. When calculating the life subscriptions allocation to the current year, you need to think how many life members there are.
3. In the income and expenditure account, the used sports equipment at valuation figure must remain constant.

HIREPURCHASE AND LEASING

Where goods are sold on terms other than cash, the buyer and the seller have to make an arrangement through which the resulting debt will be settled. The commonest alternative is to arrange for (usually short) a credit period at the end of which payment is made. Other alternatives include use of bills of exchange and other instruments.

The more radical arrangement is where structured payments are made in instalments over a period to cover the selling price of the asset plus often an additional charge for the delay of the payments (interest). These are usually of three kinds:
(1) Credit sale agreements
(2) Hirepurchase agreements, and
(3) Leasing agreements.

Credit Sale Agreements.

In this agreement the ownership of the goods passes immediately to the buyer but payments are made in a number of instalments which may cover the selling price and interest. The payment of future instalments cannot be avoided by returning the asset.

Hire Purchase Agreements

The vendor supplies the goods on hire to the customer with the option to buy the goods upon the fulfilment of certain conditions, usually the payment of a number of instalments and a nominal price.

Leasing Agreements

This is a contract of hire between a lessee and a lessor whereby the lessee obtains possession and use of the asset for an agreed period of time without the option of ownership passing over to the lessee.

There are two types of leases:

a) Finance lease, which "transfers substantially all the risks and rewards incident to ownership of an asset" to the lessee. Title to the asset may pass or not at the end of the lease. It is normally not cancellable and is for most of the economic life of the asset.

b) An operating lease, which is a lease other than a finance lease. It does not transfer many of the risks and rewards of ownership. It is usually for short periods of time with the asset being leased to successive lessees.

The finance for credit transaction of this nature is usually provided by:

(a) Manufacturers or dealers who use leasing or hire purchase as a means of marketing their products
(b) Finance companies eg. Banks and finance houses, etc) who effecting land money by enabling their clients to gain use of usually costly assets for all or most of their useful lives, while holding tittle to the asset as a security.

The Accounting issues in Leases and Hire-Purchase

(a) Operating leases - when an asset is under an operating lease, the lessee pays monthly/annual (periodic) rentals to the lessor for the period of the lease. Usually the lessor is responsible for the maintenance of the asset. This posses no accounting problem as the lessee treats the rental as a revenue expense during he period it is incurred, while the lessor tales such rentals as income for the same period. Any maintenance expense on the asset is treated as a revenue expense and the asset itself is accounted for as a fixed asset in accordance with IAS 16 (Property, Plant & Equipment by the lessor.
b) Finance Leases and Hire-Purchase . Although the legal form of these contracts clearly differentiates them, for all intents and purposes the two have the following common features.
   (ii) The asset is going to be possessed and used by the lessor or hire-purchaser for all or most of its useful life. The lessor is even responsible for all the risks and rewards of ownership.

   (ii) The total hire-purchase price or lease rentals exceed the price of buying the asset outright (cash price). This means the lessor is effectively paying full price of the asset plus a charge associated with the delayed payments (instalments)

In conclusion, in line with the concept of "substance over form", which states that a transaction should be accounted for to show its financial reality other that merely its legal form, the two contracts should be basically accounted for in the same way.

According to IAS 17 (Leases Revised 1997)

a) an asset under a finance lease should be accounted for as the asset of the lessee and the unpaid part of the cash price as a liability of the lessee. The interest component of each instalment should be treated as an expense for the period when the instalment is due.

b) On asset under a finance lease should be treated as a normal sale by the lessor when the contract is made. The balance of the cash price receivable should be accounted for as a receivable. Interest in each instalment is treated as income for the period when the instalment is due.

ACCOUNTING BY THE LESSEE

When an asset is acquired under on hire-purchase or finance lease agreement, the total amount payable under the contract should be separated between the cash price and the finance charge or interest.

On agreeing the contract:

DR: Asset A/C
CR: Lessor's A/C

with the capital cost (cash price) of the asset the capital cost must be the fair value of the asset if it were bought on cash basis.

The lessee should account for this asset like any other asset of its class under IAS 16. The capital cost should be depreciated in accordance with IAS 4 (Depreciation accounting).

When an instalment is due for payment there are two alternative ways of accounting for each instalment

a) DR: Lessor's A/C - with capital component of instalment
DR: Hire-Purchase Interest or Finance Charge A/C - with
CR: Cash with total amount of instalment
The entry is made when payment is made
OR

The Actual Method

Using this method, a real interest rate desired by the lessor is used to calculate the interest due on each instalment based on the balance of cash price due during the period. The interest accruing will therefore be greatest in earlier instalments and reduces progressively as capital is repaid.

This method is recommended by IAS 17 by using the rate of interest desired by the lessor if known to the lessee, or using the lessee own incremental cost of capital (the rate of interest the lessee would pay on a new loan)

Example

On 1 January 1996 Bachu, a wine merchant, buys a small bottling and labelling machine from Silus Ltd a hire purchase terms. The cash price of the machine was Sh.7,710,000 while the hire purchase price was
Shs 10,000,00. The hire purchase agreement required the immediate payment of a Sh 2,000,000 deposit with the balance being settled in four equal annual instalments commencing on 31 December 1996. The hire purchase charge of Shs 2,290,00 represents interest at 15% per annum, calculated on the remaining balance of the liability during each accounting period. Depreciation on he plan is to be provided for at the rate of 20% per annum on a straight line basis assuming a residual value of nil.

INSURANCE CLAIMS

Organisation often incur various losses of assets and lose benefits or incur additional costs due to incidents such as fire, thefts, etc. In order to cushion themselves against them. As the aim of insurance is to indemnify, the actual loss suffered is what is to be compensated by the insurer.

Most fixed assets are easy to fix a value lost from the cost records, valuations, deprecations, etc. However, as far as trade stocks and loss of benefits (eg, profit) and additional costs (collectively called consequential claims) are concerned this is not possible. But these items can be computed (infact estimated) from records which may have survived the fire. These are composed of purchases and sales to the date of the fire.

Using these figures together with those of the previous year's closing stock and gross profit percentage.
It's possible to c/stock.
This is done by preparing a memorandum trading a/c where the gross profit is found by applying the previous year's percentage tot the current years sales to the date of the fire and the balancing figure being the closing stock (stock on the date of the fire).

Example

On 30th Sept 1993 fire destroyed the stores of Guma Ltd and a greater part of the stock was lost. The Company prepares a/cs to 30th June each year. During 1993 the books of the company which were safe at the head office disclosed the following information:

	SH	
Stock on 0I July 1993	162,500	
Purchases to 30 th September	275.000	
Wages to 30th September		112,500
Sales to 30th September	500,000	

During the last three years the gross profit to sales percentage overaged at 25%.

Stock to the time of Sh.35,000 was salvaged.
Prepare an account setting out the amount to be claimed from the Insurance Company.

MEMORUNDUM TRANDING A/C FOR THE THREE MONTHS ENDED 30TH SEPTEMBER 1993

		SH		SH.
Sales				500,000
Less:	COST OF SALES			
	Opening Stock	162,500		
Add:	Purchases	275,000		
		437,500		
Less:	Closing stock (Bal. Fig.)		175,000	
		262,500		
Add:	Wages	112,500		
				375,000
Gross Profit (25% of 500,000)				125,000

AVERAGE CLAUSE

Many policies take out by firms contain an "average" clause. In this clause if the insured has insured for a lower value than the actual value of the asset (stock) involved, the insurer shall only compensate for the portion of the loss equal to the proportion of the insured sum to the value of the property.

$$\text{Amount to be Claimed} = \text{Value of Stock Destroyed} \times \frac{\text{Value Insured}}{\text{Total Value of Stock on Date of Fire}}$$

CONSEQUENTIAL LOSSES

Where a fire destroys business property, there is an instant loss of the property itself and aslo other losses which may arise therefrom.
They are:

a) Loss of profit due to reduced or ceased production

b) Loss of fixed income due to reduced or non-recovery due to loss of the asset. (Eg. Rent,

rates, etc)

c) Increase in operating costs due need to rent/hire other assets to continue production.

