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DEPARTMENT OF BUSINESS AND SOCIAL STUDIES

COURSE CODE: BBM 125

COURSE TITLE: FUNDAMENTALS OF ACCOUNTING II

Instructional Material for BBM - distance learning

TABLE OF CONTENT

COURSE OUTLINE

BBM 125: FUNDAMENTALS OF ACCOUNTING II

Pre-requisites: BBM 114

Purpose: To develop the learners deeper understanding of the principles of book-keeping and accounts and the ability to maintain books of accounts and preparation of financial statements
Course Objectives: By the end of the course unit the student should be able to:-

- Compile accounting data
- Prepare financial statements
- Interpret accounting information
- Use accounting information in decision making.

Course Content:

- Partnership accounts; the partnership agreement, formation of a partnership, final accounts of partnerships, valuation of goodwill and change in partnership
- Introduction to company accounts, Introduction to published financial statements
- Financial Reporting by Manufacturing enterprise
- Financial statement analysis
- Cash flow Statements
- Accounting for not for profit organizations
- Incomplete records

Teaching / Learning Methodologies: Lectures and tutorials; group discussion; demonstration; Individual assignment; Case studies

Instructional Materials and Equipment: Projector; test books; design catalogues; computer laboratory; design software; simulators

Recommended Text Books:

- Honrgren and Sundem, G. L, *Introduction to Financial Accounting*, (6th Edition), New York; Prentice Hall
- Larson, K.M and Pyre, D, *Fundamentals of Accounting Principles*, (12th Edition), Prentice Hall
- Frank Woods & Alan Sangster, Business accounting,(9th) Prentice Hall

Text Books for further Reading:

- Wood, Frank, *Business Accounting* (17th Edition), International Thompson

TOPIC ONE: MANUFACTURING ACCOUNTS

Learning Objectives
By the end of the topic you should be able to:

- Define direct and indirect costs
- Administration cost of a manufacturing firm.
- Selling and distribution costs
- Transfer price
- Prepare manufacturing accounts

1.1 INTRODUCTION

Some firms may manufacture or produce goods rather than buy due to savings in operational costs. (i.e. it is cheaper to produce the goods rather than buy). Due to additional costs involved in the production process, additional information is reported in the final accounts. These firms incur manufacturing cost. Therefore in addition to the preparation of trading profit & loss A/c and balance sheet, they also prepare manufacturing account to show the manufacturing costs.

The purpose of the manufacturing account is to report all the costs incurred in producing goods. The costs incurred in the manufacture are classified as either direct or indirect.

Direct costs /prime costs
These are costs that one can easily identify in the product or which one can easily associate with the product. Direct costs are further divided into the following categories:

(a) *Direct materials* These are the cost of raw materials which one can directly identify in product e.g. wheat in breach, cloth in clothes e.tc.

(b) *Direct Labour* This is labour costs which is directly associated with a product e.g. wages of a machine operator or wages of a machine operator or wages of labourers directly involved in product process e.g. sorting out materials, mixing etc.

(c) *Direct expenses* These are expenses which are directly incurred in the process of manufacture of a product e.g royalties paid to the owner of a machine or to the owner of a quarry land where minerals are extracted.

Note The total of direct materials, labour and expenses make up *prime cost.*

Indirect costs overheads
These are costs not easily identified in a product or associated with it. They are divided into: -

(a) *Indirect materials* These are costs raw materials which one cannot easily identify with a particular product e.g. salt/sugar in bread, buttons in clothes, bolts in furniture etc.

(b) *Indirect Labour* This is labour cost which is not easily associated with a product e.g. salary of a foreman or supervisor. Because such a person is supervising several production floors his/her services cannot be associated with one single production process.

(c) *Indirect expenses* These are expenses which can't be directly associated with the product e.g. insurance of factory machines, buildings, rent, water, power & lighting, depth of machines, etc

Other examples include; rent for the factory, depreciation of plant and machinery used in production

Note The totals of indirect materials, indirect labour and indirect expenses are refereed to as *factory costs overheads.*

Work in progress (W-I-P) These are materials, labour and overheads which are in the process of manufacture. W-I-P can either be opening W-I-P or closing W-I-P.

The manufacturing account shows the factory cost of goods produced that will be shown in the trading account in place of purchases.

Format

Name

Manufacturing Trading Profit and Loss Account for the year ended 31 December

	Kshs	Kshs	
Raw Materials			
Opening stock of raw materials		XX	
Purchases of raw materials	XX		
Add carriage inwards	XX		
	XX		
Less returns outwards	(XX)	XX	
Cost of raw materials available for use		XX	
Less closing stock of raw materials		(XX)	
Raw materials consumed		XX	
Direct labour (factory wages)		XX	
Direct expenses		XX	
Prime cost		XX	
Factory overheads			
Salary to factory manager	XX		
Depreciation on – Plant and machinery	XX		
- Factory buildings	XX		
Other expenses – Factory power	XX		
Lighting and heating	XX		
Water	XX		
Cleaners wages	XX	XX	
Total cost of production		XX	
Add: opening Work In Progress	XX		
Less: closing Work In Progress	(XX)	XX	
Factory cost of production (cost of finished goods)		XX	Note 1
Factory Profit		XX	
Finished goods at a transfer price		XX	Note 2
Sales		XX	
Less returns inwards		(XX)	
		XX	
Less cost of sales			
Opening stock – finished goods	XX		
Factory cost of production/transfer price	XX		
	XX		
Less closing stock of finished goods	(XX)	(XX)	

Gross profit		XX
Add factory profit		XX
Other incomes – discount received		XX
- Profit on disposal		XX
		XX
Less expenses		
Salaries and wages – administration & non production	XX	
Rent for administration building	XX	
Depreciation - Delivery vans	XX	
- Fixtures and distribution	XX	
Other selling and distribution costs	XX	(XX)
Net profit/(net loss)		XX/(XX)

For the statement of financial position, the format is the same for all the assets and liabilities except for the current assets section whereby the stock at the end of the period should be shown for each type of stock as per this format:

Current Assets	£	£
Stock: raw materials	XX	
Work in progress	XX	
Finished goods	XX	XX

Note 1: This represents the total costs of all the units produced during the period and therefore will be taken to the trading account as the goods are transferred to the selling department.

Note 2: If the firm transfers the goods to the selling department at a price higher than the cost of production, then this generates a factory profit. The goods will be shown in the trading account at the transfer price and the factory profit is added to the Gross Profit of the period.

1.2 OTHER COSTS

Administration Expenses these are expenses incurred in providing control, direction and management of the firm Such as expenses relating to secretarial, accounting, rent, rates, insurance, water, electricity etc for the office. Also included in depth of office furniture & equip, office building office stationery, manufacture costs of office equipment, legal expenses, etc.

Selling & distribution expenses These are expenses incurred to secure orders and increase sales of the enterprise. These expenses are incurred in the movement of finished goods from factory to the warehouse and then delivering the goods to customers' e.g transport charges for moving goods from factory to warehouse & vice versa, warehouse costs, depreciation of delivering van and related costs etc.

Example 1.1

B spikes
Trial Balance as on 31 December 2002

	Dr	Cr
Stock of raw materials 1.1.2009	21,000	
Stock of finished goods 1.1.2009	38,900	
Work in progress 1.1.2009	13,500	
Wages(direct £180,000: factory indirect£145,000)	325,000	
Royalties	7,000	
Carriage inwards (on raw materials)	3,500	
Purchases of raw materials	370,000	
Productive machinery (cost Kshs. 280,000)	230,000	
Accounting machinery (cost Kshs. 20,000)	12,000	
General factory expenses	31,000	
Lighting	7,500	
Factory power	13,700	
Administrative salaries	44,000	
Sales representatives' salaries	30,000	
Commission on sales	11,500	
Rent	12,000	
Insurance	4,200	
General administration expenses	13,400	
Bank charges	2,300	
Discounts allowed	4,800	
Carriage outwards	5,900	
Sales		1000,000
Debtors and creditors	142,300	125,000
Bank	56,800	
Cash	1,500	
Drawings	20,000	
Capital as at 1.1.2009		29,680
	1,421,800	1,421,800

Notes at 31.12.2009

1. Stock of raw materials Kshs. 24,000, stock of finished goods Kshs. 40,000, work in progress Kshs. 15,000.
2. Lighting, and rent and insurance are to be apportioned: factory 5/6ths, administration 1/6th.
3. Depreciation on productive and accounting machinery at 10 per cent per annum on cost.

Required:
Prepare a manufacturing, Trading Profit and Loss Account for the year ended 31 December 2009.

B Spikes

Manufacturing, Trading Profit and Loss Account for the year ended 31 December 2009

Raw Materials	£	£
Opening Stock of raw materials		21,000
Purchases	370,000	
Carriage inwards on raw materials	3,500	373,500
		394,500
Less: closing stock of raw materials		(24,000)
Raw materials consumed		370,500
Direct wages		180,000
PRIME COST		550,500
Factory Overheads		
Wages	145,000	
Royalties	7,000	
Depreciation: productive machinery	28,000	
General factory expenses	31,000	
Lighting(5/6 x 7,500)	6,250	
Factory power	13,700	
Rent(5/6 x 12,000)	10,000	
Insurance(5/6 x 4,200)	3,500	24,4,450
Total cost of production		794,950
Add: opening work in progress		13,500
		808,450
Less: closing work in progress		(15,000)
Factory cost production per finished goods		793,450
Sales		1,000,000
Less cost of sales		
Opening stock of finished goods	38,900	
Factory cost of production	793,450	
	832,350	
Less closing stock of finished goods	(40,000)	792,350
Gross profit		207,650
Expenses		
Accounting machinery – depreciation	2,000	
Lighting (1/6 x 7,500)	1,250	
Administrative salaries	44,000	
Sales representatives salaries	30,000	
Commission on sales	11,500	
Rent (1/6 x 12,000)	2,000	
Insurance (1/6 x 4200)	700	
General administrative expenses	13,400	
Bank charges	2,300	
Discounts allowed	4,800	
Carriage outwards	5,900	(117,850)
Net profit		89,800

B Spikes
Statement of Financial Position as at 31 December 2002

	Cost	Depreciation	Net Book Value
Non current Assets	Kshs	Kshs	Kshs
Productive machinery	280,000	(78,000)	202,000
Accounting machinery	20,000	(10,000)	10,000
	300,000	88,000	212,000
Current Assets			
Stock: raw materials	24,000		
Finished goods	40,000		
Work in progress	15,000	79,000	
Debtors		142,300	
Cash at bank		56,800	
Cash in hand		1,500	
		279,600	
Current liabilities			
Creditors		(125,000)	154,600
			366,600
Capital			296,800
Add net profit			89,800
			386,600
Less drawings			(20,000)
			366,600

Example 1.2
Bibi Maridadi owns and manages a small manufacturing business. The following balances have been extracted from her books of account at 31 January 2009:

	Dr	Cr
	Sh	Sh
Capital at 1 February 2009		171,120
Accounts payable		86,000
Bank and cash balance	5,400	
Accounts receivable	92,000	
Drawings	60,000	
Administration expenses	150,360	
Advertising expenses	12,000	
Factory direct wages	60,000	
Factory indirect wages	24,000	
Factory power	36,000	
Furniture and fittings (all offices)	18,400	
Heat and light	16,000	
Plant and equipment	276,800	
Motor vehicle (used by salesmen)	144,000	
Plant hire	4,000	
Provision for bad debts		3,200
Provision for depreciation 1 February 2009:		
– Furniture and fittings		9,200
– Plant and equipment		138,400

– Motor vehicle		24,000
Raw material purchases	228,000	
Rent rates	20,000	
Sales		829,440
Selling and distribution expenses	66,400	
Inventories at cost, 1 February 2009:		
– Raw materials	8,000	
– Work in progress	16,000	
– Finished goods	24,000	
	1,261,360	1,261,360

The following additional information is provided:

(i) Accruals at 31 January 2010 were:

Factory power	-	Sh.1,600
Rent and rates	-	Sh. 4,000

There was also prepayment of Sh. 800 for salesmen's motor vehicle insurance.

(ii) Inventories at 31 January 2010, were valued at cost as follows:

Raw materials	-	Sh. 15,200
Work in progress	-	Sh. 30,400
Finished goods	-	Sh. 45,600

(iii) Depreciation is to be charged on plant and equipment, motor vehicle, furniture and fittings at the rates of 20%, 25% and 10% per annum respectively on cost.

(iv) Expenditure on heat and light, and rent and rates is to be apportioned between the factory and office in the ratio of 9 to 1 and 3 to 2 respectively.

(v) The provision for bad debts is to be made equal to 5% of accounts receivable at 31 January 2010.

Required:

Using the vertical method, prepare Bibi Maridadi's manufacturing, trading and profit and loss account for the year ended 31 January 1986 and a balance sheet as at that date. (20 marks)

Solution:

Bibi Maridadi

Manufacturing, Trading and Profit and Loss Account for the year ended 31 January 2010

Direct materials	Sh	Sh
Opening stock of raw materials		8,000
Add: purchases of raw materials		228,000
		236,000
Less: closing stock of raw materials		(15,200)
Raw materials consumed		220,800
Factory direct wages		60,000
PRIME COST		280,800
Factory overheads		
Factory indirect wages	24,000	
Factory power	37,600	
Plant hire	4,000	

Heat and light	14,400	
Rent and rates	14,400	
Depreciation on plant	55,360	149,760
		430,560
Add opening work in progress		16,000
		446,560
Less closing work in progress		(30,400)
Factory cost of production		416,160
Sales		829,440
Less cost of sales		
Opening stock of finished goods	24,000	
Add factory cost of production	416,160	
	440,160	
Less closing stock of finished goods	(45,600)	394,560
Gross profit		434,880
Less expenses		
Increase in provision for doubtful debts	1,400	
Rent and rates	9,600	
Heat and light	1,600	
Depreciation: motor vehicle	36,000	
Furniture and fittings	1,840	
Selling and distribution expenses	65,600	
Administration expenses	150,360	
Advertising expenses	12,000	278,400
Net profit		156,480

Bibi Maridadi

Statement of Financial Position as at 31 January 2010

	Cost	Depreciation	Net Book Value
Non current Assets	Kshs	Kshs	Kshs
Plant and equipment	276,800	(193,760)	83,040
Furniture and fittings	18,400	(11,040)	7,360
Motor vehicle	144,000	(60,000)	84,000
	439,200	(264,800)	174,400
Current Assets			
Stock: Raw materials	15,200		
Work in progress	30,400		
Finished goods	45,600	91,200	
Debtors	92,000		
Less: provision for doubtful debts	(4,600)	87,400	
Prepayments		800	
Cash in hand and bank		5,400	
		184,800	
Current liabilities			
Creditors	86,000		
Accruals	5,600	(91,600)	93,200
			267,600
Capital			171,120
Add net profit			156,480
			327,600
Less drawings			(60,000)
			267,600

1.3 Unrealised Profits on Closing Stock

In most cases where business transfers finished goods at a profit to the selling department and the goods are reflected in the balance sheet at the transfer price, then the closing stock includes a profit that has not been earned or realised. If the mark up profit (the profit based on cost of production is always uniform, then any changes in the value of closing stock will result in a reduction or an increase in the unrealised profits.

If there is an increase on unrealised profit on the closing stock, then this increase will be reduced from the gross profit from our profit and loss account and if there is a reduction in unrealised profits, then this reduction will be added to the gross profit in our profit and loss account.

Any unrealised profit of closing stock should be deducted from the closing stock in the balance sheet.

The slight change in the format of the Profit and Loss Account and Balance Sheet will be as follows

Increase in unrealised profit in closing stock (UPCS)
Profit and loss (extract) Account for year ended……….

	£	£
Gross profit		X
Add: factory profit		X
Add: other expenses		X
		X
Less expenses		
Other expenses	X	
Increase in unrealised profit on closing stock	X	(X)
Net profit		X

Decrease in UPCS
Profit and Loss Account (extract) for year ended …………

	£	£
Gross profit		X
Add: factory profit		X
Add: other incomes		X
Add: decrease in UPCS		X
		X
Less expenses		
Other expenses		(X)
Net profit		X

Example: 1.3

A firm always values its stock (finished goods) at a mark-up of 20% on cost of production. The opening stock of finished goods for the period was valued at Sh. 100,000. (The marked up cost) The closing stock at the end of the financial period was Sh.160, 000.

Opening Stock:	100,000 (marked up)	=	120%
	(16,667)	=	(20%)
	83,333	=	100%
Closing Stock	160,000 (marked up)	=	120%
	(26,667)	=	(20%)

133,333 = 100%

UPCS

		Balance b/f	16,667
Balance c/d	26,667	Profit and loss a/c	10,000
	26,667		26,667

Profit and Loss (Extract)

Less: Expenses:	Sh	Sh
Increase in unrealized profits on closing stock	10,000	

Statement of Financial Position (Extract)

Current Assets	Sh	Sh
Stock:		
Raw materials	X	
Work in progress	X	
Finished goods	160,000	
Less: UPCS	(26,667)	133,333

1.4 Review Question

Question 1

Mr Cherono trades as a retailer of electric lamps and related products under the name of Chero Hardware. Most goods in which he trades are purchased from various suppliers in a finished form. In addition, a separate department of the firm manufactures various types of lampshades from purchased raw materials. When finished, the lampshades are transferred to the shop at an agreed transfer price for sale. No lampshades are sold other than through the shop.