The method of calculating the profit cost is usually given in the policy. But usually the following steps are applied:

1. Calculate the percentage on the decrease in turnover between the specified period after the fire and the corresponding period in the previous year using the formulae below:

   a) Gross Profit % = $\frac{\text{Sum Assured}}{\text{Turnover for 12 months preeding fire}}$ x 100

   b) Gross Profit Percentage = $\frac{\text{Net Profit + Standing Charges for last F Tear x 100}}{\text{Turnover for last F. Year}}$

2. Apply the lower of the two percentages obtained above to the actual shortage in sales during the period
   of indemnity.

3. Increase in working expenses will be compensated at the lower of:

   a) Actual increase in working expenses
   b) $\frac{\text{Net Profit + Insured Constant Expenses}}{\text{Net Profit + All constant Expenses}}$ x Increased working cost

   c) Gross profit on sales resulting from the increased working expenses.

4. Apply Average Clause by the formula:

   Gross Claim x $\frac{\text{Amount of Policy}}{\text{Gross Profit for 12 months' Sales immediately preceding date of the Fire.}}$

Example:

X Co. Ltd prepares accounts annually to 30th Sept. On 28th Feb 1996, their premises were destroyed by fire. The Co. had effected a loss of profits insurance for £20,000 the period of indemnity being six months after the fire the profits for the year to 30th Sept. 95 were £12,000 after debiting standing charges of £4,000 and the turnover for that year was £240,000. The turnover for the year to 28th Feb 1996 was £250,000 (of which £100,000 related to the last six months) and that for the six months to 31st Aug 1996 was £50,000.

Calculate the amount recoverable from the insurance company.

SOLN

		£
Turnover for six months immediately after the fire-insured period (01.03-31.08. 1993)	=	50,000
Turnover for same period in previous year was (£250,000 - £100,000)	=	150,000

£ <u>100,000</u>

The percentage of 100,000 to be claimed will be the lower of

(1) $\frac{£20,000}{£250,000}$ x 100 = 8%

(2) $\frac{£20,000 \quad x \quad £\ 4000}{£240,000}$ x 1000 = 6,67%

Claim will be 6.67 of £100,000 = £6,667

COMPENSATION CLAIMS

A claim for compensation may arise out of:-

a) Compulsory acquisition of premises
b) Personal injuries
c) Fidelity Insurance

Compulsory acquisition of premises arise when government, local authorities or other statutory bodies describes to dispossess the owner of premises due to need to carry out a dev. Activity, eg, road construction, school development, etc.

The owner of such premise may suffer the following losses.

a) Loss of beneficial interest (usually profits)and goodwill.
b) Value of un-expired lease
c) Loss on compulsory sale of assets
d) Premium paid on acquisition of new premises
e) Removal expenses
f) Damages incurred due to inability to fulfill contracts entered into
g) Loss of trading

Personal injuries may cause the following losses

a) Income owing to incapacity
b) Possible life disability
c) Medical expenses incurred.

Events after the Balance Sheet Date:

Objective

1. To prescribe when an enterprise should adjust its financial statements for events after the balance sheet date; and

2. To prescribe the disclosures that an enterprise should give above the date when financial statements were authorized for issue and about events after the balance sheet date.

The standard also requires that an enterprise should not prepare its financial statements on a going concern basis if events after the balance sheet date indicate that the going concern assumption is not appropriate.

Events after the balance sheet date are those events, both favourable and unfavourable, that occur between the balance sheet date and the date when the financial statements are authorized for issue.

Two types of events an be identified:

a) Those that provide evidence of conditions that existed at the balance sheet date (adjusting events after the balance sheet date); and

b) Those that are indicative of conditions that arose after the balance sheet date (non-adjusting events after the balance sheet date).

Authorising financial statements for use:
The board of directors reviews the financial statements and authorizes them for issue.

In some cases the management of an enterprise is required to issue its financial statements to a supervisory board (made up solely of non-executives) for approval. In such cases, the financial statements are authorized for issue when management authorizes them for issue to the supervisory board.

The supervisory board is made up solely of non-executives and may include representatives of employees and other outside interests.

Importance of date of authorization for issue:

Events after the balance sheet date include all events up to the date when the financial statements are authorized for issue, even if those events occur after the publication of a profit announcement or of other selected financial informations.

Adjusting Events After the Balance Sheet Date:

An enterprise should adjust the amount recognized in its financial statements to reflect adjusting events after the balance sheet date.

Examples:

1. The receipt of information after the balance sheet date indicating that an asset was impaired at the balance sheet date, or that the amount of a previously recognized impairment loss for that asset needs to be adjusted. Such as:

a) Bankruptcy of a customer which occurs after the balance sheet date usually confirms that a loss already existed at the balance sheet date on a trade receivable account and that the enterprise needs to adjust the carrying amount of the trade receivable account; and

b) The sale of inventories after the balance sheet date may give evidence about their net realizable value at the balance sheet date.

2. The determination after the balance sheet of the amount of profit sharing or bonus payments, if the enterprise had a present legal or constructive obligation at the balance sheet date to make such payments as a result of events before that date.

3. The determination after the balance sheet date of the cost of assets purchased, or the proceeds from assets sold, before the balance sheet date.

4. The resolution after the balance sheet date of a court case which, because it confirms that an enterprise already had a present obligation at the balance sheet date, requires the enterprise to adjust a provision already recognized, or to recognize a provision instead of merely disclosing a contingent liability;

5. The discovery of fraud or errors that show that the financial statements were incorrect.

Non-Adjusting Events After the Balance Sheet Date:

An enterprise should not adjust the amounts recognized in its financial statements to reflect non-adjusting events after the balance sheet date.

Example:

a) Decline in market value of investments between the balance sheet date and the date when financial statements are authorized for issue. I.e the fall in market value does not normally relate to the condition of the investments at the balance sheet date, but reflects circumstances that have arisen in the following period.
However, where the non-adjusting events after the balance sheet date are of such importance that non-disclosure would affect the ability of the users of financial statements to make proper evaluations and decisions, an enterprise should disclose the following information for each significant category of non adjusting events:

i) the nature of the event; and
ii) an estimate of its financial effect, or a statement that such an estimate cannot be made.

Examples of non-adjusting events after the balance sheet of importance:

i) A major business combination after the balance sheet date (IAS 22) or disposing of a major subsidiary.

ii) Announcing a plan to discontinue an operation, disposing of assets or setting liabilities attributable to a discontinuing operation or entering into binding agreements to sell such assets or settle such liabilities (IAS 35).
iii) Major purchases and disposals of assets or expropriation of major assets by government.

iv) The destruction of a major production plant by a fire after the balance sheet date.

v) Announcing, or commencing the implementation of, a major restricting (IAS 37, provisions, contingent liabilities and contingent assets).

vi) Abnormally large changes after the balance sheet date in asset prices or foreign exchange rates.

vii) Commencing major litigation arising solely out of events that occurred after the balance sheet date.

viii) Changes in tax rates or tax laws enacted or announced after the balance sheet date that have a significant effect on current and deferred tax assets and liabilities.

ix) Major ordinary share transactions and potential ordinary share transactions after the balance sheet date (IAS 33).

DIVIDENDS:

If dividends to holders of equity instruments are proposed or declared after the balance sheet date, an enterprise should not recognize those dividends as a liability at the balance sheet date.

IAS 1, requires an enterprise to disclose the amount of dividends that were proposed or declared after the balance sheet date but before the financial statements were authorized for issue either

a) on the face of the balance sheet as a separate component of equity or
b) in the notes to the financial statements.

GOING CONCERN:

An enterprise should not prepare its financial statements on a going concern basis if management determines after the balance sheet date either that it intends to liquidate the enterprise or to cease trading, or that it has no realistic alternative but to do so.

IAS 1, requires disclosures if:

a) the financial statements are not prepared on a going concern basis; or
b) management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the enterprise's ability to continue as a going concern.

DISCLOSURE:

1. The date when the financial statements were authorized for issue and who gave that authorization.

2. The fact that enterprise's owners or other parties have the power to ament financial statements after issuance, if applicable.

Updating disclosures:

If an enterprise receives information after the balance sheet date abut conditions that existed at the balance sheet date, the enterprise should update disclosures that relate to these conditions, in the light of the new information. E.g. contingent liability.

CONTINGENT LIABILITIES, CONTINGENT ASSETS AND EVENTS AFTER THE BALANCE SHEET DATE.

Accounting for contingencies

IAS 37, Provisions, Contingent Liabilities and Contingent Assets was introduced in September 1998. Only the sections of IAS 37 relating to contingencies are relevant for your studies.
IAS 10, Events after the Balance sheet date was issued in May 1999 and modifies the rules relating to such events.
Contingent liability:

A contingent liability is:
a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

b) a present obligation that arises from past events but is not recognized because"
   i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
   ii) the amount of the obligation cannot be measured with sufficient reliability.

Contingent asset:

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurance or non-occurance of one or more uncertain future events not wholly within the control of the enterprise.

Accounting for contingent assets and liabilities
The requirements of IAS 37 as regards contingent assets and liabilities are summarized in the following table:

	Contingent liabilities	Contingent assets
Virtually certain (therefore not contingent	Provide	Recognise
Probable	Provide	Disclose by note
Possible	Disclose by note	No disclosure
Remote	No disclosure	No disclosure

Note that when there is the possibility of recovery from a third party of all or part of a contingent liability, this must be treated as a separate matter, and a contingent asset only recognized if its receipt is virtually certain.

Degree of probability

IAS 37 recognises four degrees of probability for contingencies and their possible interpretation as shown::

Virtually certain	Probability above 95%
Probable	Probability above 50% and up to 95%
Possible	Probability of 5% to 50%
Remote	Probability below 5%.

When the disclosure is made by note, it should state:

- the nature of the contingency.
- the uncertain factors that may affect the future outcome.
- an estimate of the financial effect, or a statement that such an estimate cannot be made.

BILLS OF EXCHANGE:

A bill of exchange has been defined by the Bill of Exchange Act as:

"A bill of exchange is an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a sum certain in money to or to the order of a specified person or to bearer".

It is an instrument of credit. It is normally payable after 90 days.
It is transferable from one person to another by endorsement. It may be discounted with a commercial bank. I.e. the bank will take over the bill from the holder paying him out the face value of the bill less an amount called discounting charges. The bank then collects the cash from the acceptor on the due date.

Essentials of a bill

1. It must contain an "order to pay" even when expressed in a polite language.
2. The order must be unconditional (no other conditions attached).
3. It must be addressed by one person to another person.
4. The drawer, drawee and payee must be certain.
5. The sum payable must be certain.
6. It must be in writing and signed by the drawer.
7. If it is not payable on demand then the time of payment must be fixed or determinable.

SPECIMEN OF A BILL OF EXCHANGE:

Kampala
Shs.100,000 15th January 2002

Three months after date (or on demand) pay to "Gawaya" or order the sum of one hundred thousand shillings only, for the value received

To, Kaleb stamp
Plot 52/2 William Street, Kampala

1. **Parties to a bill of exchange:**

   a) **Drawer:**

He is the creditor and writes a bill of exchange on the debtor. He signs on the bill of exchange. He may be known as the holder. He is not named on the above specimen.

b) Drawee
He is the debtor and a bill is written on him. He is also known as acceptor after he has signed the bill. He is Kaleb in the specimen.

c) **Payee**
The person to whom payment of the bill is to be made on the maturity date. Some times the drawer and payee are one person. In the specimen, Gawaya is the payee.

2. **Stamp:**
The value of the stamp affixed to every bill varies with the amount of the bill of exchange.

3. **Amount:**
This is written twice; once in figures and again in words to avoid the possibility of alteration.

4. **Date:**
This must be given on the face of the bill and the period of the bill is counted from this date. 3 days of grace are given to the drawee to pay the amount of the bill. I.e. the specimen bill of exchange is payable on 18th April 2002.

5. **Term:**
The period after which the payment of the bill becomes due. It should be clearly written on the bill.

6. **For value received:**
These words indicate that the drawer is drawing the bill in consideration of the goods he has sold to the drawee on credit.

Acceptance of the bill:

"The acceptance of a bill is the signification by the drawee of his assent to the order of the drawer". The drawee signifies his consent in writing to the drawer by signing across the face of the bill with or without the word accepted' and delivers back the bill to the holder or gives notice of acceptance to the holder.

The drawee is not liable on the bill until he gives his acceptance, thereby becoming the acceptor.

General acceptance:

The drawee accepts the order of the drawer to pay the sum specified in the bill in full, without any condition or qualification; the acceptance is said to be general, absolute or un qualified.

Qualified acceptance:

The drawee accepts the bill subject to some condition or qualification, thereby varying the terms as expressed in the bill. An acceptance may be qualified as to time, place, amount or parties.

Classification of Bill of Exchange:

a) Inland bills:
Drawn outside the county but mad payable in or drawn upon persons residing in that country.

OR:

Drawn in side the country but made payable in or drawn upon persons living outside the country. Foreign bills are usually drawn in sets of three. Each set being sent separately to the destination. After the acceptance of one set the other two sets become inoperative.

The period of the due date of the foreign bill is to be counted from the date when it is seen and accepted by the drawee whereas in case of an inland bill it is counted from the date given in the bill.

Advantages of Bills of Exchange:

1. It is a legal evidence of debt i.e. creditor can sue debtor on the basis of a bill of exchange.
2. It can be discounted and cash can be obtained before the date of maturity.
3. It is a negotiable instrument and can be transferred for settlement of one's debt.
4. It provides an easy and convenient method of transmitting money from one place to another.
5. It helps to increase business transactions.
6. Foreign trade is facilitated with the help of foreign bills of exchange.

PROMISSORY NOTES

"A promissory note is an unconditional promise in writing made by one person to another signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money, to, or to the order of, a specified person or to bearer. It may take the following form:

Kampala
15th January 2002

shs. 100,000
I promise to pay Gawaya or order the sum of shillings one hundred thousand only on demand.

………………..
Kato

Both promissory notes and Bill of exchange are negotiable instruments and are provided for by the Bill of Exchange Act, but they differ in the following respects:

1. A bill is an "order to pay" whereas a promissory note is a "promise to pay"
2. A bill of exchange requires 3 parties but a promissory note only requires two parties i.e. the maker and the payee (or promisor and promisee).
3. A bill of exchange is drawn by the creditor but a promissory note is written by the debtor.

4. A bill of exchange is required to be accepted by the drawee whereas a promissory note needs no acceptance because the debtor himself makes the promise to make the payment.
5. Foreign bills are drawn in a set of three whereas foreign promissory notes are drawn in one set only.

6. Foreign bills must be noted and protested on their being dishonoured but foreign promissory notes do not need only noting and protesting on their dishonour.

Accounting treatment:

Both bill of exchange and promissory notes are treated alike in accounting.

a) Bills payable: (a liability)
In the buyers books regarding goods purchased on credit:
(i) when the bill is accepted
Dr: Creditors a/c
Cr: Bills payable a/c

(ii) when the bill is paid
Dr: Bill payable a/c
Cr: Bank a/c

b) Bills receivable: (an asset).
In the books of the seller regarding the goods sold on credit:
(i) when the bill is accepted by the debtor.
Dr: Bills receivable a/c
Cr: Debtors account.