The firm's Accounts Assistant presents you with the following trial balance at 30 June 2010:

	Sh	Sh
Capital account – Cherono		740,000
Drawings – Cherono	95,000	
Long term loan (interest at 15% p.a)		240,000
Fixtures and fittings at cost	900,000	
Accumulated depreciation at 1 July 2009		350,000
Motor vehicle at cost	208,000	
Accumulated depreciation at 1 July 2009		60,000
Stock at 1 July 2009 (at cost):		
Raw materials for lampshades	40,000	
Completed lampshades	20,000	
Other goods	328,000	
Trade debtors and creditors	122,000	
Bank balance	98,000	
Sales		4,100,000
Purchases – raw materials for lampshades	855,000	
- other goods	2,400,000	
Wages	254,000	

Rent and rates	96,000	
Water and electricity	47,000	
Motor expenses	60,800	
Repairs	12,000	
Interest on loan	18,000	
Bank charges	4,000	
Insurance	18,000	
Sundry expenses	21,200	
	5,597,000	5,597,000

Additional Information:

(i) Rent and rates include a prepayment of rates of Sh. 6,000.
(ii) The insurance includes a premium for the period ending 31 October 2010.
(iii) A trade debt of Sh. 14,000 is not expected to be realized.
(iv) During the year a pick-up van, which was bought for Sh. 86,000, was sold for Sh. 30,000, and replaced with another pick-up van costing Sh. 152,000. Both transactions have been posted to the motor vehicle account. No disposal account has been opened. The straight-line rates of depreciation based on cost are 25% p.a. for motor vehicle and 10% p.a. for fixtures and fittings. A full year's depreciation is charged in the year of acquisition and none in the year of disposal.
(v) Accruals at 30 June 2010 were:

Water and electricity	Sh. 5,000
Sundry expenses	Sh. 4,000

(vi) Stocks at 30 June 2010 were:

	Sh.
Lampshades raw materials	80,000
Lampshades (at transfer price)	30,000
Other goods at cost	252,000

(a) The agreed transfer price for lampshades produced was Sh. 1,000,000. The workshop produced 50,000 lampshades during the year.
(b) Wages include those of the lampshades making employee who has been paid Sh. 50,000 for the year. In addition, she is entitled to a commission on the annual profit of her department of 10% p.a. after charging such commission. Shop assistants' wages were Sh. 108,000.
(c) The apportionment of rent and rates; and water and electricity to the lampshades is 25% of the total.

Required:

(a) Prepare a manufacturing, trading and profit and loss accounts for the year ended 30 June 2010, disclosing clearly (i) the profit earned by the lampshades-making department and (ii) the gross profit earned by the shop.
(b) Prepare a statement of financial position as at 30 June 2010.

1.5 References

Honrgren and Sundem, G. L, *Introduction to Financial Accounting*, (6th Edition), New York; Prentice Hall
Larson, K.M and Pyre, D, *Fundamentals of Accounting Principles*, (12th Edition), Prentice Hall
Frank Woods & Alan Sangster, Business accounting, (9th) Prentice Hall

TOPIC TWO: PARTNERSHIP

Learning Objectives

Upon completion of this topic you should be able to:

- Describe arrange of methods of arriving at the selling of a business
- Explain and calculate super profits
- Explain why goodwill exist
- Calculate the adjustments needed when there is some form of change in a partnership
- Explain why there may be a the need for revaluation of assets in a partnership
- Calculate the amount of asset revaluation gain or attributable to each partner
- Make the necessary entries to the ledger accounts when assets are revalued.
- Record the entries relating to the dissolution of a partinership.

2.1 INTRODUCTION

A partnership is a relationship that subsists between two or more persons carrying on a business common with a view to making profit. Among others, reasons for partnership may be-

a) Additional capital incase a sole trader or one person is not able to raise sufficient capital.
b) Incase there is need for skills or expertise in certain areas of the business.
c) To involve more persons in the business especially for a family.

2.2 MEMBERSHIP

A partnership has minimum membership of two (2) maximum of fifty (50) except for professional firms (e.g.) lawyers, doctors, accountants etc. whose maximum membership is twenty (20) persons.

Where two or more persons wish to form a partnership, then it is recommended that they agree on the terms upon which the partnership will be run and the relationship between each other. This is done in writing and signed off as agreed by all the partners and therefore it becomes a partnership deed or agreement.

Contents of partnership agreement

a) Name(s) and address(s) of both the firm and the partners
b) Capital to be contributed by each partner
c) The profit sharing ratios that may be expressed as a fraction or as a percentage.
d) Salaries to be paid to any partners who will be involved in the active management of the business
e) Any interest to be charged on drawings made by the partners.
f) Interests to be given to the partners on their capital balances.
g) Procedures to be taken on the retirement or admission of a partner.

2.3 ACCOUNTING FOR PARTNERSHIPS

The interest of the partners in the business is either long term or short-term. The long-term interest is the capital contributed by each partner and the balance is expected to remain fixed. It will only change when the partners agree or incase of any changes in the partnership like admission of or retirement of a partner.

The short-term interest is reflected in form of a current account which is affected by the trading activities of the partnership (i.e.) the profits or losses and any drawings made by the partners.

In most partnerships, both a capital and a current account are maintained and therefore the capital account becomes a fixed capital account. When there is no distinction between a capital account and a current account then any short- term changes are passed through the capital account therefore the capital account becomes a *fluctuating capital account.*
Some of the transactions to be passed through the capital account and the current account are shown in the following formats.

(Assume a firm of 3 partners A, B and C)

Capital Account

	A	B	C		A	B	C
	sh	sh	sh		sh	sh	sh
Loss or revaluation	xx	xx	xx	Bal b/d	xx	xx	xx
Goodwill written off	xx	xx	xx	Additional capital	xx	xx	xx
				(c/book or asset)			
				Gains on revaluation	xx	xx	xx
Bal c/d	xx	xx	xx	Goodwill	xx	xx	xx
	xx	xx	xx		xx	xx	xx
				Bal b/d	xx	xx	xx

Current Account

	A	B	C		A	B	C
	sh	sh	sh		sh	sh	sh
Bal b/d		xx		Bal b/d	xx		xx
Interest on drawings	xx	xx	xx	Interest on capital	xx	xx	xx
Drawings	xx	xx	xx	Salaries	xx	xx	xx
				Share of profits	xx	xx	xx
Bal c/d	xx	xx	-	Loan interest	-	xx	-
				Bal c/d			xx
	xx	xx	xx		xx	xx	xx
			xx	Bal b/d	xx	xx	xx

2.4: FORMAT FOR FINAL ACCOUNTS:

a) Profit and Loss Account
The profit and loss account is exactly as the one for the sole trader and in addition to the profit and loss account, a new section called the *appropriation account* is included and this account shows how the partners share the Net Profit for the period. (In addition to other expenses in the profit and loss, an expense for interest on loan given by one of the partners is included and the credit entry is made on the partner's current account) The format for the Appropriation account is as follows:

			sh	sh
	Net Profit for the year			xx
Add:	Interest on drawings.			
		A	xx	
		B	xx	
		C	xx	xx
				xx
Less:	Interest on capital.			
		A	xx	
		B	xx	
		C	xx	(xx)
			£	£
				xx
Less:	Salaries			
		A	xx	
		B	xx	
		C	xx	(xx)
				xx
Balance of profit to be shared in percentage ratio				
		A (ratio)	xx	
		B (ratio)	xx	
		C (ratio)	xx	(xx)

b) Balance sheet

The balance sheet also the same as that for a sole trader but the interest of each partner in the business should be shown separately and any loan given by a partner to the firm is also shown separately in the non-correct liability section therefore, the format will be as follows.

	sh	sh	sh
Net assets.			xx
Capital: A			xx
B			xx
C			xx
			xx
Current account A		xx	
B		xx	
C (debit balance).		(xx)	xx
			xx
Non-current liabilities			
10% loan – B		xx	
10% loan – bank		xx	xx
			xx

Example 2.1

Read the following and answer the questions below.

A and B own a grocery shop. Their first financial year ended on 31 December 2002.
The following balances were taken from the books on that date:

Capital:	A- £60,000;	B - £48,000.
Partnership salaries:	A - £9,000;	B - £6,000.
Drawings:	A - £12,000;	B - £13,400.

The firm's net profit for the year was £32,840.
Interest on capital is to be allowed at 10% per year.
Profits and losses are to be shared equally.

(a) From the information above prepared the firm's appropriation account and the partners' current accounts.

Solution

A and B
Profit and Loss Appropriation account for the year ended 31 Dec 2002

		sh	sh
Net Profit for the year			32,840
Less:	Interest on capital		
	A	6000	
	B	4800	(10,800)
			22,040
Less:	Salaries		
	A	9000	
	B	6000	(15,000)
Balance of profit to be shared in Profit Share Ratio			7,040
	A ½	3520	
	B ½	3520	(7,040)

Current Account

	A	B		A	B
	sh	sh		sh	sh
Drawings	12,860	13,400	Interest on capital	6,000	4,800
			Salaries	9,000	6,000
Bal c/d	5,660	920	Profit shared.	3,520	3,520
	18,520	14,320		18,520	14,320
			Bal b/d	5,660	920

Example 2.2
Draw up a profit and loss appropriation account for the year ended 31 December 2007

i. Net profits sh30,350
ii. Interest to be charged on capitals: W sh2,000; Psh1,500; H sh900
iii. Interest to be charged on drawings; W sh240; P sh180; H sh130
iv. Salaries to be credited: P sh2,000; H sh3,500.
v. Profits to be shared: W 50%; P 30%; H20%.
vi. Current accounts: balances b/f W sh1,860; P sh946; H sh717
vii. Capital accounts: balances b/f W sh40,000; P sh30,000; H sh18,000
viii. Drawings: W sh9,200; P sh7,100; H sh6,900.

Solutions

W,P and H

Profit and Loss Appropriation Account for the year ended 31 December 2002

		sh	sh
	Net profit for the year		30,350
Add:	Interest on drawings		
	W	240	
	P	180	
	H	130	550
			30,900
Less:	Interest on capital		
	W	2,000	
	P	1,500	
	H	900	(4,400)
			26,500
Less:	Salaries		
	P	2,000	
	H	3,500	(5,500)
Balance of profit to be shared			21,000
	W 50%	10,500	
	Pl 30%	6,300	
	H 20%	4,200	(21,000)

Current Account

	W	P	H		W	P	H
	sh	sh	sh		sh	sh	sh
Interest on draw	240	180	130	Bal b/d	1,860	946	717
Drawings	9,200	7,100	6,900	Interest on capital	2,000	1,500	900
Bal c/d				Salaries		2,000	3,500
				Share of profits	10,000	6,300	4,200
Bal c/d	4,920	3,466	2,287				
	14,360	10,746	9,317		14,360	10,746	9,317

Balance sheet (extract) as at 31 Dec 2002

	sh	sh	sh
Net Assets			xx
Capital W			40,000
P			30,000
H			18,000
			88,000
Current Accounts			
W		4,920	
Pl		3,466	
H		2,287	10,673
			98,673

Example 2.3

The following list of balances as at 30 September 2009 has been extracted from the books of Brick and Stone, trading partnership, sharing the balance of profits and losses in the proportions 3:2 respectively.

		sh	
Printing, stationery and postage		3,500	
Sales		322,100	
Stock in hand at 1 October 2008		23,000	
Purchases		208,200	
Rent and rates		10,300	
Staff salaries		36,100	
Telephone charges		2,900	
Motor vehicle running costs		5,620	
Discounts allowable		950	
Discount receivable		370	
Sales returns		2,100	
Purchases returns		6,100	
Carriage inwards		1,700	
Carriage outwards		2,400	
Fixtures and fittings: at cost		26,000	
Provision for depreciation		11,200	
Motor vehicles: at cost		46,000	
Provision for depreciation		25,000	
Provision for doubtful debts		300	
Drawings:	Brick	24,000	
	Stone	11,000	
Current account balances			
At 1 October 2008:			
	Brick	3,600	credit
	Stone	2,400	credit
Capital account balances			
At 1 October 2009:			
	Brick		33,000
	Stone		17,000
Debtors			9,300
Creditors			8,400
Balance at bank			7,700

Additional information

1. sh10, 000 is to be transferred from Brick's capital account to a newly opened Brick Loan Account on 1 July 2009.
2. Interest at 10 per cent per annum on the loan is to be credited to Brick.
3. Stone is to be credited with a salary at the rate of sh12, 000 per annum from 1 April 2009.
4. Stock in hand at 30 September 2009has been valued at cost at sh32, 000.
5. Telephone charges accrued due at 30 September 2009 amounted to sh400 and rent of sh600 prepaid at that date.
6. During the year ended 30 September 2009 Stone has taken goods costing sh1, 000 for his own use.
7. Depreciation is to be provided at the following annual rates on the straight line basis:

Fixtures and fittings	10%
Motor vehicles	20%

Required:

(a) Prepare a trading and profit loss account for the year ended 30 September 2009.

(b) Prepare a balance sheet as at 30 September 2009 which should include summaries of the partners' capital and current accounts for the year ended on that date.

Note: In both (a) and (b) vertical forms of presentation should be used.

Solution

Brick and Stone.
Trial Balance As At 30 September 2009

		Debit	Credit
		sh	sh
Printing and stationery and postage		3,500	
Sales			322,100
Stock (1 October 2008)		23,000	
Purchases		208,200	
Rent and rates		10,300	
Heat and light		8,700	
Staff salaries		36,100	
Telephone charges		2,900	
Motor vehicle running expenses		5,620	
Discounts allowable		950	
Discounts receivable			370
Sales returns		2,100	
Purchases returns			6,100
Carriage inwards		1,700	
Carriage outwards		2,400	
Fixtures and fittings at cost		26,000	
Provision for depreciation			11,200
Motor vehicles at cost		46,000	
Provision for depreciation			25,000
Provision for doubtful debts			300
Drawings:	Brick	24,000	
	Stone	11,000	
Current accounts:			
	Brick		3,600
	Stone		2,400
Capital accounts:			
	Brick		33,000
	Stone		17,000
Debtors		9,300	
Creditors			8,400
Balance at bank		7,700	
		429,470	429,470

Trading and Profit Loss Account For the Year Ended 30 September 2009

		sh	sh	sh
	Sales			322,100
Less:	Sales returns			2,100
				320,000
less cost of sales				
	Opening Stock		23,000	
	Purchases (adjustment)	207,200		
Add:	Carriage inwards	1,700		
		208,900		
Less:	Purchases returns	(6,100)	202,800	
			225,800	
Less:	Closing Stock		(32,000)	(193,800)
	Gross profit			126,200
	Discount receivable			370
Less Expenses				
	Telephone charges (adjustment))	3,300		
	Printing and stationery and postage	3,500		
	Rent and rages (adjustment)	9,700		
	Heat and light	8,700		
	Staff salaries	36,100		
	Motor vehicle running expense	5,620		
	Discount allowable	950		
	Carriage outwards	2,400		
	Depreciation on fixtures and fittings	2,600		
	Depreciation on motor vehicles	9,200		
	Interest on loan (adjustment)	250	(82,320)	
	Net profit			44,250
Less:	Salaries Stone (adjustment)			(6,000)
	Balance of profit to be shared			38,250
	Brick $\frac{3}{5}$	22,950		
	Stone $\frac{2}{5}$	15,300		(38,250

Balance sheet as at 30 September 2009

Non current Asset	sh	sh	sh
Fixtures and fittings	26,000	(13,800)	12,200
Motor vehicles	46,000	(34,200)	11,800
	72,000	48,000	24,000
Current Asset			
Stock		32,000	
Debtors	9,300		
Less: Provision	(300)	9,000	
Payments		600	
Cash at bank		7,700	
		49,300	
Current Liabilities			
Creditors	8,400		
Accruals	400	(8,800)	40,500
			64,500

Capital

Brick (adjustment)		23,000
Stone		17,000
Current:		
Brick } adjustment	2,800	
Stone	11,700	14,500
		54,500
Non-Current Liabilities		
10% loan – Brick		10,000
		64,500

Current Account

	Brick	Stone		Brick	Stone
	sh	sh		sh	sh
Drawings	24,000	12,000 (adj)	Bal b/d	3,600	2,400
			Interest on loan	250	
Bal c/d	2,800	11,700	Salaries.		6,000
			Share profits	22,950	15,300
	26,800	26,800		26,800	23,700

2.5 GOODWILL

This is defined as the advantage, whatever it may be, a person gets by continuing to be entitled to represent to the outside would that he is carrying on a business which has been carried on for sometime previously. "Judge Warey in Hull V Frases"
Goodwill is the element that arises from a business due to its reputation and therefore, enjoys benefits that a new business may not get. (e.g.) A new business may not make profits easily during the first year of trading.
Factors that contribute to goodwill

1. Quality of products/Services
2. Good personnel
3. Marketing
4. Location
5.

In accounting, goodwill is very important for ascertaining the element or the share of a partner's effort to improve the business. The problem is normally to ascertain the value or cost of goodwill.
There are two types of goodwill:

a) *Non-Purchase goodwill*

Non- purchased goodwill is determined by using subjective estimates. There are various approaches to these. Goodwill maybe arrived at by taking the average profits for lets say three previous years of trading.
Due to this subjective estimate, this type of goodwill is not maintained or shown in the accounts.

b) *Purchased goodwill*

This is less subjective because it is the excess amount paid for a business above its net assets.
This is less subjective because it is the excess amounts paid for a business above its net assets.
(e.g) If a business pays Sh.3.5 m to acquire the net assets (i.e. in these case the net assets will be total assets less total liabilities) of another business that is still trading on and the value of the net asset is 3 M, therefore the purchased goodwill may be shown in the accounts as an intangible asset. Purchased goodwill can be treated in the following three main ways:

i. Goodwill is written off from the accounts
ii. Is carried at its value an amortized over a period of time
iii. Carried at its value without being amortized.