(ii) when cash is received from the debtor on maturity
Dr: Bank account
Cr: Bills receivable account.

(iii) when discounted with a bank
- Dr: Bank a/c
Cr: Bills receivable a/c] with amount received.

- Dr: Discount charges a/c
Cr: Bills receivable a/c] with the amount of discount.

Endorsement:

The holder of the bill negotiates the bill to another person in payment of his own debt by signing on the back of the bill indicating that the proceeds of the bill may be paid away to a specific person or party.

Entry: Dr: Creditors a/c
Cr: Bills receivable a/c

Dishonour of Bill.

The drawee or acceptor fails to make the payment on the due date or the date of maturity of the bill.
Entries:

(i) where the bill has not been discounted or endorsed.
Dr: Debtors a/c
Cr: Bills receivable] with the face value of the bill.

(ii) where it has been discounted with a bank
Dr: Debtors a/c] with the face value of the bill.
Cr: Bank a/c

(iii) where it has been endorsed over to a creditor
Dr: Debtors a/c
Cr: Creditors a/c] with the face value of the bill.

Noting charges:

Noting is done by recording the fact of dishonour, the date of dishonour and the reasons for dishonour, (if any) by the notary public. The fees charged by the notary public are called noting charges. "Protest" is the term that covers the legal formalities needed to preserve the holders rights against the drawer and previous endorsers of a foreign bill. Noting and protesting charges are paid ultimately by the acceptor.

Retiring a bill:

Where the acceptor pays off before maturity, he demands a <u>rebate</u> because he has not availed the full term of credit. Where the acceptor is unable to pay on the due date, he may request the drawer to cancel the original bill and draw a new bill for an extended period. The request should be made before the maturity date of the original bill. If the request is accepted by the drawer, the original bill is said to be <u>retired</u>. The new bill includes the amount of the old bill plus the <u>interest charged by the drawer for the extended period.</u>
The bill is also said to have been <u>renewed.</u>

<u>Books of the drawer:</u>

1. Dr: Debtors a/c
Cr: Bills receivable a/c] with face value of bill retired.

2. Dr: Debtors a/c
Cr: Interest receivable a/c] with interest charged on the issue of a new bill.

3. Dr: Bills receivable a/c
Cr: Debtors a/c] with value of old bill plus interest charge.

Books of the acceptor:

1. Dr: Bills payable a/c
Cr: Creditors a/c] with face value of the bill.

2. Dr: Interest payable a/c
Cr: Creditors a/c] with interest charged on issue of new bill.

3. Dr: Creditors a/c
   Cr: Bills payable a/c] with value of old bill plus interest charged.

Accounting bill:

A bill of exchange which has been accepted, drawn or endorsed by a person not in the course of ordinary business transactions, but for the specific object of enabling another person to raise funds by discounting the bill on the strength of the first person's name.

Example:

Clays Ltd sold goods value at shs.; 50m to Nile Ltd on 1st May 20x9 and drew upon them a three month's bill of exchange for that amount. Nile Ltd accepted the bill. On July 31 20x9 Nile Ltd expressed their liability to meet the bill and offered to pay clays Ltd shs. 10m in cash and to accept a fresh bill for the balance plus interest at 10% p.a. for three months. Clays Ltd agreed to the proposal and the bill was renewed. This amount was paid by Nile Ltd on 31 October 20x9.

Required:

Show relevant entries in the ledgers of (a) Clays Ltd. (b) Nile Ltd.

Solution

Books of Clays Ltd:

Dr Nile Ltd's a/c

	Shs.000		Shs. 000
1/5/20x9 Sales a/c	50,000	1/5/20x9 Bills receivable a/c	50,000
31/7/20x9 Bills receivable a/c	50,000	31/7/20x9 Cash a/c	10,000
31/7/20x9 Interest receivable a/c	1,000	31/7/20x9 Bills receivable a/c	41,000
	51,000		55,000

Bill receivable account

	Shs.000		Shs.000
1/5/20x9 Nile Ltd's a/c	50,000	31/7/20x9 Nile Ltd's a/c	50,000
31/7/20x9 Nile Ltd's a/c	41,000	31/10/20x9 Cash a/c	41,000

Cash account

	Shs. 000		Shs. 000
31/7/20x9 Nile Ltd's a/c	10,000		
31/10/20x9 Bills receivable a/c	41,000		

Interest Receivable account

	Shs. 000		Shs. 000
31/12/20x9 Profit and loss a/c	1,000	31/7/20x9 Nile Ltd's a/c	1,000

Books of Nile Ltd:

Clays Ltd's a/c

	Shs. 000		Shs. 000
1/5/20x9 Bills payable a/c	50,000	1/5/20x9 Purchases a/c	50,000
31/7/20x9 Cash a/c	10,000	31/7/20x9 Bills payable a/c	50,000
31/7/20x9 Bills payable a/c	41,000	31/7/20x9 Interest payable a/c	1,000
	51,000		51,000

Cash account

	Shs. 000		Shs. 000
		31/7/20x9 Clays Ltd's a/c	10,000
		31/10/20x9 Clays Ltd's a/c	41,000

Interest payable account

	Shs. 000		Shs. 000
31/7/20x9 Clays Ltd's a/c	1,000	31/12/20x9 Profit and loss a/c	1,000

INSOLVENCY:

If the acceptor of a bill or a maker of a promissory note becomes insolvent, the bill or promissory note should be treated as dishonoured. It is possible that a partial payment may be made by the estate of the insolvent. The balance of the amount due not recovered should be written off as bad debts in the drawers books.
The deficiency should be credited to profit and loss a/c and debited to Drawers a/c in the insolvent's books (in come to acceptor).

Example 2.

A sold goods to the value of shs. 100,000 to B, taking a bill at 3 months therefore. A discounted the bill at 10% p.a. with his bank. On maturity, the bill was returned by the bank dishonoured with shs.1000 as noting charges. B paid shs. 40,000 and the noting charges and gave another bill at 3

months for shs.60,000 and 10% interest but before maturity he had become bankrupt and ultimately paid to his creditors 80%.

Required:

Journal entries in the books of A and prepare B's account in A's books"

Journal entries:

Particulars	Folio	Dr Shs.	Cr Shs.
B's account Sales account Being the sale of goods to B on credit.		100,000	 100,000
Bills receivable account B's account Being bill drawn on B payable after 3 months		100,000	 100,000
Bank account Discount charges a/c Bills receivable a/c Being the bill discounted at 10% p.a.		97,500 2,500	 100,000
B's account Bank account Being bill dishonoured and noting charges		101,000	 101,000
Bank account B's account Being amount received from B.		41,000	 41,000
B's account Interest receivable account Being interest on shs.60,000 at 10% p.a. for the extended 3 months credit period.		1,500	 1,500
Bills receivable account B's account Being bill drawn by A on B for the balance of the amount including interest.		61,500	 61,500

Exercise:

1. On 15th May PQ Ltd sold goods to RT Ltd for £10,000. PQ Ltd received in payment a 3-month's bill. On 15th June, PQ Ltd discounted the bill at a bank for £9700. On 18th August, the bill was dishonoured. Show the entries in the ledgers of PQ Ltd.

2. a) with reference to a bill of exchange, write short notes on the following:
   - Drawer - Accepter - Endorser - Days of grace.

   b) The following information is available to you.
      i) Mwavaja of Uganda forwarded a sale of goods to Lina and Company of Kenya on 18th July 20x2 drawing on Lina a 3 month's bill for shs.70,000

representing 80% of the invoice value. Lina and company drew a cheque on their bankers on 21 October 20x2 to meet the bill.

ii) In order to finance the above transaction, Lina and Company on 19th October 20x2 drew a bill for 3 months on T.K. Bank for shs.70,000, discounting this bill with T.K. Bank, the latter holding title documents to the sale as security. The discounting charges was shs.1000 and the commission was 0.5%. Lina and company received a cheque for the balance, which they deposited in their bank. On 23 January 20x3 the above mentioned bill (ii) was retrieved. Lina and company issued a cheque to meet it whereupon they drew a new bill for 3 months for shs.80,000 on T.K. Bank and provided additional security. This bill was discounted by T.K. Bank at the same rate of commission as before. Discounting charges were shs.1100. Lina and company limited received a cheque for the balance and banked it.

Required:

Ledger entries in Lina and company's books.

ROYALTY ACCOUNTS:

"A periodic payment to the owner of an asset for the use of his ownership rights".
Royalty may also be defined as the "remuneration payable to a person in respect of the use of an asset, calculated with reference to the quantity produced or sold as a result of use of such asset". It may arise in respect of

- Extraction of minerals from the ground.
- Publishing books with the permission of the author.
- the use of artistic work e.g. music, movies, etc.

The amount of payment should not be hump sum. Royaltie agreements will contain clauses dealing with:

a) Royalty per unit of output.
b) minimum rent payable.
c) recovery of short-workings.
d) right to sub-let part or whole of royalty agreements.

Minimum Rent: (dead rent, flat rent, rock rent).

The minimum amount that must be paid by the lessee (tenant) to the lessor (landlord) in any particular year even if the lessee has not derived any benefit out of the asset. It acts as a negative in center to the lessee calling him to make full use of the asset. In periods when royalty payable exceeds this minimum rent figure, the amount payable shall be the actual amount of royalty.
i.e Lessee pays the royalty or minimum rent, whichever is greater.

Short workings

The excess of minimum rent over royalty. In the initial stages of the lease, the minimum rnt may be higher than the actual royalty payable. Short workings may be carried forward for a specific period as per lease agreement.

Recoupment of short workings:

The short working clause empowers the lessee to recover the amount paid in excess of actual royalty out of the excess royalty over minimum rent (surplus). Till the stage of recovery is reached, he can accumulate the short workings and when once the stage of surplus is reached, he can recover and after full recovery, pay the actual royalty.

The right of recoupment may either be restricted or unrestricted.

It restricted, the lessee may be permitted to recoup short workings for a few years only.

a) **Recoupment over a fixed period from commencement of lease agreement**:

The lessee is permitted to recoup short workings for a few years only commencing from the date of agreement. As soon as the period of recoupment expires, all unrecouped short workings are immediately transferred to profit and loss account.

Fluctuating right of recoupment of short workings:

The agreement may provide that short workings can be recouped by the lessee in the next two or three years after the year to which short workings relate.

Sub-lease:

Where the lessee is given the right to sublet part of the rights. On the exercise of this right three parties come into existence; lesser, lessee and sub lessee. The relationship between the lessee and the sub lessee is the same as between the lessor and the lessee. The amount of royalties payable by the lessee to the original landlord must be calculated on the total output of both the lessee and the sub lessee.

Accounts required and their purposes:

Royalties Payable Account:

Shows royalty payable on the actual extraction or production for the period, being the total of the tenant's and sub-tenant's production.
Royalties are part o the cost of production or sales and should be transferred to production, manufacturing or trading account and never to profit and loss account.
Shows actual amount paid to the landlord i.e. minimum rent or rent payable less short workings recouped.

Short workings Account:

This is debited with the royalty on the short workings. Unrecoverable short-workings are debited to profit and loss account.

Accounts for sub-tenants:

Three accounts are opened i.e.
- Royalties receivable account.
- Sub-tenant's account
- Short workings account (sub-tenant).

Where a sub-lease is made at a profit to the lessee, the amount receivable will consist of that payable to the landlord and that transferred to profit and loss account.

Accounting entries:

1. When there is no provision for minimum rent:

   (a) Royalties based on actual production:
   Dr: Royalties payable account
   Cr: Landlord account.

   (b) Cash paid to the landlord:
   Dr: Landlord's account
   Cr: Cash account.

2. When there is provision for minimum rent:

   (a) Royalty based on production
   Dr: Royalties payable account.
   Cr: Landlord's account.

   (b) Short workings to be recovered in future:
   Dr: Short workings account
   Cr: Landlord's account.

   (c) Cash paid to landlord:
   Dr: Landlord's account
   Cr: cash account.

   (d) Short workings irrecoverable (if any):
   Dr: Profit and loss account
   Cr: short workings account.

3. When Royalties exceed minimum rent:

   (a) Royalty based on actual production:
   Dr: Royalties payable account
   Cr: Landlord's account.

   (b) Short workings recouped (if any):
   Dr: Landlord's account
   Cr: short workings account.

   © Cash paid to the landlord:
   Dr: Landlord's account
   Cr: cash account.

   (c) Short workings irrecoverable:
   Dr: profit and loss account

Cr: short workings account.

4.3 **Entries in case of a sub-lease:**

a) Royalties payable based on actual production (own + subtenant)
Dr: Royalty payable account.
Cr: Landlord's account.

b) Royalty received (based on sub-tenant's production)
Dr: Sub-tenant's account
Cr: Royalties receivable account.

c) Short workings recoverable in future by sub-tenant:
Dr: sub-tenant's account
Cr: short workings (sub-tenant) account.

d) Royalty payable by tenant on sub-tenants production.
Dr: Royalties receivable account
Cr: Royalties payable account.

e) Profit on sub-lease
Dr: Royalties receivable account.
Cr: profit and loss account.

f) Short workings irrecoverable by sub-tenant:
Dr: short workings (sub-tenant) account
Cr: profit and loss account.

Example:

The lease of a plant of land is granted to Z upon the basis of a royalty of 10 pence per ton on the day extracted, subject to a minimum rent of £2000 per annum. Z has the right to recoup short workings during the first seven years of the lease but not afterwards. Z granted a sub-lease for five years from 1st January 20x1 to XY Ltd on one-half of the area for a royalty of 15 pence per ton merging in a minimum rent of £1,250 per annum. Under the terms of the sub-lease, XY Ltd. can recoup short workings in any of the two years immediately following that in which short workings accrued. The output in tons for Z and XY Ltd was as follows:

	Z	XY Ltd
31 December 20x1 First year	10,000 tons	6500 tons
31 December 20x2	16,000 tons	8000 tons
31 December 20x3	20,000 tons	8200 tons
31 December 20x4	25,000 tons	9000 tons
31 December 20x5	26,000 tons	9900 tons
31 December 20x6	20,000 tons	-
31 December 20x7	22,000 tons	-
31 December 20x8	30,000 tons	-

From the figures above prepare in the books of "z".

a) Royalty Account – Payable and Receivable.
b) Landlord's Account.
c) Short workings account.
d) Sub-tenant's account.

e) Short workings sub – tenant's account.