The practice is normally to carry it in the accounts together with the other assets (as an intangible asset) and amortize it over estimated period of time.

In a partnership, there are normally three situations where goodwill is accounted for in the accounts:

a) If there is a change in the profit sharing ratio.
b) On admission of a new partner.
c) On retirement of an old partner.

Example (when there is a change in profit sharing ratio)
When there is a change in the profit sharing ratio, then goodwill is introduced in the accounts by

Dr. Goodwill account
Cr. Partner's capital account (the credit is based on the old profit sharing ratio.)

The goodwill may remain in the accounts and therefore no partner entries will be made.
If the goodwill is to be written off from the accounts, this will be done by
Debiting partner's capital account (in the new profit sharing ratio)
Crediting goodwill account

Example 2.4
A and B have been trading as partners sharing profits and losses equally. They decided to change profit sharing ration to 3:2. The capital balances are:
A: - Sh.1, 000,000
B: - Sh.1, 500,000
Goodwill has been agreed at Sh.500, 000.

Required: The partner's capital balances assuming that:
1) Goodwill is to be retained in the accounts
2) Goodwill is to be written off form the accounts.

Solution:

1) Capital Account

	A	B		A	B
			Bal b/d	1,000,000	1,500,000
			Goodwill(OPSR)	250,000	250,000
Bal c/d	12,500,000	1,750,000			
	12,500,000	1,750,000			

2) Capital Account

	A	B		A	B
Goodwill (NPRS)	300,000	200,000	Bal b/d	1,000,000	1,500,000
Bal c/d (NPSR)	950,000	1,550,000	Goodwill (OPSR)	250,000	250,000
	12,500,000	1,750,000		12,500,000	1,750,000

2.6: REVALUATION OF ASSETS

The business may revalue some of the assets to reflect their fair values (e.g.) based on market price.
The revaluation is normally done when a new partner is to be admitted or an old partner is retiring.

Any revaluation gains or losses are passed through a new account (i.e) a Revaluation account and the balance on this account profit or low on revaluation is transferred to the partner's capital accounts in the existing profit sharing ratio.

Example: 2.5
(A, B, and C are trading as partners sharing profits and losses in the ratio of 2:2:1. They have the following assets and liabilities at the book values and they wish to restate these values at market values and agreed values.

Assets/Liabilities	Book value sh	Market price/Agreed value sh	Gain) Loss
Buildings	2,000,000	2,500,000	100,000
Fixtures, Fittings & furniture	900,000	800,000	(100,000)
Motor vehicle	1,200,000	1,150,000	(50,000)
Stock	700,000	650,000	(50,000)
Debtors	450,000	400,000	(50,000)
Creditors	800,000	700,000	100,000

Required:
Prepare Revaluation account and the partner's capital account given the partner's balances as

A sh3, 000,000
B sh2, 500,000
C sh1, 500,000

Revaluation Account

	sh		sh
Fixtures	100,000	buildings	500,000
Motor vehicles	50,000	Creditors	100,000
Stock	50,000		
Debtors	50,000		
Capital A/C A $\frac{2}{5}$	140,000		
B $\frac{2}{5}$	140,000		
C $\frac{1}{5}$	70,000		
	600,000		600,000

Capital Account

	A	B	C		A	B	C
Goodwill	sh 000	sh 000	sh 000		sh 000	sh 000	sh000
				Bal b/d	3,000	2,500	1,500
Bal c/d	3,140	2,640	1,510	Revaluation	140	140	70
	3,140	2,640	1,570		3,140	2,640	1,570

If there is a profit on revaluation, then the profit will be transferred to the partner's capital account by:

Dr. Revaluation

Cr. Partner's capital account in the profit share ratio

If there is loss then

Dr. Partner's capital account

Cr. Revaluation in the profit share ratio

Example 2.6

Alan, Bob and Charles are in partnership sharing profits and losses in the ratio 3:2:1 respectively.

The balance sheet for the partnership as at 30 June 19X6 is as follows;

	sh	sh
Fixed Assets		
Premises		90,000
Plant		37,000
Vehicles		15,000
Fixtures		2,000
		144,000
Current Assets		
Stock	62,379	
Debtors	34,980	
Cash	760	98,119
		sh242,119
Capital		

Alan		85,000
Bob		65,000
Charles		35,000
		185,000
Current account		
Alan	3,714	
Bob	(2,509)	
Charles	4,678	5,883
Loan – Charles		28,000
Current liabilities		
Creditors		19,036
Bank overdraft		4,200
		sh242,119

Charles decides to retire from the business on 30 June2006, and Don is admitted as a partner on that date. The following matters are agreed:

a) Certain assets were revalued;
   - Premises sh120,000
   - Plant sh35,000
   - Stock sh54,179
b) Provision is to be made for doubtful debts in the sum of sh3,000.
c) Goodwill is to be recorded in the books on the day Charles retires in the sum of sh42,000. The partners in the new firm do not wish to maintain a goodwill account so that amount is to be written back against the new partners' capital accounts.
d) Alan and Bob are to share profits in the same ratio as before, and Don is to have the same share of profits as Bob.
e) Charles is to take his car at its book value of sh3,900 in part payment, and the balance of all he is owed by the firm in cash except sh20,000 which he is willing to leave as a loan account.
f) The partners in the new firm are to start on an equal footing so far as capital and current accounts are concerned. Don is to contribute cash to bring his capital and current accounts to the same amount as the original partner from the old firm who has the lower investment in the business.

The original partner in the old firm who has the higher investment will draw out cash so that his capital and current account balances equal those of his new partners.

Required;

a) Account for the above transactions, including goodwill and retiring partners' accounts.
b) Draft a balance sheet for the partnership of Alan, Bob and Don as at 30 June 2009

Solution:

Capital Accounts

	Don	Alan	Bob	Charles		Don	Alan	Bob	Charles
	sh	sh	sh	sh		sh	sh	sh	sh
Goodwill written	12,000	18,000	12,000	-	Bal b/d	-	85,000	65,000	35,000

	Don	Alan	Bob	Charles		Don	Alan	Bob	Charles
off Motor vehicle	-	-	-	3,900	Goodwill	-	21,000	14,000	7,000
Cashbook	-	21,000		38,100	Cash book	79,000	-	-	-
Bal c/d	67,000	67,000	67,000	-					
	79,000	106,000	79,000	42,000		79,000	106,000	79,000	42,000

Current Accounts

	Don	Alan	Bob	Charles		Don	Alan	Bob	Charles
	sh	sh	sh	sh		sh	sh	sh	sh
Bal b/d	-	-	2,509	-	Bal b/d	-	3,714	-	4,678
Cash book	9,023			7,478	Revaluation a/c	-	8,400	5,600	2,800
					Cash book	3,091	-	-	-
Bal c/d	3,091	3,091	3,091	-					
	3,091	12,114	5,600	7,478		3,091	12,114	5,600	7,478

Revaluation Account

	sh		sh
Plant	2,000	Premises	30,000
Stock	8,200		
Debtors	3,000		
Profits shared:			
Alan	8,400		
Bob	5,600		
Charles	2,800		
	30,000		30,000

Cash book

	sh		sh
Bal b/d	760	Charles – capital account	38,100
Don - capital account	79,000	Loan	8,000
Current account	3,091	Current account	7,478
		Alan – capital account	21,000
		Current account	9,023
		Bal c/d	******

Cash book

	sh		sh
		Bal b/d	4,200
Don - capital account	79,000	Charles – capital account	38,100
Current account	3,091	Loan account	8,000
		Current account	7,478
		Alan – capital account	21,000
		Current account	9,023

Alan, Bob and Don Partnership

Balance Sheet as at 30 June 2006

Fixed Assets	Cost	Depreciation	NBV
Premises			120,000
Plant			35,000
Vehicles			1,100
Fixtures			2,000
			168,100
Current Assets			
Stock		54,179	
Debtors		31,980	
Cash		760	
		86,919	
Less Current Liabilities			
Creditors	19,036		
Bank overdraft	5,710	(24,746)	62,173
			230,273
Capital accounts			
Alan	67,000		
Bob	67,000		
Don	67,000		201,000
Current Accounts			
Alan	3,091		
Bob	3,091		
Don	3,091		9,273
			210,273
Non current liabilities			
Loan – Charles			20,000
			230,273

Notes:

i. Goodwill introduced shared among the partners in the old partnership in current profit sharing ratios.
ii. Same case applies for any gain or loss in the revaluation of assets.
iii. Goodwill written off in the new profit sharing ratios against the capital accounts only for the new partners.
iv. When there is no enough cash to be paid to the retiring partners, his balance remains in the business as a loan

2.7; ADMISSION OF NEW PARTNER.

When a new partner is admitted into the firm, this marks the end of the old partnership and the beginning of a new one. The new partner will have to bring in the capital that is due from him as per the agreement and also pay for a share of the goodwill.

Goodwill is credited to the partner's account (only the old) and is again written off by debiting the partner's account (inclusive of the new one in the new Profit Sharing Ratio).

If the admission is taking place part way through the financial period, then the new partner will be entitled to the profits or losses for the remaining part of the financial period. (i.e from the point of joining the partnership). Care should be taken when apportioning interest on capital, salaries and profits because of the changes

Example: 2.7

The following was the partnership trial balance as at 30 April 2009:

	Sh.	Sh.
Fixed capital accounts		
Rotich		750,000
Sinei		500,000
Current accounts		
Rotich		400,000
Sinei		300,000
Leasehold premises (purchased 1 May 2008)	2,250,000	
Purchases	4,100,000	
Motor vehicle (cost)	1,600,000	
Balance at bank	820,000	
Salaries (including partners' drawings)	1,300,000	
Stocks: 30 April 2008	1,200,000	
Furniture and fittings (cost)	300,000	
Debtors	225,000	
Accountancy and audit fees	105,000	
Wages	550,000	
Rent, rates and electricity	310,000	
General expenses (Sh.352, 400 for the six months to 31 October 2008)	660,000	
Cash introduced – Tonui		1,250,000
	Sh.	Sh.
Sales (Sh.3, 500,000 to 31 October 2008)		8,750,000
Accumulated depreciation: 1 May 20008		300,000
Furniture and fittings		100,000
Creditors		1,070,000
	13,420,000	13,420,000

Additional information:

1. On I November 2000 Tonui was admitted as a partner and from that date profits and losses were to be shared on the ratio 2:2:1. For the purposes of this admission, the value of goodwill was agreed at Sh.3, 000,000. No account for goodwill was to be maintained in the books, adjusting entries for transactions between the partners being made in their current accounts. On that date, Tonui introduced Sh.1, 250,000 more into the firm of which Sh.375, 000 comprised his fixed capital and the balance was credited to his current account.
2. Interest on fixed capitals was still to be allowed at the rate of 10% per annum after Tonui's admission. In addition, after Tonui's admission, no interest was to be charged or allowed on current accounts.
3. Any apportionment of gross profit was to be made on the basis of sales. Expenses, unless otherwise indicated were to be apportioned on a time basis.
4. A charge was to be made fro depreciation on motor vehicle and furniture and fittings at 20% and 10% per annum respectively, calculated on cost.

5. On 30 April, the stock was valued at Sh.1, 275,000.
6. Salaries included the following partners' drawings:
   Rotich Sh.150, 000, Sinei Sh.120, 000 and Tonui Sh. 62,500
7. A difference in the books of Sh.48,000 had been written off at 30 April 2009 to general expenses, which was later found to be due to the following clerical errors:
   - Sales returns of Sh. 32,000 had been debited to sales returns but had not been posted to the account of the customer concerned;
   - The purchases journal had been undercast by Sh.80,000
8. Doubtful debts (for which full provision was required) amounted to Sh.30, 000 and Sh.40, 000 as at 31 October 2008 and 30 April 2009respectively.
9. On 30 April 2008 rates and rent paid in advance amounted to Sh.50, 000 and a provision of Sh.15, 000 for electricity consumed was required.

Required:

a) Trading and profit and loss account for the year ended 30 April 2009. (9 marks)
b) Partners' current accounts for the year ended 30 April 2009 (4 marks)
c) Balance sheet as at 30 April 20019 (7 marks)

(Total: 20 marks)

Solution

Rotich, Sinei and Tonui
Trading, P Rofit and Loss Account for the year ended 30 April 2009

		Sh.	Sh.
Sales			8,750,000
Less:	cost of sales		
	Opening stock	1,200,000	
	Purchases	4,180,000	
		5,380,000	
Less: Closing stock		(1,275,000)	4,105,000
Gross Profit			4,645,000

	1.3.2000-3.10.2000		1.11.2000-30.4.2001			
	Sh	Sh	Sh	Sh	Sh	Sh
Gross profit $\frac{S}{TS} \times GP$		1,858,000		2,787,000		4,645,000
Expenses						
Dep. Motor Vehicle	160,000		160,000		320,000	
Furniture	15,000		15,000		30,000	
Salaries	483,750		483,750		967,500	
Accountancy fees	52,500		52500		105,000	
Wages	275,000		275,000		550,000	
Rent, rates, electricity	137,500		137,500		275,000	
General expenses	362,400		359,600		612,000	
Prov. For depreciation	30,000	(1,506,150)	10,000	(1,393,350)	40,000	2,899,500
Net Profit		351,850		1,393,650		1,745,500
Less: Interest on capital						
Rotich	37,500		37,500		75,000	

Sinei	25,000		25,000		50,000	
Tonui	-	(62,500)	18,750	(81,250)	18,750	(143,750)
Balance of profit shared		289,350		1,312,400		1,601,750
Rotich ⅔ ⅖	192,900		524,960		717,860	
Sinei ⅓ ⅖	96,450		524,960		621,410	
Tonui - ⅕	-	(289,350)	262,480	(1,312,400)	262,480	(1,601,750

b)

Current Account

	R Sh.	S Sh.	T Sh.		R Sh.	S Sh.	C Sh.
Goodwill w/o	1,200,000	1,200,000	600,000	Bal b/d	400,000	300,000	-
Capital A/C	-	-	375,000	Cash book			1,250,000
Drawings	150,000	120,000	62,500	Goodwill (2:1)	2,000,000	1,000,000	
				Interest on capital	75,000	50,000	18,750
				Profit share	717,860	621,410	262,480
Bal c/d	1,842,860	651,410	493,730				
	3,192,860	1,971,410	1,531,230		3,192,860	1,971,410	1,531,230

Rotich, Sinei and Tonui
Balance Sheet as at 30 April 2009

Non-Current Assets	Sh	Sh.	Sh.
Leasehold premises	2,250,000	-	2,250,000
Furniture and Fittings	300,000	(130,000)	170,000
Motor vehicle	1,600,000	(620,000	980,000
	4,150,000	(750,000)	3,400,000
Current Assets			
Stock	1,275,000		
Debtors	193,000		
Less Provision	(40,000)	153,000	
Prepayments		50,000	
Balance at bank		820,000	

			2,298,000	
Current Liability				
Creditors	1,070,000			
Accruals	15,000	(1,085,000)	1,213,000	
				4,613,000
Capital: Rotich				750,000
Sinei				500,000
Tonui				375,000
				1,625,000
Current Account: Rotich		1,842,860		
Sinei		651,410		
Tonui		493,730		2,988,000
				4,613,000

(d) The adjusting entries on admission of a new partner should be made to the capital account (i.e) for any introduction of goodwill and revaluation of assets

Some of the adjustments may also be made in the current accounts if adjustments are made in the capital account and the admission is partway through the financial period, then any interest to be charged on capital will be based on the adjusted capital balance.

If the adjustments are made in the current account then there will be no change on the capital balance and therefore no change on the interest charged on the capital balances

2.8:RETIREMENT OF PARTNER

When a partner retires (i.e.) leaves the firm and the others partners are left to continue with the business then the retirement marks the end of one partnership and the start of a new one.

The partner who is leaving should be paid all the amounts due to him. This includes:

a) Capital balance

This will be all the amounts the partner has invested in the firm. Some firms may not be able to refund the amount in full and therefore it may be transferred t o a loan account whereby interest will be paid on the balance.

(b) Goodwill

Because this partner contributed to the improvement (existence) of the partnership therefore it will be fair to pay him his share of the goodwill. Goodwill is introduced to the accounts in the old profit sharing ratio ((i.e.) credited to all the partner's capital accounts in the old profit sharing ratio), then written off from the accounts by debiting the capital accounts of the remaining partners in the new profit share ratio.

(c) *Credit balance on the current account*

This amount due to the partner is paid directly from the cashbook or transferred to the Capital account whereby the total cash payable is to be determined.

The transfer is made by:

Dr. Current account
Cr. Capital account

(d) Share of profits

If the retirement takes place during the financial period, then the retiring partner is entitled to take profits made up to the point of retirement. Any interest of capital, salaries and balance of profit shared in profit share ratio will be credited to the partner's current account. Therefore the profit and loss account will be split between the two periods and appointment of profits done and this will be based on the terms of the partnership in each period.

Example 2.8

Kyamba, Onyango and Wakil were partners in a manufacturing and retail business and shared profits and losses in the ratio 2:2:1 respectively

Given below is the balance sheet of the partnership as at 31 March 2009.

Balance sheet as at 31 March 2009

Assets	Sh.	Sh.
Non-current assets:		
Fixed assets		465,000
Current assets:		
Stock 294,000		
Debtors	209,000	503,000
		968,000
Capital and liabilities:		
Capital accounts:		
Kyamba	160,000	
Onyango	140,000	
Wakil	200,000	
		500,000
Current accounts:		
Kyamba	65,300	
Onyango	49,000	
Wakil	53,000	
		167,300
		667,300
Current Liabilities:		
Bank overdraft	48,000	
Trade creditors	252,000	
		300,700
		968,000

Additional information:

1. On 1 April 2009, Wakil retired from the partnership and was to start a business as a sole trader while Kyamba and Onyango continued in partnership.
2. On retirement of Wakil, the manufacturing business was transferred to him while Kyamba and Onyango continued with the retail business

   The assets and liabilities transferred to Wakil were as follows:

	Net book value	Transfer value
	Sh	Sh.
Fixed assets	260,000	306,000
Stocks	166,000	157,000

Debtors	172,000	165,000
Creditors	156,000	156,000

Wakil obtained a loan from a commercial bank and paid into the partnership the net amount due for him.

3. On retirement of Wakil form the partnership, goodwill was valued at Sh.200, 000 but was not to be maintained in the books of the partnership of Kyamba and Onyango.
4. After retirement of Wakil on 1 April 2009, Kyamba and Onyango agreed on the following terms and details of the new partnership.

   - Kyamba and Onyango to introduce additional capital of Sh.48, 000 and Sh.68, 000 respectively.
   - Each partner was entitled to interest on capital at 10% per annum with effect from 1 April 2009 and the balance of the profits be shared equally after allowing for annual salaries of Sh.72, 000 to Kyamba and Sh.60, 000 to Onyango.

5. The profit of the new partnership before interest on capitals and partners' salaries was Sh.240, 000 for the year ended 31 March 2010.
6. The profits made by the new partnership increased stocks by Sh.100,000, debtors by Sh.90,000 and bank balance by Sh.50,000.
7. Drawings by the partners in the year were Kyamba Sh.85, 000 and Onyango Sh.70, 000.

Required:

a) Profit and loss and appropriation account for the year ended 31 March 2002

b) Capital accounts for the year ended 31 March 2010 (4 marks)

c) Current accounts for the year ended 31 March 2010. (4 marks)

d) Balance sheet of the new partnership as at 31 March 2010. (8 marks)

(Total: 20 marks)

Solution

Kyamba and Onyango

Profit and loss appropriation account for the year ended 31.3.2010

	Sh	Sh.
Net profit for the year		240,000
Less: Interest on capital		
Kyamba	20,000	
Onyango	20,000	(40,000)
		200,000
Less: Salaries		
Kyamba	72,000	
Onyango	60,000	(132,000)
Balance of profits shared in PSR		68,000
Kyamba ½	34,000	
Onyango ½	34,000	(68,000)

b) Capital Account

	K	O	W		K	O	W
(2) Goodwill in New PSR	100,000	100,000	-	Bal b/d	160,000	140,000	200,000
(4) Fixed Assets			306,000	(1)Goodwill in old PSR	80,000	80,000	40,000
Stocks			157,000	Cashbook	48,000	68,000	-
Debtors			165,000	Profit on transfer in old PSR	12,000	12,000	6,000
				Creditors			156,000
Bal c/d	200,000	200,000		Current account (3)			53,000
				Cash book (**)			173,000
	300,000	3000,000	628,000		300,000	300,000	628,000

c) Current Account

	K	O	W		K	O	W
	Sh	Sh	Sh		Sh	Sh	sh
Capital	-	-	53,000	Bal b/d	65,300	49,000	53,000
Drawings	85,000	70,000	-	Interest on capital	20,000	20,000	-
				Salaries	72,000	60,000	-
Bal c/d	106,300	93,000	-	Share of profits	34,000	34,000	-
	191,300	163,000	53,000		191,300	163,000	53,000

Kyamba and Onyango
Balance Sheet as at 31 March 2002.

Non-Current Assets	Sh.	Sh.
Current Assets		205,000
Stock	228,000	
Debtors	127,000	
Bank	135,300	
	490,300	
Liabilities		
Creditors	(96,000)	394,300
		599,300
Capital:		
Kyamba		200,000
Onyango		200,000
		400,000
Current:		
Kyamba	106,300	
Onyango	93,000	199,300
		599,300

b) Bank

Working capital	173,000	Bal b/d	48,700
Kyamba- capital	48,000	Drawings	
Onyango – capital	68,000	Kyamba	85,000
Increase	50,000	Onyango	10,000
		Bal c/d	135,300
	339,000		339,000

Workings:

Non Current Assets:

Bal b/f	465,000
Transfer	260,000
Balance	205,000

Stock:

Bal b/f	294,000
Transfer	(166,000)
Increase	100,000
	228,000

Debtors:

Bal b/f	209,000
Transfer	(172,000)
Increase	90,000
	127,000

Creditors:

Bal b/f	252,000
Transfer	156,000
	96,000

2.9 REVIEW QUESTIONS

Question One

1. K. Kimeu and M. Maingi are in partnership as manufactures of Tick Toys, Kimeu being responsible for the factory and Maingi for the sales. All completed toys are transferred from the factory to sales department at agreed price. Profits are shared on the following basis:

	Factory	Sales Department
Kimeu	80%	40%
Maingi	20%	60%

The following trial balance has been extracted from the books at 31 March 2009:

		Sh.		Sh.
Freehold factory at cost	1,053,750			
Factory plant, at cost		843,750		
Provision for depreciation 1 April 2008			151,250	
Delivery van, at cost		401,250		
Provision for depreciation 1 April 2008			86,250	
Stocks at 1 April 2008				
Raw materials		100,700		
Work-in-progress		85,000		
Toys completed (30,000 at Sh.40)	1,200,000			
Sales (45,500 toys)		2,775,500		
Purchases of raw materials		716,250		
Factory wages		375,500		
Sales department wages	150,750			
Expenses:				
Factory		301,750		
Sales Department		250,500		
Provision for doubtful debts 1 April 2008				40,000
Trade debtors and creditors		450,000		150,000
Bank overdraft			176,200	
Capital accounts:				
Kimeu				1,400,000
Maingi				1,425,000
Drawings:				
Kimeu		150,000		
Maingi		125,000		
		6,204,200		6,204,200

Additional information:

i. 38,000 toys at Sh.45 each were manufactured and transferred to Sales Department during the year. Tys in stock at the end of the year were to be valued at Sh. 45 each. Stock of raw materials was Sh.79.50 and work-in-progress was valued at prime cost of Sh.126, 250 at 31 March2009.

ii. Accrued expenses outstanding at 31 March 2009

	Factory	Sales Department
	Sh.	Sh.
Expenses	52,250	27,000
Factory wages	7,000	-

iii Provision for depreciation is to be made as follows:

- Factory plant 10% p.a. on cost
- Delivery van 20% p.a. on cost

iv The general provision for bad debts is to be maintained at 10% of the trade debtors.

Required:
Manufacturing, trading and profit and loss accounts for the year ended 31 March 2009 and a balance sheet as at that date.

(20 marks)

Question Two

Amis, Lodge and Pym were in partnership sharing profits and losses in the ratio 5:3:2. The following trial balance has been extracted from their books of accounts as at 31 March 2008

	sh	sh
Bank interest received		
Capital accounts (as at 1 April 2007):		
Amis		80,000
Lodge		15,000
Pym		5,000
Carriage inwards	4,000	
Carriage outwards	12,000	
Cash at bank	4,900	
Current accounts:		
Amis	1,000	
Lodge	500	
Pym	400	
Discount allowed	10,000	
Discount received		4,530
Drawings:		
Amis	25,000	
Lodge	22,000	
Pym	15,000	
Motor vehicles:	80,000	
Accumulated depreciation (at 1 April 2007)		20,000
Office expenses	30,400	
Plant and machinery:		
At cost	100,000	
Accumulated depreciation (at 1 April 2007)		36,000
Provision for bad and doubtful debts		
(at 1 April 2007)		420
Purchases	225,000	
Rent, rates, heat and light	8,800	
Sales		404,500
Stock (at 1 April 2007)	30,000	
Trade creditors		16,500
Trade debtors	14,300	

	£583,300	£583,300

Additional information:

1. Stock at 31 arch 2008 was valued at sh35,000.
2. Depreciation on the fixed assets is to be charged as follows:
   a. Motor vehicles – 25% on the reduced balance
   b. Plant and machinery – 25% on the original cost.

   There were no purchases or sales of fixed assets during the year to 31 March 2008
3. The provision for bad and doubtful debts is to be maintained at a level equivalent to 5% of the total trade debtors as at 31 March 2008.
4. An office expense of sh405 was owing at 31 March 2008, and some rent amounting to sh1,5000 had been paid in advance as at that date. These items had not been included in the list of balances shown in the trial balance.
5. Interest on drawings and on the debit balance on each partner's current account is to be charged as follows:

	sh
Amis	1,000
Lodge	900
Pym	720

6. According to the partnership agreement, Pym is allowed a salary of sh13,000 per annum. This amount was owing to Pym for the year to 31 March 2008, and needs to be accounted for.
7. The partnership agreement also allows each partner interest on his capital account at a rate of 10% per annum. There were no movements on the respective partners' capital accounts during the year to 31 March 2008, and the interest had not been credited to them as at that date.

Required:

a) Prepare the Partners trading, profit and loss account for the year ended 31 March 2008
b) The partners current accounts and a balance sheet as at 31 March 2008

2.10 REFERENCES

Wood, Frank, *Business Accounting* (17th Edition), International Thompson. Pages 480-506

Honrgren and Sundem, G. L, *Introduction to Financial Accounting*, (6th Edition), New York; Prentice Hall. pages 60-90

TOPIC THREE: COMPANY ACCOUNTS

Learning Objectives
By the end of the topic you should be able to:
- Explain how a company is formed
- Define important company accounts terms
- Prepare final company accounts
- Prepare published company accounts

3.1 INTRODUCTION

Limited companies come into existence because of the growth in size of business and the need to have many investors in the business. Partnerships are not suitable for such businesses because the membership is limited to twenty persons. There are two principle types of companies:

Private companies Are companies owned by two or more people but not exceeding fifty members excluding both current and past employees of the company? These companies have the words 'limited' at the end of the name. Being private, they cannot invite the members of the public to invest in their ownership.

Public companies They are much larger in size as compared to private companies. They have the words 'public limited' company at the end of their name. They can invite the members of the public to invest in their ownership and the companies may be quoted/listed on the stock exchange.

Legal formalities governing the formation of a company
A Company is formed by a group of people called promoters. For a private company there are 2 promoters while there are 7 promoters incase of a public company. Promoters must submit the following documents to the registrar of companies.

i) Memorandum of Association (M.O.A)
This is the constitution of a company and it sets out the main objectives of the company being formed. Companies are required only to undertake projects/objectives which are laid down in the M.O.A. Any business which the company undertakes that is not specified in the M.O.A is void/ultra vires (beyond the powers). Thus any individual, who engages with a company in activities that are ultra vires, cannot have a legal redress because these contracts are unenforceable in the court of law and vice versa.

ii) Articles of Association (A.O.A)
This document specifies the internal rules that govern the day-to-day activities of the company e.g. appointment of directors, voting rights of shareholders, etc.

iii) List of directors.

iv) Declaration of compliance
Promoters must sign a statement implying that they have complied with all the rules and regulations governing the formation of the company.

If the registrar is satisfied that all the legal formalities have been complied with, issues the promoters with a certificate of incorporation which signifies the birth of the company. After the registrar has satisfied himself that all the legal formalities have been complied with, the issues the promoters with a certificate of incorporation which signifies the birth of company. After receipt of certification incorporation, private company can start trading immediately. Public limited Companies however, must wait to be issued with a trading certificate after raising the minimum capital to start the business operations.

After formation of a company, directors have to think of ways of raising capital to start business operations. There are various ways of raising capital e.g. Issues of shares and debentures. Raising capital through issue of shares.

3.2 SHARE CAPITAL OF A COMPANY

The owner's interest in a limited company consists of share capital. The share capital is divided into shares. A share is the smallest unit of ownership in a company. The investor will then pay for and be issued with the shares and therefore, they become owners.

Each share has a flat value called Par value/face value/nominal value. For instance, if a company decides to set up a share capital of Sh. 200,000, it may decide to issue:
200,000 shares of Sh. 1 each per value.
100,000 shares of Sh. 2 each per value.
400,000 shares of Sh. 50 each per value.

There are two main types of share capital

Preference share capital This is made up of preference shares and a preference share carries the right to a final dividend, which is expressed as a percentage of their par value. For example, 10% preference shares. Preference shares do not carry a right to vote and therefore no control in the company.

Ordinary Share capital These are the most common shares. They carry no right to a fixed dividend but are entitled to residual value of the business during winding up, and all profits after the claim on the entire preference dividend have been paid. The more the number of ordinary shares one holds, the higher the control of the company.

Share capital may also have the following meaning:

Authorized share capital Also called, registered or nominal capital. It is the total of the share capital which the company is allowed to issue to shareholders. A company cannot issue more shares than the amount that is authorized.

Issued share capital This is the total of the share capital actually issued to the shareholders**.**

Called up share capital This is the amount the shareholders have been asked to pay where the amount of capital required is less than the issued share capital. For example, if a firm issues ordinary shares of Kshs. 1 each and request the shareholders to pay 60cents. Assuming that the issued shares are 100,000 shares, then the called up share capital will be:
60cents $\times$ 100,000 = Kshs. 60,000
Uncalled share capital This is part of the issued share capital for which the company has not requested for payment and therefore these amounts will be received in the future. In the above

illustration, because the firm had not requested for 40cents, therefore the uncalled capital is 40cents × 100,000 = Kshs. 40,000.

Paid-up share capital This is the total of the share capital, which has been paid for by the shareholders.
Market value This is the value of a share in the open market. It is the value at which a share can be bought/sold in the stock exchange.

Share premium This is the profit obtained on the sale of shares by company. It arises when shares are sold at a higher value than the par/nominal value.

Share Discount This arises where shares are sold at a lower value than their nominal value during a public offer.

Issued share capital This is the capital that has already been subscribed by members of the public.

Authorized share capital This is the capital which directors are authorized by law to collect from members of the public. It is usually specified in the memorandum of association.

Prospectus A document/advertisement inviting members of the public to subscribe for shares in a limited public company.

Example 3.1
A limited has an authorized share capital of 200,000 shares of Kshs1 each out of which only 150,000 shares have been issued, Although the firm requested the shareholders to pay 80cents per share, the shareholders were able to pay 50cents per share.

Required:
Determine the:
i) Authorized share capital
ii) Issued share capital
iii) Called up share capital
iv) Uncalled up share capital
v) Paid up share capital

Solution
Authorized share capital
200,000 × Kshs.1 = Kshs. 200,000

Issued share capital
150,000 × Kshs.1 = Kshs.150, 000

Called up share capital
150,000 × 80cents = Kshs. 120,000

Uncalled up share capital
150,000 ×20 cents = Kshs. 30,000

Paid up share capital
150,000 × 50cents = Kshs.75, 000

Bonus shares Are shares issued to existing shareholders free of charge. They are paid out from either the share premium, balance of retained profits of the General Reserves.
A scrip issue is similar to bonus issue only that a scrip issue gives the shareholder the choice of receiving cash or stock dividends. In a bonus issue the shareholder has no choice but to take up the shares.
Example 3.2
A Ltd has 100,000 shares at £1 each to form an ordinary share capital of £100,000 and a balance on the share premium $^{A}/_{C}$ of £50,000. It issues some bonus shares to existing shareholders at a rate of 1 share for every 5 shares held. This amount is to be financed by the share premium. The entries will be as follows:

Shares to be issued:

$\frac{100,000}{5} \times 1 = 20,000$

Dr. Share premium $^{A}/_{C}$ [20,000 × Kshs.1]	20,000
Cr. Ordinary share capital	20,000

A bonus issue of 20,000 shares

Financial Position (extract)

Ordinary shares of Kshs.1		120,000
Capital Reserves		
Share premium	30,000	

A right issue is an option on the part of the shareholder given by the company to existing shareholders at a price lower than the market price.
It involves selling ordinary shares to existing shareholders of the company on a prorata basis.
When the rights are issued the shareholders have 2 options available.
Buy the new shares and exercise their rights
Sell the rights in the market,
Ignore the rights.
A rights issue therefore gives the shareholder the right (but not an obligation) to buy the new shares issued by the company.
Example 3.3
A Ltd has a share capital of £200,000 trade up of 100,000shares of £2 each. The balance on the share premium is £60,000. Additional capital is raised by way of a right issue. The term is:
For every 5 shares held in the company, a shareholder can buy 2 shares at a price of Kshs.2.5 per share.
Required:
The journal entries to reflect the above transaction assuming that all the shareholders exercise their rights and the relevant balance sheet extract.