Royalty Payable Account

	£		£
31/12/x1 Landlord's a/c	1,650	31/12/x1 Royalty rec. a/c	650
		31/12/x1 Manufacturing a/c	1,000
	1,650		1,650
31/12/x2 Landlord's a/c	2,400	31/12/x2 Royalty Rec. a/c	800
		31/12/x2 Manufacturing a/c	1,600
	2,400		2,400
31/12/x3 Landlord's a/c	2,820	31/12/x3 Royalty Rec. a/c	820
		31/12/x3 Manufacturing A/C	2,000
	2,820		2,820
31/12/X4 Landlord's a/c	3,400	31/12/x4 Royalty Rec. a/c	900
		31/12/x4 Manufacturing a/c	2,500
	3,400		3,400
31/12/x5 Landlord's a/c	3,590	31/12/x5 Royalty Rec. a/c	990
		31/12/x5 Manufacturing a/c	2,600
	3,590		3,590
31/12/x6 Landlord's a/c	2,000	19x6 Manufacturing a/c	2,000
31/12/x7 Landlord's a/c	2,200	31/12/x7 Manufacturing a/c	2,200
31/12/x8 Landlord's a/c	3,000	31/12/x8 Manufacturing a/c	3,000

Landlord's account

Dec. 31	£	Dec. 31	£
20x1 Cash	2,000	20x1 Royalty pay. A/c	1,650
		20x1 Short workings a/c	350
	2,000		2,000
20x2 short workings a/c	350	20x2 Royalty pay. A/c	2,400
20x2 cash a/c	2,050		
	2,400		2,400
20x3 cash a/c	2,820	20x3 Royalty pay. A/c	2,820
20x4 cash a/c	3,400	20x4 Royalty pay. A/c	3,400
20x5 cash a/c	3,590	20x5 Royalty pay. A/c	3,590
20x6 cash a/c	2,000	20x6 Royalty pay a/c	2,000
20x7 cash a/c	2,200	20x7 Royalty pay a/c	2,200
20x8 cash a/c	3,000	20x8 Royalty pay. A/c	3,000

Short workings account

Dec. 31	£	Dec. 31	£
20x1 Landlord's a/c	350	20x1 Balance c/d	350
20x1 Balance b/d	350	20x2 Landlord's account	350

Royalty Received Account

31 Dec	£	31 Dec.	£
20x1 Royalty Pay a/c	650	20x1 Sub-tenant's a/c	975

20x1 Profit and loss a/c	325		
	975		975
20x2 Royalty pay a/c	800	20x2 Sub-tenant's a/c	1,200
20x2 Profit and loss a/c	400		
	1,200		1,200
20x3 Royalty pay. A.c	820	20x3 Sub-tenant's a/c	1,230
20x3 Profit and loss a/c	410		
	1,230		1,230
20x4 Royalty pay. A/c	900	20x4 Sub-tenant's a/c	1,350
20x4 Profit and loss a/c	450		
	1,350		1,350
20x5 Royalty pay a/c	990	20x5 Sub-tenant's a/c	1,485
20x5 Profit and loss a/c	495		
	1,485		1,485

Short workings (sub-tenant's) a/c

Dec. 31	£	Dec. 31	£
20x1 Balance c/d	275	20x1 Sub-tenant's a/c	275
20x2 Balance c/d	325	20x2 Balance b/d	275
		20x2 Sub-tenant's a/c	50
	325		235
20x3 Profit and loss a/c	275	20x3 Balance b/d	325
20x3 Balance c/d	70	20x3 Sub-tenant's a/c	20
	345		345
20x4 Sub-tenant/s a/c	70	20x4 Balance b/d	70

Sub-tenant's accounts:

Dec. 31	£	Dec. 31	£
20x1 Royalty Rec. a/c	975	20x1 cash a/c	1,250
20x1 Short workings (sub-tenant)	275		
	1,250		1,250
20x2 Royalty Rec. a/c	1,200	20x2 cash a/c	1,250
20x2 Short workings (subtenant)a/c	50		
	1,250		1,250
20x3 Royalty Rec. a/c	1,230	20x3 cash a/c	1,250
20x3 short workings (subtenant) a/c	20		
	1,250		1,250
20x4 Royalty Rec. a/c	1,350	20x4 short workings (subtenant)a/c	70
		20x4 cash account	1,280
	1,350		1,350
20x5 Royalty Rec. a/c	1,485	20x5 cash account	1,485

Exercise

1. XY Ltd had patented quick-boiling kettle and gave the domestic appliances company the right to manufacture and sell under a license for seven years. The stipulated terms were as follows:

a) A royalty of shs. 4 to be paid for each kettle sold.
b) A minimum payment of shs.20,000 per annum.
c) The right to deduct in two following years any excess of the minimum payment over the calculated royalties in any year.

The number of kettle sold was:-

Year ended 31.12.20x6 4,000
Year ended 31.12.20x7 4,500
Year ended 31.12.20x8 5,400
Year ended 31.12.20x9 6,500

Give the ledger accounts, as they would appear in the books of the domestic appliances company to record these transactions.

2. A landlord granted to the mining company Ltd. a lease of mineral rights over his property for a period of 10 years from 1st January 19-2. The rent payable was a minimum of shs. 80,000 a year, merging in a royalty of shs.1 per ton payable annually. Short workings could be recouped out of subsequent excess workings over the period of the lease. At the end of the first year, the mining company Ltd, granted a sub-lease to mining lessees Ltd. In respect of one-half of the area for a period of nine years. Mining lessees were to pay a minimum rent of shs.44,000 merging in a royalty of shs.1.50 a ton payable annually. Short workings could be recouped out of subsequent excess workings in any of the three years immediately following that in which the short workings occurred.

The following tonnages were mined from the property.

	Mining Co.	Mining Lessees
Year 1	40,000 tons	-
2	75,000 tons	15,000 tons
Year 3	60,000 tons	18,000 tons
4	65,000 tons	20,000 tons
5	70,000 tons	35,000 tons
6	49,000 tons	35,000 tons
7	46,000 tons	40,000 tons

Prepare ledger accounts in the books of mining company Ltd.

CONSIGNMENT ACCOUNTS:

Sometimes the manufacturers or wholesalers send goods to their agents in other places or countries for sale on commission basis. The agents are required to sell these goods in the best possible manner and remit the sale proceeds after deducting expenses and their own commission.

Terms:

a) Consignment: The goods sent by the principal to his agent for the purpose of sale on his behalf.
b) Consignor: The sender of goods (owner).
c) Consignee: The person to whom goods are sent for the purpose of sale.
d) Consignment outwards – the dispatch of goods from the point of view of the consignor.
e) Consignment inwards: The receipt of goods dispatched by the consignor from the point of view of the consignee.

Distinction between a consignment and a sale:

1. In a sale, the legal ownership of goods sold is transferred to the buyer, whereas in a consignment of goods, the legal ownership of the goods is not transferred to the consignee till goods are sold, then title is transferred to the buyer.

2. In a sale of goods, the seller is creditor and buyer is debtor whereas in a consignment, the consignor is principal and the consignee is agent.

3. In a consignment, expenses incurred by the consignee in connection with the goods consigned to him are borne by the consignor whereas in a sale, expense incurred after sale of goods are borne by the purchaser.

4. In a consignment, risk attached to the goods sold lies with the consignor till the goods are finally sold. Whereas in a sale risk attached to the goods sold is transferred to the buyer.

5. In a consignment, goods not sold by the consignee are returned but in a sale, once goods are sold, they are not returnable.

6. In a consignment, account sale is required to be submitted periodically by the consignee to the consignor however, no account sale is necessary in a sale.

7. In a consignment, unsold stocks with the consignee are stocks of the consigner whereas in a sale, the seller has nothing to do with stocks of the buyer.

NOTE:

1. In the absence of negligence on the part of the agent, the principal shall be responsible for any loss or damage to the goods during transit or during storage of goods sent on consignment.

2. The agent is entitled to pre-determined commission on sales and normally, has no share in consignor's profits.

3. The agent is not responsible for any loss on account of bad debts unless he is in the receipt of del-credere commission.

Accounts required and their purpose:

Books of the consignor:

Accounts opened are

1. Goods sent on consignment account.
   - records cost of goods sent on consignment.
   - Records returns from consignee at cost.
   - At period end, balance is transferred to purchases.
   - There is never opening or closing balance.

2. **Consignee's account:**
   - credited with expenses incurred on behalf of consignment.
   - Credited with cash or bills sent to consignor.
   - Debited with cash collected from sales.
   - Balance represents amount due to consignor.

3. **Consignment account:**
   - is the profit and loss account of the consignment.
   - Debit with cost of goods sent on consignment and expenses incurred thereon.
   - Debit with consignee's expenses and commission (per account sales).
   - Credited with cash and credit sales.