Shares to be issued

$\frac{100,000}{5} \times 2 = 40,000$ shares

Dr cash book	[40,000 × Kshs. 2.5]	Kshs. 100,000
Cr Ordinary share capital	[40,000 × Kshs. 2]	Kshs. 80,000
Cr Share Premium	[40,000 × Kshs. 0.5]	Kshs. 20,000

Financial Position (extract)

140,000 Ordinary shares @ £2 280,000

Capital Reserves

Share premium 80,000

The principal distinctions between unlimited partnerships and limited companies are:

Unlimited Partnerships	Limited Companies
No separate Legal Entity apart from its members	Separate legal entity, which is not affect by changes in its membership. A company may contract, sue or be sued in it's own name.
Liability of each member for debts of the firm is unlimited.	If the company is limited by share, each shareholder is limited to the amount he has agreed to pay the company for share allotted.
Number of partners limited to 20 except for professional firms.	A limited company must have at least 2 members. The maximum number of shares is restricted to the company's authorized share capital.
Every partner can normally take part in the management of the business. He can legally bind the firm by his action.	Rights to management are delegated to directors who alone can act on behalf of and bind the company.
Copy of accounts need not be filed with the Registrar of Companies	Copies of accounts must be registered with the Registrar of Companies
Although a written Partnership deed is desirable it is not mandatory.	A company is required to have a memorandum and articles of association which defines powers and duties of directors.
A partnership is subject to the partnership Act which can be varied by mutual agreement.	A company is subject to the Companies Act the provisions of which cannot be varied.
The partners contribute the capital by agreement. The amount need not be fixed.	The authorized share capital is fixed by the memorandum of association. It can be altered by passing ordinary resolution or by the court.
A share in a partnership cannot be transferable except by the consent of all partners.	In public companies shares are freely transferable. In private companies share transfer are subject to any restrictions imposed by the articles of association.
A partnership is not obliged to keep statutory books of account and an audit is not compulsory.	A company is required to keep specialized accounting records and is subject to compulsory audit.

3.3 FINAL ACCOUNTED OF A COMPANY

The profit and loss account of a company, is the same as that of a sole trader, but there are additional expenses that are unique to the company and therefore, they should be included in the in this account (e.g.)

- Director's fees salaries and other expenses
- Audit fees
- Amortization e.g. goodwill
- Debenture interest

In addition to the P & L $^{A/C}$, just like a partnership has an appropriation $^{A}/_{C}$ which shows the allocation of the net profit for the period. Therefore, the format will be as shown:

Format for Company Accounts

B Limited

Trading, profit and loss and Appropriation Account for the year ended 31.12. 20xx

	Kshs	Kshs	Kshs
Sales			x
Less Returns inwards			(x)
			x
Less Cost of Sales			
Opening Stock		x	
Purchases	x		
Add Carriage in	x		
	x		
Less purchase returns	(x)	x	
		x	
Less Closing stock		(x)	(x)
Gross Profit			x
Add incomes			x
Discount received			x
Profit on disposal (sale of Assets)			x
Income from investment (can also be shown below)			x
Other incomes e.g. interest received from bank			x
			x
Less Expenses		x	
Other expenses		x	
Directors salaries/fees/----		x	
Audit fees		x	
Debenture Interest		x	
Amortization of good will			(x)
Operating profit for the period			x
Add investment income			x
Profit before tax			x
Taxation: Corporation tax		x	
Transfer to deferred tax		x	
Under or over provision		x	(x)
Profit after tax			x
Less: transfer to the general reserve			(x)
			x
Less: Dividends			
Preference dividend: Interim paid		x	
Final proposed		x	
		x	
Ordinary dividend: Interim paid		x	
Final proposed		x	(x)
Retained profit for the year			x
Retained profit b/f			x
Retained profit c/d			x

B Limited

Financial Statement Position as at 31.12.20xx

	Kshs	Kshs	Kshs
Non current Assets	Cost	Acc. Dep.	NBV
Land & Building			
Plant and Machinery	x	(x)	x
Fixtures, Furniture & Fittings	x	(x)	x
Motor vehicle	x	(x)	x
	x	(x)	x
Intangible Assets	x	x	x
Goodwill			
Copyrights, patents	x	(x)	x
	x	(x)	x
(Longterm) Investments (mkt value sh x)	x	x	
			x
Current Assets			x
Stock			
Debtors		x	
Less provision for bad debts	x		
Prepayments	(x)	x	
(Short term) Investments		x	
Cash at bank		x	
Cash in hand		x	
		x	
Current liabilities		x	
Bank overdraft			
Creditors	x		
Accruals	x		
Interest payable(debenture interest)	x		
Tax payable	x		
Dividends payable	x		
	x	(x)	x
Financed by			x
Authorized share capital			
100,000 ordinary shares of £1 each			x
100,000 preference shares of £1 each			x
			x
Issued and Fully paid			(x)
80,000 ordinary shares of £1 each			x
50,000 10% preference shares of £1 each			
			x
Capital Reserves			x
Share premium			
Revaluation Reserve		x	
Capital Redemption Reserve		x	
Revenue Reserves		x	x
General Reserve			
Profit and loss $^{A}/_{C}$		x	
		x	x
Deffered tax $^{A}/_{C}$			x

Non Current Liabilities		x
10% debenture		
Other Long term Loans	x	
	x	x
		x

Director's salaries Salaries, fees and other expenses in relation to the directors are expenses as far as company accounts are concerned. This is different from that of Partnerships & Sole traders which are shown as appropriations – expenses.

Audit fees All companies are required to prepare the accounts which should be audited and therefore any fees paid in relation to audit and accountancy is an expense.
Debenture interest Loans taken up by companies are called debentures. The interest paid on these loans is charged as an expenses and unpaid amount are shown as current liabilities in the business. The debenture is classified under non-current liability**.**

Corporation tax Companies pay corporation tax on the profits they earn. This is shown in the accounts because a company is a separate legal entity unlike for sole traders and partnerships whose tax is shown as drawings.

The tax is listed under those 3 items as shown in the appropriation (under/over provision for previous period, transfer to deferred tax corporation tax for the year). The under provision and corporation tax relate to direct liability to the government and therefore is a deduction from the net profit for the period. Transfer to deferred tax is to cater for future possible tax liability.

Assume that a firm had estimated that the corporation tax for the year ended 31.12.99 is £150,000. In 2000, the liability is now agreed at £160,000, which the company pays and at the end of the year 2000, the company estimates that the tax liability is £140,000.

Prepare a tax $^{A}/_{C}$ and show the amount to be deducted as tax for the year (ignore deferred tax).

(e.g.) Taxation Account

Cashbook	160,000	Bal b/d	150,000
Bal c/d	140,000	Appropriation	150,000
	300,000		300,000

Under provision 10,000 (160 -150)
Corporation tax 140,000

Dividends Shareholders are also entitled to a share of profits made by the company and this is because the shareholders do not make drawings from the company. A company may pay dividends in two stages during the cause of the financial period:

Interim dividends Is paid part way --- the financial period. (e.g.) after the 6 months

Final proposed Is paid after the year-end or after the completion to final accounts.
If a company pays in these 2 stages then the dividend section of the P & L appropriation should disclose interim paid and final proposed.

Capital reserves Amounts reflected in Capital reserves cannot be paid out or distributed to shareholders. The three types of capital reserves are:

Share Premium A share premium arises when accompanies issues shares at a price that is more than the par value. The share premium may be applied in the following:

- Paying un issued shares.
- Writing off preliminary expenses.
- Write off discounts on shares.

Example 3.4
A Ltd wishes to raise capital by issuing 100,000 ordinary shares at Kshs.1 each (per value) and the issue price (selling price) is Kshs.1.5 each.
The following are the entries to be made in the A/C.
Dr Cashbook (100,000 × Kshs. 1.5) 150,000
Cr Ordinary shares capital (100,000 × Kshs.1) = 100,000
Cr Sahre Premium $^{A}/_{C}$ (100,000 ×Kshs.0.5) = 50,000
Issue of shares at a premium of Kshs. 0.5

Revaluation reserve: Any gain made on revaluation of non current Assets especially for Land and buildings. When company sells its property to realize the gain, the amount is transferred to the profit and loss account.

Capital Redemption Reserve A reserve created after redemption or purchase of Preference shares without issuing new shares. The transfer is made from either the share premium or the profit and loss account.

Revenue reserves This can be distributed and includes the retained profits (P & L Accounts) and the General Reserves. Transfers are made from the Profits to the General reserves to provide for expansion or purchase of non current assets. The General Reserves can also be used to issue bonus Shares.

3.4 DEBENTURE LOANS

The term debenture is used when a limited company receives money on loan, and certificates called debenture certificates are issued to the lender.
They are also called loan stock or loan capital. Debenture interest has to be paid whether profits are made or not. A debenture may either be redeemable of irredeemable. Redeemable is repayable at or by a particular date and irredeemable is payable when the company is officially terminated.
Example 3.5
Just before you launch yourself into the question that follows remember that everything you have learnt about double entry bookkeeping and the presentation of year end accounts is valid in the context of companies, subject only to the points we have added in this session.

The following is the trial balance of Transit Ltd at 31 March 20X8.

	Kshs	Kshs
Issued share capital (ordinary shares of Kshs. 1 each)		42,000
Leasehold properties, at cost	75,000	
Motor vans, at cost (used for distribution)	2,500	

Provision for depreciation on motor vans to 31 March 20X7		1,000
Administration expenses	7,650	
Distribution expenses	10,000	
Stock, 31 March 20X7	12,000	
Purchases	138,750	
Sales		206,500
Directors' remuneration (administrative)	25,000	
Rents receivable		3,600
Investments at cost	6,750	
Investment income		340
7% Debentures		15,000
Debenture interest	1,050	
Bank interest	162	
Bank overdraft		730
Debtors and creditors	31,000	24,100
Interim dividend paid	1,260	
Profit and loss account, 31 March 20X7		17,852
	311,122	311,122

You ascertain the following:
All the motor vans were purchased on 1 April 20X5. Depreciation has been, and is to be, provided at the rate of 20% per annum on cost from the date of purchase to the date of sale. On 31 March 20X8 one van, which had cost £900, was sold for Kshs. 550, as part settlement of the price of £800 of a new van, but no entries with regard to these transactions were made in the books.
The estimated corporation tax liability for the year to 31 March 20X8 is Kshs.12, 700.
It is proposed to pay a final dividend of 10% for the year to 31 March 20X8.
Stock at the lower of cost or net realizable value on 31 March 20X8 is Kshs.16,700.

Required:

Prepare, without taking into account the relevant statutory provisions:

- A comprehensive income statement for the year ended 31 March 20X8:
- A financial position as at that date.

Solution:

Transit Ltd
Profit and Loss $^{A}/_{C}$ for the year ended 31.3.20X8

	Kshs	Kshs
Gross profit		72,450
Profit on disposal of van		190
Rent Receivable		3,600
		76,240
Less: Expenses		
Depreciation on motor vans	500	
Administration expenses	32,650	
Distribution expenses	10,000	
Debenture interest	1,050	
Bank interest	162	(44,362)
Trading profit for the year		31,878
Add investment income		340
Profit before tax		32,218
Taxation		(12,700)
Profit after tax		19,518
Less: Dividends		
Interim paid	1,260	
Final proposed	4,200	(5,460)
Retained profit for the year		14,058
Retained profit b/f		17,852
Retained profit c/d		31,910

Transit Ltd
Balance sheet as at 31.3.20X8

	Kshs	Kshs	Kshs
Non-Current Assets			
Leasehold properties	75,000	-	75,000
Motor vans	2,400	(960)	1,440
	77,400	960	76,440
Investments			6,750
			83,190
Current Assets			
Stock		16,700	
Debtors		31,000	
		47,700	
Current liabilities			
Bank overdraft	980		
Creditors	24,100		
Tax payable	12,700		
Proposed dividends	4,200	(41,980)	5,720
			88,910
Financed by:			
Authorized issued and fully paid			
42000 ordinary share of £1			42,000
Revenue Reserves			
Profit and Loss $^{A}/_{C}$ c/f			31,910
			73,910
Non-Current liabilities			
7% Debentures			15,000
			88,910

Workings

Sales		206,500
Less: Cost of sales		
Opening stock	12,000	
Purchases	138,750	
	150,750	
Less Closing stock	(16,700)	(134,050)
Gross profit		72,450

Motor Vehicle – Depreciation

Disposal	540	Bal b/d	1,000
Bal c/d	960	P & L	500
	1,500		1,500

Motor vehicle

Bal b/f	2,500	Disposal	900
Disposal	550		
Cashbook	250	Bal c/d	2,400
	3,300		3,300

Motor vehicle Disposal

Disposal	900	Motor Vehicle	550
P & L	190	Depreciation	540
	1090		1090

Example 3.6

Owik-Freez p.l.c. is a company which provides refrigerated storage facilities to local farmers. Services offered include the collection of produce, the use of rapid freezing equipment, storage of the frozen produce and transport from frozen storage in refrigerated vehicles to any point within the country. Orders for these services are secured by the company's sales staff.

The company's revenue consists of charges for transport and freezing, and of storage rentals. Customers may hire storage space either on a long-term contract basis at advantageous charges (payable in advance) or on a casual basis (invoiced monthly).

A considerable amount of electricity from the public supply is used by the company in the freezing and storage operations. In the event of a sudden failure in this supply, the company is able to generate its own emergency supplies from standby generators kept for this purpose. An insurance policy has been taken out to protect the company against the claims which would arise should any of the frozen produce deteriorate as the result of power or equipment failure.

At the end of the company's financial year ended 30 September 2008, the assistant accountant extracted the following balances from the ledgers.

Assets Account	£
Land and buildings (at cost)	390,000
Plant (at cost)	271,900
Vehicle (at cost)	82,600
Provision for depreciation (at 1 October 2007):	
Land and buildings	39,600
Plant	144,800
Vehicles	27,050
Stock of consumable stores (at 30 September2008)	23,449
Debtor – for rentals	18,204
for charges	2,332
Bank	30,710
Cash	1,103
Liability Accounts	
Trade Creditors	7,390
7% Debentures 2004/2012	80,000
Ordinary Share Capital (see note 7)	200,000
General reserve	25,000
Unappropriated profit (at 1 October 2007)	108,284
Share Premium	15,000
Revenue Accounts	
Storage rentals – long term contracts	302,090
Casual	85,063
Freezing charges	112,810
Transport charges	90,107
Expense Accounts	
Wages, salaries and related expenses	128,004
Rates	79,112
Electricity	76,860
Transport costs	43,271
Repairs	30,319
Consumable stores	29,800
Postages, stationery, telephones	15,604
Insurance premium	7,800
Debenture interest	5,600
Sundries	9,176
Other Accounts	
Suspense (credit balance)	8,650

Notes at 30 September 2008:
At the beginning of the 1981-82 financial year, the company had sold refrigeration plant (which had originally cost Kshs. 26,000 and on which Kshs. 20,800 had been provided as depreciation to date of disposal) for Kshs. 4,000. The only accounting entries relative to this disposal which have been made so far, are a debit to Bank and a credit to Suspense of the amount of the sale proceeds.
In April 2008, the compressor unit in No.7 storage unit failed and as a consequence the contents deteriorated to such an extent that they had to be disposed of by incineration. Compensation of Kshs1,350 was paid to the farmer by Owik – Freez by cheque and debited to Suspense.

The insurance company has admitted liability under the policy but no further ledger entries have as yet been made.

During the 2007-08 financial year, the company replaced one of its refrigerated vehicles, which has originally cost Kshs.16, 400 and on which Kshs.13, 120 had been provided as depreciation to date of disposal. A trade-in (part exchange) allowance of Kshs. 6,000 was granted in respect to this vehicle. A replacement vehicle was acquired at a list price of Kshs. 27,000. The entries relating to the disposal of the old vehicle have not yet been made, except that the trade-in allowance has been debited to Vehicles and credited to Suspense. The balance of the price of the new vehicle has been paid by cheque and debited to Vehicles account.

It is the company's policy to provide for depreciation on a straight line basis calculated on the cost of fixed assets held at the end of each financial year and assuming no residual value. Annual depreciation rates are:

	%
Building	2
Plant	10
Vehicles	25

The 'Buildings' content of the item Land and Buildings included in asset account balances is £120,000.

Adjustments, not yet posted to the accounts, should be made for the following items:

	Kshs
Storage rentals received in advance	25,631
Insurance premium prepaid	600
Wages and Salaried accrued	1,920
Rates prepaid	28,820
Electricity accrued	5,757

Consumable stores include £4131 and Repairs include £9972 relating to vehicles.

The authorized and issued capital of the company consists of 400,000 Ordinary Shares of Kshs. 0.50 per share. The directors have recommended a dividend for the year of Kshs.0.12 per share.

Required:

Prepare, for internal circulation purposes, a Profit and Loss account for Qwik-Freez p.l.c.for the year ended 30 September 2008 and a Balance Sheet at that date. All workings must be shown.
(18 marks)

Open the Suspense account and post the entries needed to eliminate the opening credit balance.
(2 marks)
(20 marks)

Solution:

Qwik-Freez (East Anglia) p.l.c.
Profit and Loss Account for the year ended 30 September 2008

Workings:

	Kshs	Kshs
Revenue		
Storage rentals – long term (302,090 –		276,459
25631)		85,063
casual		112,810
Freezing charges		<u>90,107</u>
Transport charges		564,439
Less:		
Expenses	129,924	
Wages, Salaries etc. (128,004 + 1,920)	50,292	
Rates (79,112 – 28,820)	82,617	
Electricity (76,860 – 5,757)	57,374	
Transport costs (43,271 + 4,131 + 9,972)	20,347	
Repairs (30,319 – 9,972)	25,669	
Consumable stores (29,800 – 4,131)	15,604	
Postages, stationery, telephones	7,200	
Insurance premiums (7,800 - 600)	43,540	
1,2 *Depreciation	5,600	
Debenture Interest	<u>9,176</u>	
Sundries		<u>447,343</u>
		117,096
		<u>1,520</u>
5 Profit (less loss) on disposal of fixed assets		118,616
Net Profit For The Year		<u>108,284</u>
Retained profit brought forward		226,900
Distributed profit		
Less:		<u>48,000</u>
Ordinary dividends proposed		<u>178,900</u>
Retained profit carried forward		

Workings:

	Land	Buildings	Plant	Vehicle	Total
Fixed Assets:	Kshs	Kshs	Kshs	Kshs	Kshs
Balance 1 October 1981	270,000	120,000	271,900	55,600	717,500
(veh 82,600 – (6,000 + 21,000))					
Acquisitions (21,000 – 6,000)				27000	27,000
Disposals			(26,000)	(16,400)	(42,400)
Balance 30 September 1982	270,000	120,000	245,900	66,200	702,100

Depreciation					
-rate	-	2%	10	25	
	Kshs	Kshs	Kshs	Kshs	Kshs
-current year charge	-	2,400	24,590	16,550	43,540

Alternatively the depreciation charge for vehicles (Kshs.16, 550) can be classified as a transport cost, thereby increasing that figure to Kshs.73, 924.

Provision for Depreciation:					
Balance 1 October 2007	-	39,600	144,800	27,050	211,450
Disposals			(20,800)	(13,120)	(33,920)
Current year charge	-	2,400	24,590	16,550	43,540
Balance 30 September 2008	-	42,000	148,590	30,480	221,070
	Kshs	Kshs	Kshs	Kshs	£
Written down values at 30 September 2008	270,000	78,000	97,310	35,720	481,030
Proceeds from disposals			4,000	6,000	10,000
Less:					
Written down values of disposals			5,200	3,280	8,480
(26,000 – 20,800)					
(16,400 – 13,120)					
Profit/(Loss) on disposals			(1,200)	2,720	1,520

Example 3.6

Mwanga and Sons Ltd is a small manufacturing firm owned by members of the family. The following trial balance was extracted from the books of the company as at 31 March 2009:

	Sh.	Sh.
Freehold property, at cost (land Sh. 75,000)	125,000	
Plant, at cost	130,000	
Depreciation		62,000
Motor vehicle, at cost	53,000	
Depreciation – motor vehicle		30,500
Fittings and fixtures, at cost	38,600	
Depreciation – fittings and fixtures		11,790
20,000 Ordinary shares of Sh. 10 each authorized, issued and fully paid		200,000
Share premium		50,000
General reserve		120,000
Interim dividend paid	16,000	
Cash at bank and in hand	33,570	
Accounts receivable and payable	130,540	57,430
15% Debentures		100,000
Discount received		3,640
Profit and loss account 1 April 2008		103,870
Purchases of raw materials	942,380	
Sales of finished goods		1,254,760
Inventories 1 April 2008:		
Raw materials	33,060	
Work in progress	57,660	
Finished goods	107,860	

Provision for doubtful debts		6,400
Bad debts	4,890	
Rates and insurance	9,430	
Wages	108,370	
Factory power	22,560	
Light and water	16,280	
Plant maintenance	10,970	
Salaries	90,000	
Returns of raw material		3,240
Sales returns	1,360	
Advertising	8,580	
Transport expenses (Sales department)	24,320	
Bank charges	3,040	
General expenses	36,160	
	2,003,630	2,003,63

Additional information:

- Depreciation is to be provided for the year using the reducing balance method and applying rates of 15% on plant, 25% on motor vehicle and 10% on fittings and fixtures.
- Building is to be depreciated at the rate of 4% using the straight-line method. (Assume the whole building is used for manufacturing purposes).
- Provision for doubtful debts is to be adjusted to a figure equal to 10% of accounts receivable.
- Light and water, insurance and general expenses are to be apportioned in the ratio 4:1 between factory and administrative overheads.

	Sh.
Electricity and wateer accrued was	860
Insurance prepaid was	270
Rates prepaid were	780

Inventories were valued at:

Raw materials	139,630
Work in progress	82,450
Finished goods	124,320

- Debenture interest has not yet been paid.
- The directors require provision for a final dividend which will bring the dividend for the year up to Sh. 2 per share.

Required:
Prepare in vertical form a Manufacturing, Trading and Profit and Loss Account for the year ended 31 March 2009 and a Balance Sheet as at that date.

Mwanga and Sons Ltd

Manufacturing Account for the year ended 31 March 2009

Raw materials:		
Opening stocks		33,060
Purchases	942,380	
Less Returns In.	(3,240)	939,140
		972,140
Less Closing stocks		(139,630)
Prime Costs		832,570
Factory Overheads:		
Plant depreciation	10,200	
Rates and insurance	2,000	
Factory power	6,704	
Light and water	22,560	
Plant maintenance	13,712	
General expenses	10,970	
	28,928	95,074
Opening W.I.P.		927,644
Less: Closing W.I.P.	57,660	
Goods manufactured	(82,450)	(24,790)
		902,854

Trading, Profit and Loss Account for the Year Ended 31 March 2009

	Shs	**Shs**
Sales		1,254,760
Less: Closing stocks		(1,360)
		1,253,400
Opening stock	107,860	
Goods manufactured	902,854	
	1,010,714	
Less: Closing stocks	(124,320)	886,394
		367,006
Discount received		3,640
		370,646
Debenture interest	15,000	
Provision for bad debts	6,654	
Depreciation		
- Motor vehicle	5,625	
- Fittings and fixtures	2,681	
Dividend		
- Interim	16,000	
- Fianl	24,000	40,000
Retained Profit for the year		49,150
Retained Profit brought forward		103,870
Retained Profit carried forward		153,870

Financial Statement Position 31 March 2009

	Cost	Depreciation	Net
Fixed Assets	£	£	£
Freehold property	125,000	2,000	123,000
Plant	130,000	72,200	57,800
Motor vehicle	53,000	36,125	16,875
Fittings and fixtures	38,600	14,471	24,129
	346,600	124,796	221,804
Current Assets			
Stocks			
- Raw materials	139,630		
- work in progress	82,450		
- finished goods	124,320	346,400	
Debtors, less provisions		117,486	
Cash at bank and in hand		33,570	
Prepaid expenses		1,050	
		498,506	
Current Liabilities			
Creditors		57,430	
Accruals		15,860	
Dividend proposed		24,000	
		97,290	
Net current assets			401,216
			623,020
Financed by:			
Authorized, and issued share capital:			
20,000 Ordinary shares each Sh. 10			200,000
Reserves:			
Share Premium		50,000	
General Reserve		120,000	
Profit and Loss account		153,000	323,020
			523,020
15% debentures			100,000
			623,020

Workings:

Rate And Insurance

B/d	9,430	Prepaid	270
		Prepaid	780
		Profit and Loss Account	1,676
		Factory	6,704
	9,430		9,430

3.5 REVIEW QUESTIONS

Question One

The chief accountant of AZ Limited has extracted the following trial balance as at 31 October 2009.

	Sh.	Sh.
Authorized and issued capital		
Share premium		40000000
8% debenture stock		500000
Profit and loss stock		
Motor vehicles at cost	16500000	10000000
Provision for depreciation on motor vehicle		
Plant and machinery at cost	25800000	5500000
Provision for depreciation on plant and machinery		
Land buildings at cost	30000000	3400000
Stock in hand 1 November 2008 – Finished goods	420000	
– Raw materials	380000	6300000
– Work-in-progress	560000	
	Sh.	
Trade debtors	7360000	
Office furniture and equipment at cost	890000	
Provision for depreciation on office furniture and equipment		**Sh.**
Trade creditors	9500000	
Purchase of raw materials		185000
Sales of finished goods	1350000	1000000
Direct wages	395000	
Direct expenses	290000	28550000
Factory expenses	350000	
Indirect materials	150000	
Factory insurance	485000	
Sales room expenses	620000	
Administration expenses	840000	
Office salaries and wages	656000	
Vehicles running expenses	640000	
Bad debts written-off		
Balance at bank – overdrawn	96610000	
		1175000
		96610000

Notes:

Closing stock includes

– Finished goods

– Raw materials

– Work-in-progress

Accrued salaries

The directors recommended a dividend of 10% on the issued share capital and a transfer of Sh. 2,000,000 to a general reserve.

Debenture interest has not been paid
Depreciation is provided on straight-line method at 10% and 25% per annum on furniture and equipment, plant and machinery and motor vehicles respectively.
The overdraft interest of Sh. 725000 was communicated to the company by the bank on 5 November 1999 and therefore it has not been posted in the cash book.

Required:
Manufacturing, trading, profit and loss account for the year ended 31 October 1999.
(12 marks)
Balance sheet as at 31 October 2009. (8 marks)
(Total: 20 marks)

Question Two
The Chief Accountant of KK Ltd has extracted the following trial balance as at 31 October 2008.

	Sh,'000'	**Sh,'000'**
Authorized and issued capital (shares of Sh. 20 each fully		30,000
paid)		350
Share premium		3,500
10% premium		2,000
General reserve		2,850
Profit and loss account 1 November 2007	3,500	
Motor vehicles at cost		265
Provision for depreciation	44,500	
Freehold property	1,375	
Trade debtors		460
Trade creditor	95,650	127,450
Purchases and sales	3,478	
Stock in hand 1 November 2007	1,540	
Furniture and fittings at cost		138
Provision for depreciation	500	
Goodwill		385
Rent receivable	2,285	
Salaries and wages	358	
General expenses	2,470	
Vehicles running expenses	124	
Bad debts	568	
Telephone and postage	269	
Water and electricity	289	
Rates and insurance	10,492	
Cash at bank	167,398	167,398

Notes:
1. Credit sales amounting to Sh.165, 000 were made on 31 October 2008 but no entries were made in the books.
2. Returns outwards amounting to Sh.128, 000 were dispatched on 31 October 1998 but no entries were made in the books.
3. Closing stock was valued at Sh.4, 398,000.
4. Accrued salaries and telephone bills amounted to Sh.134, 000 and Sh.55, 000 respectively.
5. Rent for the month of October 2008 amounting to Sh.35, 000 had not been received from the tenant.

6. Provision for depreciation on furniture and fittings and the motor vehicles are 10% and 20% on cost respectively.
7. Provision for bad and doubtful debts of 5% on trade debtors should be made.
8. Corporation tax should be provided at 35% of the net profit before tax.
9. The directors propose a dividend of 15% on issued share capital and a transfer of Sh.2, 500,000 to the general reserve.
10. The debenture interest has not yet been paid.

Required:

1. Trading, profit and loss account for the year ended 31 October 2008. (13 marks)
2. Balance sheet as at 31 October 2008. (7 marks)

(Total: 20 marks)

3.6 REFERENCES

Wood, Frank, *Business Accounting* (9th Edition), International Thompson. Honrgren and Sundem, G. L, *Introduction to Financial Accounting*, (6th Edition), New York; Prentice Hall.

CHAPTER FOUR: FINANCIAL STATEMENT ANALYSIS/ RATIO ANALYSIS

4.1 DEFINITION

Financial statement analysis is the process of identifying the strength and weaknesses of the firm by establishing and analyzing the relationships between various items in the financial statement. This relationship is expressed by the use of ratios.

Basic Financial Statement

a. *Balance sheet:* This indicates the financial position of a firm at a given point, in time. It shows the assets/resources of the firm and the respective liabilities that were incurred to finance these assets.
b. *Income Statement:* This indicates the financial performance of a firm during a given financial year. This performance is indicated by profitability of the firm.

Financial statements also includes cash flow statement which shows changes in cash position of the entity, value added statement and employee statement.

Classification of Financial Ratios Financial ratios are broadly classified into five categories:

a. Liquidity ratios
b. Turnover/asset management ratios
c. Gearing/capital structure ratios
d. Profitability ratios
e. Valuation/stock market ratios

Important Definitions

a. Net working capital= Current assets – Current Liabilities
b. Equity/networth = Ordinary share capital +retained earnings + other reserves
c. Operating profits =Profits/earnings before interest and tax (EBIT)
d. Net assets/capital employed = Total assets –Current liabilities
   (Equity +Long term liabilities)
e. Earnings attributable to ordinary shareholders = Profit after tax
   and preference dividends
f. Net profits =Profit after tax
g. Fixed return/charge capital = Long term liabilities with a fixed/constant rate of return (debentures (long term debt) + preference share capital.

Liquidity ratios

These ratios indicate the ability of a firm to meet its short term financial obligations (current liabilities) as and when they fall due for payment. The ratios generally express the relationship between current assets and current liabilities. They include;

a. Current ratio = $\frac{\text{Current assets}}{\text{Current liabilities}}$

   This ratio indicates the number of times current liabilities are covered by current assets e.g. a ratio of 1.5 means that current assets are 1.5 times of current liabilities.

b. Quick/acid test ratio = $\frac{\text{Current assets –stock}}{\text{Current liabilities}}$

This ratio indicates the ability of a firm to meet its current liabilities from the **more** liquid current assets. Stock is excluded for two reasons

i. It is valued at historical cost which may be different from the market value.
ii. It may be difficulty to convert stock into cash quickly in order to meet current liabilities.

c. Cash ratio = $\frac{\text{Cash in hand \& bank + short term marketable securities}}{\text{Current liabilities}}$

The ratio indicates the ability to meet current liabilities from the *most* liquid current assets of the firm. Short term marketable securities refer to short term investment of idle cash where such investments can be converted into cash quickly e.g. investment in treasury bills and commercial paper.

Turnover/asset management ratios

These ratios indicate the efficiency with which the firm is utilizing the resources/assets at its disposal to generate sales revenue. The ratios are associated with the level of sales of the firm. They include:

a. Stock/inventory turnover = $\frac{\text{Cost of sales}}{\text{Average/closing stock}}$

Where average stock = $\frac{\text{(opening stock + closing stock)}}{2}$

This ratio indicates the frequency/ number of times the stock was turned over into sales/ the number of times in a year did the 'buy- sell' process occur. The higher the stock turnover ratio, the better the firm. A low stock turnover may be caused by the following:

i. Charging higher prices than competitors where the customers will then shift their patronage to the competitors
ii. Maintenance of high levels of stock which may be absolute/slow moving.
iii. Where the firm has failed to sell on credit to stimulate sales while competitors are selling on credit.

b. Stock holding period = $\frac{\text{365 days}}{\text{Stock turnover ratio}}$

Or

$= \frac{\text{365 days}}{\text{Cost of sales}} \times \text{average/closing stock}$

The ratio indicates the number of days stock was held in the ware house before it was sold. A long holding period indicates slow stock turnover.

c. Debtors/Accounts receivable turnover = $\frac{\text{annual credit sales}}{\text{Average/closing debtors}}$

The ratio indicates the number of times or the frequency with which customers buy goods/services on credit per annum. The higher the debtors' turnover, the better the firm and the shorter the credit period.

d. Debtors collection period = $\frac{\text{365 days}}{\text{Debtors' turnover}}$

Or

$$\frac{\text{365 days}}{\text{Annual credit sales}} \times \text{average/closing debtors}$$

This ratio indicates the length of time in days customers took to pay their dues to the firm. It shows the credit period granted to customers by the firm f. The shorter the period, the higher the debtors turnover and vice versa.

e. Creditors turnover $= \dfrac{\text{Credit purchases per annum}}{\text{Average/closing creditors}}$

This ratio indicates the number of times the firm went to buy goods on credit. It's the frequency of credit purchases by the firm. The shorter the credit period granted by suppliers, the higher the creditors turnover and vice versa.

f. Creditors' payment period $= \dfrac{\text{365 days}}{\text{Creditors' turnover ratio}}$

Or

$$= \frac{\text{365 days}}{\text{Creditors' purchases per annum}} \times \text{Average/closing creditors}$$

This ratio indicates the number of days the firm took before paying suppliers for goods bought on credit. It is the credit period granted by suppliers.

g. Fixed assets turnover ratio $= \dfrac{\text{Sales per annum}}{\text{Total fixed assets}}$

This ratio indicates the efficiency with which the firm utilized its fixed assets to generate sales revenue e.g. a ratio of 1.6 means that shs.1 of fixed assets was utilized to generate shs.1.60 of sales.

h. Total assets turnover ratio $= \dfrac{\text{Sales per annum}}{\text{Total assets}}$

This ratio indicates the efficiency with which the firm utilized its total assets to generate sales revenue.