- Credited with value of unsold stock in the hands of the consignee at the end of the period.
- Balance of the account represents profit or loss on consignment for the accounting period.

4. **Consignment debtors account:**
   Where consignee is not a del credere agent, this provides a control account on the consignment debtors.

Points to remember:

1. Stock is value to include a proportion of all expenses incurred in getting the goods into the hands of the consignee and in a saleable condition e.g. freight, insurance, landing charges, dock dues and customs duties.

2. Care needs to be taken in apportioning expenses when goods are lost in transit.

3. No adjustment is required in the books of the consignee in case the consignor sent a proforma invoice charging goods at a higher price.

Normal loss:
May arise due to loading and unloading of the goods, evaporation and some other reasons relating to the nature of the goods. No entry is passed in the books of the consignor. The loss reduces profit on goods sold on consignment basis.

Abnormal loss:
May arise due to events such as destruction of goods by fire, theft of goods, breakage due to careless handling. The value of this loss is calculated like the unsold stock and credited to the consignment account and debited to the abnormal loss account. Any amount realized on a/c of damaged goods is credited to the abnormal loss a/c. Any balance on the abnormal loss a/c is transferred to the profit and loss account.

Accounting entries:

1. Cost of goods sent on consignment
   Dr: Consignment account
   Cr: Goods sent on consignment a/c.

2. When expenses are paid by consignor
   Dr: Consignment a/c
   Cr: Cash book

3. When expenses are paid by consignee
   Dr: Consignment a/c
   Cr: Consignee's a/c

4. To record commission due to consignee on sales
   Dr: Consignment a/c
   Cr: Consignee's a/c.
5. Cash and credit sales subject to del credere commission
   Dr: Consignment debtors a/c
   Cr: Consignment a/c

6. Insurance claim in respect of goods lost
   Dr: Insurance claim a/c
   Cr: Consignment a/c

7. Profit on consignment for the period.
   Dr: Consignment a/c
   Cr: Profit and loss a/c

8. Amount due from consignee settled by Bill of exchange
   Dr: Bills receivable a/c
   Cr: Consignee's a/c

9. Cost of goods sent on consignment for period.
   Dr: goods sent on consignment a/c
   Cr: Purchases a/c

10. Unsold stock on consignment
    Dr: stock on consignment a/c
    Cr: Consignment a/c

11. Profit element of closing stock (if invoiced at higher value)
    Dr: Consignment a/c
    Cr: Stock reserve a/c

12. Profit element on goods lost or destroyed
    Dr: consignment a/c
    Cr: goods destroyed a/c.

BOOKS OF CONSIGNEE:

1. Consignor's account.
   Shows amounts received in respect of cash sales, collections from debtors and payments made on behalf of the consignor. Commission is debited to the consignor's a/c and credited to commission receivable account. Balance on a/c is amount due to consignor.
2. Memorandum debtors a/c
   Maintained in respect of credit sales for a del credere consignee.

3. Accounts sales
   Shows proceeds of sales received by the consignee, less expenses incurred and commission charged.

Entries:

a) Goods sent by consignor
   No entry.
b) Expenses paid by consignee
   Dr: consignor's a/c
   Cr: cash book.

c) Sales made by consignee
   Dr: cash book
   Cr: consignor's a/c
d) Commission due to consignee
   Dr: consignor's a/c
   Cr: commission receivable a/c

e) Remittance of balance due to consignor by Bill of exchange
   Dr: consignor's a/c
   Cr: Bills payable a/c.

Example 1

ABC Ltd of Mombasa sent 1000 cases of medicines to XYZ Ltd of Dar-es-salaam at shs.1000 per case. Expenses on the consignment incurred by the consignor amounted to shs.30,000. XYZ Ltd wer working as del credere agents. Their ordinary commission was 5% and del credere commission 7½%. XYZ Ltd paid by cheque shs. 200,000 as an advance to ABC Ltd immediately on receipt of the consignment. After six months an account sales was received by ABC Ltd giving the following information:

- sales proceeds of 750 cases shs. 1,200,000.
- stock of unsold goods in hand 250 cases.
- commission charged at agreed rates of 5% and 7½%.
- consignee's expenses amounted to shs.50,000.
- A bill of exchange was sent by XYZ Ltd for the amount due to ABC Ltd along with the account sales. This bill was discounted immediately by ABC Ltd for shs. 780,000.

Assuming that ABC Ltd have to close their books on the receipt of above account sales, show the following entries;

a) Ledger accounts in the books of ABC Ltd.
b) Consigner's account in the books of XYZ Ltd.

Solution:

Workings:
Value of unsold stock:
Cost of 250 cases = 250 x 1000 = 250,000/=

Expenses

Paid by consignor	shs.	30,000
Paid by consignee	"	50,000
		80,000

Share of expenses for 250 cases

$\frac{250}{1000} \times 80,000 = 20,000$

cost of unsold stock 270,000

BOOKS OF ABC LTD:

Consignment account

	Shs.		Shs.
Goods sent on consignment	1,000,000	Consignee's a/c (sales)	1,200,000
Expenses (bank)	30,000	Stock (250 cases)	270,000
XYZ Ltd			
Expenses paid	50,000		
Commission	60,000		
Discount charges of bill receivable	20,000		
Profit and loss a/c	220,000		
	1,470,000		1,470,000

Bills receivable account.

	Shs.		Shs.
Consignee's a/c	800,000	Bank a/c	780,000

		Consignment a/c (discount)	20,000
	800,000		800,000

Goods sent on consignment a/c

	Shs.		Shs.
Purchases a/c	1,000,000	Consignment a/c	1,000,000

Consignment stock a/c

	Shs.		Shs.
Consignment a/c (250 cases)	270,000		

[XYZ LTD] Consignee's a/c

	Shs.		Shs.
Consignment a/c (sales)	1,200,000	***Bank a/c***	
		Advance received	200,000
		Expenses	50,000
		Commission	60,000
		Del credere commission	90,000
		Bills received a/c	800,000
	1,200,000		1,200,000

Books of XYZ Ltd.

Consignor's account

	Shs.		Shs.
Bank a/c			
ABC Ltd	200,000	Debtors a/c (sales)	1,200,000
Expenses	50,000		
Commission receivable a/c	60,000		
Del credere commission	90,000		
Bills payable a/c	800,000		
	1,200,000		1,200,000

Example 2.

On 1 July x8. David consigned goods to the value of shs.200,000 to Robert. This was made by adding 25% on the cost. David paid there on sh. 10,000 for freight and shs. 6000 for Insurance. During transit 1/10 of the goods was totally destroyed by fire and the sum of shs. 12,000 was realized from the insurance company. On arrival of the goods, Robert paid shs. 3,600 as carriage to godown. During the year to 30th June x9, Robert paid shs. 80,000 for godown rent and shs. 4,000 for selling expenses. 1/9 of the remaining goods was again destroyed by fire in godown and nothing was recovered from the Insurance Company.
Up to 30 June x9, Robert sold half of the original goods for shs. 120,000 and charged commission of 5% on sales. On 30 June x9 Robert sent a bank draft to David for the amount due from him.

Required:

Prepare the following ledger accounts in the consignor's books for the year ended 30 June x9.

a) Consignment account.
b) Goods destroyed by fire account.
c) Consignee's account.
d) Consignment stock account and balance sheet extract.