N/B Very low fixed and total assets turnover ratios can be attributed to the following factors.

1. The firm is underutilizing is assets and it is not operating at full capacity.
2. The firm may be having some assets which are non –operational/idle

Gearing/capital structure ratios

They are also called leverage ratios. They indicate the extent to which the firm has used externally borrowed fixed return/charge capital (preference share capital and long term debts) to finance the assets of the firm and subsequently increase/gear up/ level up profitability of the firm. They include: -

a. Debt ratio $= \dfrac{\text{Total Liabilities}}{\text{Total assets}}$ (current + long term liabilities)

This ratio indicates the extent to which total assets of a firm are finalized with external liabilities. A ratio of 0.35 means 35% of total assets have been financed with external borrowing while the remaining 65% is financed by owners' equity

b. Debt/Equity Ratio = $\frac{\text{Fixed charge capital (long term debt capital)}}{\text{Equity/Net worth}}$

This ratio indicates the contribution by the owners in relation to contribution by lenders e.g. a ratio of 0.45 means that for every shs.1 of equity there is shs.0.45 of fixed return capital/long term debt capital.

c. Times Interest Earned Ratio (TIER) = $\frac{\text{Operating profit (PBIT)}}{\text{Interest charges on debt}}$

This ratio indicates the number of times interest charges can be paid from operating profits. It also shows the no. of times the interest charges are covered by operating profits. It is one of the most important ratios for lenders and the higher the ratio, the better the firm. A low TIER can be attributed to: -

i. Low operating profits due to high operating expenses
ii. High interest charges due to high level of gearing associated with high level of long-term debt capital leading to payment of high interest charges.

Profitability Ratios

These rations indicate the ability of a firm to generate returns from investment and from sales. Profitability in this expressed in relation to:-

Returns from sales

Profitability in relation to sales indicates the ability of a firm to control cost of sales, operating financing expense in form of interest charges. These ratios include;

a. Gross profit margin = $\frac{\text{Gross Profit}}{\text{Sales}} \times 100$

This ratio indicates the ability of the firm to control the cost sales expenses e.g. a ratio of 40 % means that for every shs.100 of sales, shs.40 remained as gross while shs.60 cost of sales.

b. Operating Profit = $\frac{\text{Operating Profit (PBIT)}}{\text{Sales}} \text{X}100$

This ratio indicates the ability of a firm to control cost of sales and operating expenses e.g. a ratio of 28% means that for every shs.100 of sales, only shs.28 was operating profit while shs.72 was taken up by cost of sales and operating expense.

c. Net profit margin= $\frac{\text{Net Profit}}{\text{Sales}} \text{X } 100$

This ratio indicated the ability of the firm to control cost of sales, operating and financing expenses in the form of interest charges. It also called return on sales or after tax return on sales e.g. a ratio of 28% means that for every shs.100 of sales only shs.12 remained as net profits. Therefore shs.88 was taken up cost of sales, operating, financing expenses and taxation.

Return from Investments
These ratios determine the percentage yield from investment. They include:

d. Return on Equity (ROE)/ Return on Net worth (RONW) = $\frac{\text{Net profit}}{\text{EquityNetwortrh}} \times 100$

This ratio indicates the percentage return on equity of shareholders e.g. a ratio of 10% means that for every shs.100 of equity invested by shareholders, shs.10 net profit was generated.

e. Return on Investment (ROI) Return on Total Assets (ROTA) = $\frac{\text{Net profit}}{\text{Total Assets}} \times 100$

This ratio indicates the percentage return on total capital invested total assets

f. Return on Capital Employed(ROCE) Return on Net Assets (RONA) = $\frac{\text{Net profit}}{\text{Net assets/capital employed}} \times 100$

This ratio indicates the percentage return in form of net profit on capital investment in the assets.

Stock Market/Valuation Ratios
These ratios are indicators of the value of the firm and the growth of this value in future. The are most important for investors because they also indicate the percentage return on shares. They are computed from earning attributable to ordinary shareholders, dividends paid and the market value of the firm. They include;

a. Earning per share (EPS) = $\frac{\text{Earning to ordinary shares}}{\text{No of shares issued and outstanding (paid)}}$

It indicates the earning power of a firm and also the earnings or returns attributable to every share held by an investor.

b. Earning Yield (EY) = $\frac{\text{Earnings Per Share (EPS)}}{\text{Market price per share (MPS)}} \times 100$

The market price per share is the indicator of the price /investment made per share. Earnings are the expected returns per share. Therefore earnings yield indicates the percentage return for every shilling invested in the firm.

c. Dividends per share (DPS) = $\frac{\text{Dividends paid}}{\text{Number of shares issued outstanding paid}}$

This ratio indicates the dividends returns for every share held by an investor .If the firm pays all its earning attributable to ordinary shareholders then earnings per is equal to dividend per share (EPS=DPS).

d. Dividends yield (DY) $= \frac{\text{Dividend per share (DPS)}}{\text{Market price per share (MPS)}} \times 100$

This ratio indicates the percentage yield in form of cash dividend foe every shilling invested in the firm. If a firm has 100% dividend yield ratio i.e. all earnings attributable to ordinary shareholders are paid out as dividends, then dividend yield is equal to earnings yield (DY=EY)

e. Dividend cover $= \frac{\text{EPS}}{\text{DPS}}$ or $\frac{\text{Earning to ordinary shareholder}}{\text{Dividends paid}}$

This ratio indicates the number of times dividends can be paid from undistributed earnings. The higher the dividends per share the lower the dividend cover and vice versa.

f. Dividend payout $= \frac{\text{DPS}}{\text{EPS}} \times 100$

It indicates the proportion of earning to ordinary shareholders which was paid out as dividend e.g. a ratio of means 60% means 60% of earnings to ordinary shareholders was distributed as dividends while 40% was retained earning. Therefore retention ration is 100% less dividends payout ratio

g. Price to earning (P/E) ratio $= \frac{\text{MPS}}{\text{EPS}}$ or $\frac{\text{Market value of ordinary shares}}{\text{Earnings to ordinary shareholder}}$

It is the most important ratio for an investor. The market price per share (MPS) indicates the investment per share in the firm while earnings per share (EPS) indicate the earnings / cash flows generated by the investment. Price to earnings ratios thus indicates the number of years an investor would take to recoup his investment in the firm given the current market price per share and earnings per share. It simply indicated the payback period of an investment and the shorter it is the better the firm.

h. Book value per share (BVPS) $= \frac{\text{Net worth / Equity}}{\text{No. of ordinary shares fully issued \& paid.}}$

This is also called liquidating ratio and indicates liquidation dividends attributable to each shareholder assuming the firm was liquidated, all assets sold at their book values and realized cash amount distributed in the following priority:-

i) Debenture holders
ii) Current liabilities
iii) Preference shareholders
iv) Ordinary shareholders

This ratio indicates what every shareholder receives after paying off the first three stakeholders.

i. Market value to book value per share (MVBVPS) $= \frac{\text{MPS}}{\text{BVPS}}$

This ratio indicates the amount of goodwill attached to the firm, should the firm be sold as a going concern. If the ratio is greater than one it means that market value is greater than the book value of assets indicating a positive goodwill. However, the ratio is less then indicates a negative goodwill.

Trend and Industrial Analysis.
Trend analysis involves comparison of the firm's performance in a given year with other past years e.g. comparison of liquidity ratios for the past five years. Industrial analysis involves comparison of the firm's performance in a given year with that of average industrial performance or norm. When carrying out trend and industrial analysis, the following four critical issues must be noted:

1. If a given category of ratios given identify the ratios in this category e.g. when requested to comment on the liquidity position, identify liquidity ratios. If the ratios are given identify the category of the ratios e.g. when requested to comment on times interest earned ration identify it a gearing ratio.
2. State the observation made e.g. incase of industrial analysis, state whether the ratio is higher or lower than the norm, and in case of trend analysis state whether the ratios are declining or improving
3. State the reason for the observation made.
4. State the implications of the observations made e.g. increasing gearing ratios, implies more use of external capital (borrowing) to finance assets of the firm.

4.2 USES OF RATIOS

Ratios can be used in the following ways: -

1. To evaluate the ability of a firm to meet short-term maturing financial obligations as and when they fall due (liquidity ratios).
2. Ratios indicate the ability of a firm to generate returns/ from sales & investments (profitability ratios).
3. Ratios of a given year are compared with similar ratios of past years to determine the performance of a firm over time. This is called trend/time series analysis.
4. Ratios can be compared with those of competitors to determine whether the firm out-performed competitors. This is called cross-sectional analysis.
5. Efficiency ratios indicate the efficiency with which the firm is utilizing its assets or resources at its disposal to generate sales revenue.
6. Ratios of a given year of a firm can be compared with the average industrial performance or norm. This is called industrial analysis.
7. Ratios indicate the extent with which the firm has financed its assets with externally borrowed fixed return capital (gearing ratios).
8. Prediction of bankruptcy. A combination of selected ratios can be used to predict the possibility of insolvency of a firm. The combined figure of these ratios is called Z- score which was developed by Altman.

4.3 LIMITATIONS OF RATIOS

The following limitations are inherent in the use of ratios: -

1. *Historical information.* Ratios are computed from past statements thus giving historical information which may be irrelevant for future decision making.
2. *Size and diversification of firms.* Different firms are the same industries have different sizes, levels of technology and diversification. Thus it may not be possible to compare such firms, using ratios e.g. companion of Coca-Cola ltd and Softa ltd, Unilever and Bidco, Barclays Bank ltd and Equity Bank etc may not be possible.

3. *Effects of inflation.* Ratios ignore effects of inflation on the performance of a firm e.g. increase in sales may be due to increase in selling prices as a result of inflation.
4. *Different accounting policies.* Different firms in the same industry use different policies and bases. Accounting basis are broad methodologies used by accountants in preparation of financial statements. Policies are the particular bases adopted and constantly applied by a firm. These policies affect gross profits; net profit, etc. e.g. the use of FIFO vis-à-vis LIFO stock valuation methods, straight line vis-à-vis reducing balance methods of deprecation; etc.
5. *Qualitative aspects of a firm.* Ratios only capture quantitative and monetary activities of a firm and ignore important qualitative features of the firm e.g. customer satisfaction, quality of goods and services, efficiency of management, technological innovations, etc.

6. *Monopolistic firms.* It may be possible to carry out cross sectional and industrial analysis for monopolistic firms since they do not have competitors' e.g. most state corporations.
7. *Changes in ratios*. Ratios are computed only at one point in time but they keep on changing frequently e.g. liquidity ratios will change as the level of cash, debtors and stock change.

The following question will be used to illustrate the above classes of ratios
Example 4.1

ABC ltd
Profit and Loss $^{A}/_{C}$ for the year ended 31.12.2008

	Sh	Sh
Sales		850,000
Less: Cost of Sales		
Opening stock	99,500	
Purchases	559,500	
	659,000	
Less: Closing stocks	(149,000)	(510,000)
Gross profit		340,000
Less expenses		
Selling and distribution	30,000	
Depreciation	10,000	
Administration expenses	135,000	(175,000)
Earnings before interest & taxes		165,000
Interest		(15,000)
Earnings before tax		150,000
Tax @ 50%		75,000
Less ordinary dividend		75,000
(0.75 per share)		
Retained profit for the year		(15,000)
		60,000

ABC
Balance Sheet as at 31 December 2008

Non Current Assets		Sh.	Issued share capital	Sh.
Land and Buildings		250,000	(20000 share of Sh, 10)	200000
Plant & Machinery		80,000	Reserve	90000
		330,000	Retained profit	60000
Current Assets			Long term	100000
Inventory		149,000	Current liabilities.	130000
Debtors	75,000			
Less provision	(4,000)	71,000		
Cash		30,000		
		580,000		580,000

Additional Note
Cash purchases amount to 14,250.

Required: Compute the relevant ratios.

Liquidity Ratios

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\text{Current Ratio} = \frac{250{,}000}{130{,}000} = 1.92: 1$$

The higher the ratio then the more liquid the firm is.

Quick Ratio/Acid Test Ratio

$$= \frac{\text{Current Assets - Inventories}}{\text{Current Liabilities}}$$

$$= \frac{250{,}000 – 149{,}000}{130{,}000} = \frac{101{,}000}{130{,}000}$$

= 0.78: 1

This is a more refined ratio that tries to recognize the fact that stakes may not be easily converted into cash. The higher the ratio, the better for the firm as it means an improved liquidity position.

Cash Ratio

$$= \frac{\text{Cash + Marketable Securities}}{\text{Current Liabilities}}$$

$$= \frac{30{,}000}{130{,}000} = 0.23: 1$$

= 0.23: 1

This ratio assumes that stakes may not be converted into cash easily and the debtors may not pay up their accounts on time. The higher the ratio, the better for the firm as the Liquidity position is improved.

Net Working Capital Ratio.

$$= \frac{\text{Net Working Capital}}{\text{Net Assets}}$$

Net Working Capital =CA –CL = 250,000-130,000=120,000

$$\text{Net Working Capital} = \frac{120,000}{450,000} = 0.27:1$$

The higher the ratio the better for the firm and therefore the improved Liquidity position.

Gearing ratios

These measure the financial risk of a firm (the probability that a firm will not be able to pay up its debts). The more debts a business has (non owner supplied funds) the higher the financial risk.

Debt Ratio

$$= \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

This ratio measures the proportion of total assets financed by non owner supplied funds. The higher the ratio, the higher the financial risk .

$$= \frac{230,000}{580,000} = 0.4$$

40% is supplied by non owners

Debt Equity Ratio

$$= \frac{\text{Total Liabilities}}{\text{Networth (share holders funds)}}$$

$$= \frac{230,000}{350,000} = 0.66$$

40% is supplied by non-owners

This ratio measures how much has been financed by the non-owner supplied funds in relation to the amount financed by the owners i.e. for every shilling invested in the business by the owners how much has been financed by the non-owner supplied funds.

For ABC Ltd, for every 1 shilling contributed in the business by the owner, the creditor has put in 67 cents. The higher the financial risk.

Long Term Debt Ratio

$$= \frac{\text{Non Current Liabilities}}{\text{Net Assets}}$$

$$= \frac{100,000}{450,000} = 0.2$$

This measures the proportion of the total net assets financed by the non-owner supplied funds. The higher the ratio, the higher the financial risk.

Activity ratios

Stock Turnover

$$= \frac{\text{Cost of Sales}}{\text{Average Stocks}}$$

where

$$\text{Average Stocks} = \frac{\text{Opening Stock + Closing Stock}}{2}$$

$$= \frac{510{,}000}{124{,}250} = 4.1$$

= 4.1 times

This is the number of times stock has been converted to sales in a financial year. The higher the ratio the more active the firm is. An alternative formula is

$$= \frac{\text{Sales}}{\text{Closing Stock}}$$

Debtors Turnover

$$= \frac{\text{Credit Sales}}{\text{Average Debtors}}$$

Where

$$\text{Average Debtors} = \frac{\text{Opening debtors + Closing debtors}}{2}$$

Assume the opening debtors was 89,000 and all sales are on credit

$$\text{Debtor Turnover} = \frac{850{,}000}{80{,}000} = 10.625$$

The higher the ratio, the more active the firm has been (we had debtors over 10 times to generate the sales)

Note

$$\text{Average Collection Period} = \frac{360}{\text{Debtors Turnover}}$$

$$= \frac{360}{10.625} = 34 \text{ days}$$

This measure the number of days it takes for debtors to pay up. The lesser the period, the better for the firm as it improves the liquidity position.

Creditors Turnover

$$= \frac{\text{Credit Purchases}}{\text{Average Creditors}}$$

$$= \frac{545{,}250}{130{,}000}$$

= 42 times

The ratio tries to measure how many times we have creditors during a financial period. The lesser the ratio the better.

Non Current Assets Turnover (Fixed Assets Turnover)

$$= \frac{\text{Sales}}{\text{Average Fixed Assets}}$$

$$\text{A.F.A} = \frac{340{,}000 + 330{,}000}{2} = \frac{670{,}000}{2} = 335{,}000$$

$$= \frac{850{,}000}{335{,}000} = 2.54 \text{ times}$$

The ratio measures the efficiency with which the firm is using its fixed/ Non Current Assets to generate sales. The higher the ratio the more active the firm.