Solution:
Workings:

1. Goods destroyed by fire

	shs.	
Invoice price of goods consigned	200,000	
Add freight	10,000	
Insurance	6,000	
	216,000	
Less: value of goods destroyed in transit. 1/10 x 216,000	21,600	
Value of goods received by Robert (9/10 of goods consigned)	194,400	
Add: carriage to godown	3,600	
	198,000	
Less: value of goods destroyed in godown (1/9 x 198,000)	22,000	
Value of goods in godown (8/10)		176,000

Total value of goods destroyed (2/10) = 21,600 + 22,00 = 43,600

Goods sold = ½ of goods sent.

 closing stock = 8/10 - 5/10 = 3/10

$$= 176{,}000 \times \frac{10}{8} \times \frac{3}{10} = 66{,}000$$

Consignment stock account

	Shs.		Shs.
30/6/x9. Consignment a/c	66,000		

Dr — Consignment a/c — Cr

	Shs.		Shs.
1/7/x8 Goods sent on consignment	200,000	30/6/x9 Consignee's a/c (sales)	120,000
1/7/x8 Bank a/c		30/6/x9 Consignment stock a/c	66,000
Freight	10,000	30/6/x9 Goods sent on consignment a/c (excess price)	40,000
Insurance	6,000	Goods destroyed by fire	43,600
30/6/x9 Consignee's a/c			
- carriage	3,600		
- Godown rent	80,000		

- Selling expenses	4,000		
Commission (5% 120,000)	6,000		
30/6/x9 Goods destroyed			
25/125 x 2/10 x 200,000)	8,000		
Stock suspense a/c	12,000		
Closing stock (15/125 x 3/10			
X 200,000)			
Profit and loss account	12,000		
	269,600		269,600

Goods destroyed by fire account

	Shs.		Shs.
30/6/x9 Consignment a/c		30/6/x9 Consignment a/c	
- Goods destroyed in transit	21,600	Excessive price charged on goods	
- Goods destroyed in godown	22,000	destroyed	8,000
		30/6/x9 Insurance Co.	12,000
		30/6/x9 Profit & loss a/c (loss)	23,600
	43,600		43,600

Consignee's account

	Shs.		Shs.
30/6/x9 Consignment a/c (sales)	120,000	30/6/x9 Consignment a/c	
		- Carriage	3,000
		- Godown rent	8,000
		- Selling expenses	4,000
		- Commission on sales	6,000
		Bank draft	99,000
	120,000		120,000

Balance sheet (Extract)

	Shs.			Shs.
		Consignment stock	66,000	
		Less stock		
		suspense a/c	12,000	
				54,000

Exercise:

1. PQ Company of Nairobi sent goods on consignment to RST Ltd of Kampala valued at a cost of shs. 20,000. The consignor paid Insurance and freight shs. 1,500 and sh.1,000 respectively. The expenses paid by RST Ltd. amounted to shs. 2,000. The consignee is entitled to a commission at the rate of 5% of sales. The goods were sold by RST Ltd. for shs. 33,000. The payment was made by RST Ltd to PQ Company by a bank draft.

Required:

Show entries in the relevant accounts in the books of

a) PQ Company

b) RST Ltd.

2. XY Company of Nairobi consigned 800 bales of cotton to G.H. Company of Lusaka at cost price shs. 500 per bale. The expenses on consignment incurred by the consignor were; freight shs. 10,000; carriage and insurance shs. 15,000.
G.H. Company were working as del credere agents. Their ordinary commission was 4% and del credere commission 6%. G.H. Company paid by bank draft shs. 100,000 as an advance to XY Company. Immediately on receipt of the consignment goods.
Exactly after six months an "account sales" was received by XY Companyj giving the following information:
a) sales proceeds of 600 bales shs. 420,000.
b) stock of unsold goods in hand 200 bales.
c) commission charged at agreed rates of 4% and 6%.
d) consignee's expenses amounted to sh.8,000.
e) A bank draft was sent by G.H. Company to XY Company in settlement of account along with the account sales. You are required to prepare the necessary accounts recording the above in the ledgers of:
   i) The consignor
   ii) The consignee

3. On 1st October 20x1, Expol Ltd sent goods costing £2,400 on consignment to Imerce Ltd. In Northern Ireland. Expol Ltd. paid freight £92 and insurance £76 on the goods. A bill drawn by Expol Ltd on Imerse Ltd. payable in three month's time for £1,200 was discounted by Expol Ltd for £1,182. On 31st December, 20x1 Expol Ltd received an account sales from Imerse Ltd showing sales £3,010, commission £90 and expenses £37. Stock remaining unsold in the hands of Imerse Ltd was £410, at original cost.

Imerse Ltd settled the balance due for goods by means of a two month bill. Expol Ltd. discounted the bill with the bank, which deducted £17 from its face value for charges. You are required to show the necessary ledger accounts (excluding cash) in the books of both companies, recording the above transactions.

ACCOUNTS FOR PROFESSIONAL FIRMS:

Professionals maintain accounts on a cash system and rarely do they maintain accounts on accruals system. They also prepare receipts and payments accounts.

Recording transactions:

- Cash book

  - Records receipts and payments.
  - Credit transactions are noted in a memorandum book and finally in the cash book when cash is received.

- Stock register

  - Records all articles purchased for use for the profession. E.g. stationery, books, surgical instruments, furniture, typewriters, calculators, etc.
  - Records goods purchased for resale e.g. medicine. Any amount sold is noted.

Income and expenditure Account:

Prepared on the basis of information in the cashbook and stock register. Outstanding income is ignored until it is received. However, outstanding expenses are taken into consideration. In this account, income is considered on cash basis and expenditure is considered on accruals basis.

Accounts of Doctors:

Incomes are grouped from the dairy and recorded in the daily cash book having columns for visits, prescriptions prescribed and consultation fees.

Accounts of Advocates:

Advocates usually receive money from their clients either as an advance against a law suit, or other legal matters, or for the purpose of being used in a specific manner. Advocates are in the position of Trustees for all such moneys received from their clients. They should maintain separate account for all cash received from their clients as distinct from their own office cash. Thus different columns for office bank account and client's bank account.

All receipts from clients except payment against bills for services rendered are debited to the client's column in the cashbook and credited to the client's personal account.

For payments on behalf of the client, debit the clients personal account and credit the client's column in the cashbook.

A bill of costs journal is also maintained. It is ruled with two columns i.e. out for costs incurred on behalf of the client and the other for costs incurred in running own office. Where small payments on behalf of client are not debited to client's personal account but are passed through office expenses account, these are later transferred to client's personal account.

Accounts of Accountants:

These provide the following services to their clients:

- Preparation of final accounts.
- Auditing services.
- Tax consultants.
- Financial advisers.
- Other services.

The accounts of professional accountants are also maintained on cash basis. They also maintain cashbooks and stock register. The income and expenditure account is prepared at the end of the year to ascertain the profit earned from accountancy services rendered.

References

1. Clinton, B.D.; Van der Merwe, Anton (2006). "Management Accounting - Approaches, Techniques, and Management Processess". *Cost Management* (New York: Thomas Reuters RIA Group) (May/Jun).
2. Accounting Education Change Commission (1993). "Positions and Issues". *Issues Statement Number 4: Improving the Early Employment Experience of Accountants*. Sarasota, FL: American Accounting Association. Retrieved 2 November 2011.
3. Clinton, B.D.; Matuszewski, L.; Tidrick, D. (2011). "Escaping Professional Dominance?". *Cost Management* (New York: Thomas Reuters RIA Group) (Sep/Oct).
4. Professional Accountants in Business Committee *International Good Practice Guidance: Evaluating and Improving Costing in Organizations*. New York: International Federation of Accountants. July 2009. p. 24. Retrieved 10 November 2011.

5. "Taking Control of IT Costs". Nokes, Sebastian. London (Financial Times / Prentice Hall): March 20, 2000. ISBN 978-0-273-64943-4
6. Friedl, Gunther; Hans-Ulrich Kupper and Burkhard Pedell (2005). "Relevance Added: Combining ABC with German Cost Accounting". *Strategic Finance* (June): 56–61.
7. Sharman, Paul A. (2003). "Bring On German Cost Accounting". *Strategic Finance* (December): 2–9.