Total Assets Turnover

$$= \frac{\text{Sales}}{\text{Total Assets}}$$

$$= \frac{850{,}000}{580{,}000}$$

= 1,046 times

Measures the efficiency with which the firm is using its total assets to generate sales.

Profitability ratios

Profitability in Relation to Sales

Gross Profit Margin

$$= \frac{\text{Gross Profit}}{\text{Sales}} = \frac{165{,}000}{850{,}000} = 19\%$$

The higher the margin, the more profitable the firm is.

Net Profit Margin

$$= \frac{\text{Net Profit after tax}}{\text{Sales}} = \frac{75{,}000}{850{,}000} = 9\%$$

The higher the margin, the more profitable the firm is.
Margin affected by:
Operating expenses for the period.

Profitability in Relation to investment

Return On Investment

$$= \frac{\text{Net Profit after tax}}{\text{Total Assets}}$$

$$= \frac{75{,}000}{580{,}000} = 13\%$$

Shows how efficient the firm has been in using the total assets to generate returns in the business.

Return On Capital Employed

$$= \frac{\text{Net Profit after tax}}{\text{Net Assets}}$$

$$= \frac{750{,}000}{450{,}000} = 17\%$$

How efficient the firm has been in using the net assets to generate returns in the business.

Return On Equity

$$= \frac{\text{Earnings after tax}}{\text{Networth}}$$

$$= \frac{75{,}000}{850{,}000}$$

$$= 21\%$$

Efficiency of the firm in using the owner's capital to generate returns. The higher the ratio the more efficient is the firm.

Equity ratios

Earnings Per Share (EPS)

$$\text{EPS} = \frac{\text{Earnings attributable to ordinary shareholders}}{\text{No. of ordinary shares outstanding.}}$$

$$= \frac{75{,}000}{20{,}000}$$

$$= 3.75$$

This is the return expected by an investor for every share held in the firm.

Earnings Yield

$$= \frac{\text{Earnings Per Share}}{\text{Market price per share}}$$

Assume that the market price for the ABC'S shares is Sh20/Share.

$$= \frac{3.75}{20} \times 100\%$$

$$= 19\%$$

This is the return amount expected by a shareholder for every shilling invested in the business.

Dividend Per Share (DPS)

$$= \frac{\text{Total Dividend (ordinary shareholders)}}{\text{Ordinary shares outstanding.}}$$

$$= \frac{15,000}{20,000}$$

= 0.75 cts per share

This is the amount expected by an investor for every share held in the firm. The higher the amounts, the better for the firm.

Example 4.2

Beta Ltd is reviewing the financial statements of two companies, Zeta Ltd and Omega Ltd. The companies trade as wholesalers, selling electrical goods to retailers on credit. Their most recent financial statements appear below.

Profit And Loss Accounts for the Year ended 31 March 20x8

	Zeta Limited		*Omega Limited*	
	£'000	£'000	£'000	£'000
Sales		4,000		6,000
Cost of sales				
Opening stock	200		800	
Purchases	3,200		4,800	
	3,400		5,600	
Less: closing stock	400		800	
		3,000		4,800
Gross profit		1,000		1,200
Expenses				
Distribution costs	200		150	
Administrative expenses	290		250	
Interest paid	10		400	
		500		800
Profit before tax		500		400
Taxation		120		90
Net profit for the period		380		310

Balance Sheets As At 31 March 20x8

	Zeta Limited		*Omega Limited*	
	£'000	£'000	£'000	£'000
Fixed assets				
Tangible assets				
Warehouse and office buildings	1,200		5,000	
Equipment and vehicles	600		1,000	
		1,800		6,000
Current assets				
Stock	400		800	
Debtor – trade	800		900	
- sundry	150		80	
Cash at bank	-		100	
	1,350		1,180	
Current liabilities				
Creditors – trade	(800)		(800)	
- sundry	(80)		(100)	
Overdraft	(200)		-	
Taxation	(120)		(90)	
		150		890
		1,950		6,890
Long-term loan (interest 10% pa)		-		(4,000)
		1,950		2,890
Share capital		1,000		1,600
Revaluation reserve		-		500
Profit and loss account		950		790
		1,950		2,890

Required:

a) Calculate for each company a total of eight ratios which will assist in measuring the three aspects of profitability, liquidity and management of the elements of working capital. Show all workings.

(8 marks)

b) Based on the ratios you have calculated in (a), compare the two companies as regards their profitability, liquidity and working capital management.

(8 marks)

c) Omega Ltd is much more highly geared than Zera Ltd. What are the implications of this for the two companies?

(4 marks)

(20 marks)

Profitability

Gross profit margin		
$\frac{\text{Gross profit}}{\text{Sales}} \times 100\%$	$\frac{1000}{4000} \times 100\% = 25\%$	$\frac{1200}{6000} \times 100\% = 20\%$
Net profit margin		
$\frac{\text{Net profit}}{\text{Sales}} \times 100\%$	$\frac{500}{4000} \times 100\% = 12.5\%$	$\frac{400}{6000} \times 100\% = 6.7\%$
Return on capital employed		
$\frac{\text{Profit before interest and tax}}{\text{Capital employed}}$	$\frac{510}{1950} = 26.2\%$	$\frac{800}{6890} = 11.6\%$
Return on shareholders' capital		
$\frac{\text{Profit before tax}}{\text{Share capital and reserves}}$	$\frac{500}{1950} = 25.6\%$	$\frac{400}{2890} = 13.8\%$
Asset turnover		
$\frac{\text{Sales}}{\text{Capital employed}}$	$\frac{4000}{1950} = 2.1$ times	$\frac{6000}{6890} = 0.9$ times

Liquidity

Current ratio		
$\frac{\text{Current assets}}{\text{Current liabilities}}$	$\frac{1350}{1200} = 1.1:1$	$\frac{1880}{990} = 1.9:1$
Quick ratio		
$\frac{\text{Current assets – stock}}{\text{Current liabilities}}$	$\frac{950}{1200} = 0.8:1$	$\frac{1080}{990} = 1.1:1$
Gearing		
$\frac{\text{Long – term loans}}{\text{Capital}}$	$\frac{\text{nil}}{1950} = \text{nil}$	$\frac{4000}{6890} = 58\%$
Interest cover		
$\frac{\text{Profit before interest and tax}}{\text{Interest charges}}$	$\frac{510}{10} = 51$ times	$\frac{800}{400} = 2$ times

Working Capital Management

Debtors days	$\frac{800}{4000} \times 365 = 73$ days	$\frac{900}{6000} \times 365 = 55$ days
$\frac{\text{Trade debtors} \times 365 \text{ days}}{\text{Sales}}$		
Creditor days		
$\frac{\text{Trade creditors} \times 365 \text{ days}}{\text{Purchases}}$	$\frac{800}{3200} \times 365 = 91$ days	$\frac{800}{4800} \times 365 = 61$ days

Stock days

Average stock × 365 days / Cost of sales	$\frac{300}{3000} \times 365$ = 37 days	$\frac{800}{4800} \times 365$ = 61 days

Note. We have used average stock here. When you have the information use it.

Profitability
Zeta has a higher gross margin than Omega. This may indicate a differing pricing policy. Omega's net margin is lower than Zeta's. Omega's expenses are therefore proportionally higher. It should be noted that Omega's bottom line profit is reduced significantly by the interest charge. Return on Omega's capital is around half of Zeta's. Omega has a higher fixed asset base due in part to a revaluation. It may be that a revaluation of Zeta's assets will partially close the gap.

Liquidity
Omega has nearly twice as many current assets as current liabilities. Although both companies' quick ratios are much closer, Zeta's liquidity does appear to be an issue especially as there is no cash at hand. It would be wise to examine projected cashflows to see how readily Zeta's profits will improve this situation. As Zeta has no long-term loans they may be able to borrow in order to improve liquidity.

Working capital management
Zeta is turning stock over more quickly than Omega. This is beneficial in a market which can be subject to obsolescence.

Zeta's creditor and debtor days are a cause for concern. Debtors should be collected within 60 days if not sooner. 60 day collection would improve cash flow by over £140,000 reducing the debtors balance to £658,000(60/73 × £800,000).

Creditors should be paid at least as quickly as Omega pays theirs. Zeta risks damaging the goodwill it has with its suppliers. Paying creditors within 60 days would have an adverse effect on cash flow of over £270,000. The creditors balance would be £527,000 (60/91 × £800,000).

Omega is highly geared whereas Zeta has no long-term loans. Omega's gearing means that should profits fall they may not be in a position to pay the loan interest. Zeta's capital is entirely share capital and so a fixed return is not required.

Omega's loan appears to be fixed rate. This means that in times of falling interest rates Omega will have higher interest costs than say, Zeta, if Zeta borrowed the same amount. The converse is true in times of rising interest rates.

4. 4 REVIEW QUESTIONS

Question One

The balance sheet of Grand Limited, a wholesaler, at 31 December 2008 and 2009 were as follows:

	31 December 2008	2009		
	£000	£000	£000	£000
Tangible fixed assets				
Cost of valuation	126,300		162,400	
Aggregate depreciation	(50,000)	76,300	(64,000)	98,400
Current assets				
Stock	12,000		15,000	
Debtors	10,500		14,000	
Cash	1,400		2,000	
	23,900		31,000	
Current liabilities				
Trade creditors	6,800		9,400	
Corporation tax	3,400		5,000	
Proposed dividend	4,000		6,000	
	14,200		20,400	
Net current assets		9,700		10,600
		86,000		109,000
Loans (due for repayment 1999)		(60,000)		(60,000)
		26,000		49,000
Called up share capital		6,000		10,000
Share premium		1,000		3,000
Revaluation reserve		-		8,000
Profit and loss account		19,000		28,000
		26,000		49,000

The stock at 31 December 2009 was £10,000,000.

The summarized profit and loss accounts for the company for the years ended 31 December 1995 and 1996 were:

	Year ended 31 December	
	2008	2009
	£000	£000
Sales	64,000	108,000
Cost of sales	40,000	75,600
Gross profit	24,000	32,400
Expenses	10,000	12,400
Net profit before tax	14,000	20,000

Required:

a) Calculate the following accounting ratios for both years:
   - The gross profit percentage
   - The current ratio and the quick ratio (or acid test)
   - Debtors' collection period in days
   - Trade creditors' payment period in days (based on purchases figures which are to be calculated)
   - Gearing ratio.

b) Show you full workings.(10 marks)

c) Explain what you can deduce from the ratios as at 31 December 2009 and from comparing them with those for 2008. (5 marks)

d) State two points which could cause the movement in the gross profit percentages between the two years and explain how they could bring the change about. (2 marks)

e) State the extent to which you agree or disagree with the following and give brief reasons for your answers.

f) The current ratio and the quick ratio help to assess whether a company is able to meet its debts as they fall due. Therefore the higher these ratios are the better the company

g) A high gearing ratio is advantageous to shareholders, because they benefit from the income produced by investing the money borrowed. (3 marks)

(20 marks)

4. 5 REFERENCES

Wood, Frank, *Business Accounting* (9th Edition), International Thompson. Honrgren and Sundem, G. L, *Introduction to Financial Accounting*, (6th Edition), New York; Prentice Hall.

TOPIC FIVE: NON-PROFIT MAKING ORGARNITIONS

Learning Objectives

Upon completion of this topic you should be able to:

- Explain the main difference between the financial of non-profit –oriented organizations and of profit – oriented organizations
- Prepare receipt and payments accounts
- Prepare income and expenditure accounts and balance sheet for non – profit – oriented organisations.
- Calculate profit and losses fro special activities and incorporate the into the financial statements

5.1: INTRODUCTION

These are some form of organizations that are set up to promote or to cater for the welfare of the members involved and not to make a profit. These include clubs, (e.g. football clubs, sports clubs), welfare associations and any other societies (charitable institutions)

.

5.2: ACCOUNTING STATEMENTS

Because these organizations are not trading, the types of accounts to prepare are different from the ones of trading organizations. Note that-

1. Instead of a cashbook, the clubs will maintain a receipts and payments which has similar entries to those of a cashbook.
2. Instead of profit and loss account, we have an income and expenditure account.
3. Because the club is not formed by any one owner (has no owner), it is funded by members' contributions, donations, income from investments to get an accumulated fund instead of capital.

From the income and expenditure account, if the incomes are <u>more</u> than the expenditures for the period, then the club has a <u>surplus</u> and not a net profit.
If the expenditure is more than incomes, then the club has a <u>deficit</u> and not a loss.
The club may carry out some trading activities on a small scale to finance some of the clubs activities and incase a firm has a trading activity, then in addition to the income and expenditure account and the balance sheet, prepare a Bar Trading Account.

Format of the Final Accounts
Name
Income and Expenditure Account for the year ended 31 December ……

Incomes	Sh.	sh
Profit from trading activities		XX
Subscriptions		XX
Income from investments		XX
Donations		XX
Loss from trading activities	XX	
All other expenses	XX	(XX)
SURPLUS/(DEFICIT)		XX/(XX)

Name
Balance Sheet As At 31 December ……

Non current Assets	Sh.	Sh.	Sh.
Buildings	XX	(XX)	XX
Fixtures, fittings and equipment	XX	(XX)	XX
Motor vehicle	XX	(XX)	XX
	XX	(XX)	XX
Investments			XX
Current Assets			
Stocks		XX	
Debtors		XX	
Prepayments and accrued income		XX	
Cash at bank/hand (receipts + payments)		XX	
		XX	
Current liabilities			
Creditors	XX		
Accrued expenses and prepaid income	XX		
Bank overdraft	XX	(XX)	XX
			XX
Accumulated fund balance b/f			XX
Add/less surplus / deficit			XX/(XX)
Other funds			
Life membership fund		XX	
Building fund		XX	
Education fund		XX	XX
			XX

Notes to the Above Format:

a)Subscriptions
These are the amounts received by the club from the members to renew their membership. It is often paid on an annual basis.

- It is income for the club and therefore reported in the income and expenditure account.
- Depending on the policy of a club, any subscriptions due but not received are shown as accrued income (debtors for subscriptions) in the balance sheet.
- Any amounts prepaid are shown as prepaid (creditors for subscriptions).
- Some clubs will not report subscriptions as income until it is received in form of cash.

b).Income from investments
Some clubs invest excess cash in the bank (fixed deposit account), shares of limited companies, treasury bills and any other investment that may be available.

- If the club is investing with no specific intention (i.e a general investment) then income from this investment should be reported in the income and expenditure account.
- If the investment is for a specific purpose and relates to a specific fund (e.g building fund) it will not be reported in the income and expenditure account but credited directly to the fund

c).Other funds

- These are funds set up for a specific purpose and not general. They will be shown together with the accumulated fund.
- Any incomes relating to these funds, will be credited directly to the funds and any expenses will be taken off from these funds e.g. building fund, education fund

d). Life membership fund
Some members may pay some amount to become life members of the club and if this happens, there may be a need to spread out this income over the expected life of the members in the club. Depending on the policy of a club, the following accounting treatment may be allowed:

i. The full amount is reported in the Income and Expenditure account in the year it is received and therefore no balance is retained in the life membership account.
ii. The amount is shown separately in the life membership fund with no transfer in the Income and Expenditure account and hence no balance in the life membership account.
iii. To transfer some amounts from the life membership funds to the income and expenditure account over the expected life of membership to the club.

Example 1.5

The following is the receipts and payments account of the Friendship Club for the year ended 31 December 2010

	sh		sh
Balance at bank			
31 December 2008	102	Bar purchases	4,434
Entrance fees	42	Wages	416
Subscriptions: 19X0	25	Rent	186
2009	305	Heating and lighting	128
2010	35	Postage and stationery	33
Bar Sales	5,227	Insurance	18
Sale of investments	750	General expenses	46
		Payments on account	
		of new furniture	450
		Balance at bank,	
		31 December 2010	775
	6,486		6,486

The following information is also supplied:

(1)	31 December 2008	31 December 2009
Bar stock, at cost	272	315
Creditors for bar purchases	306	358
Rent due	18	36
Heating and lighting expenses due	16	19
Subscriptions due	25	40
Insurance paid in advance	5	7

2) On 31 December 2008, the club held investments which cost sh500. During the year ended 31 December 2009, these were sold for sh750.

3) Furniture was valued at sh300 on 31 December 2008. On June 19X1, the club purchased additional furniture at a cost of sh520. Depreciation of all furniture is to be provided for at the rate of 10% per annum.

Required:

(a) Prepare an income and expenditure account for the year ended 31 December 2009

(b) Prepare a balance sheet at that date.

Solution:

Friendship Club
Accumulated Fund As at 1.1.2009

	Sh.	Sh.
Assets		
Stock		272
Subscriptions due		25
Insurance prepaid		5
Investments		500
Furniture		300
Balance at bank		102
		1,204
Liabilities		
Creditors	306	
Rent due	18	
Heating and lighting expenses	16	(340)
Accumulated fund		864

Creditors

	sh		Sh.
Receipts and payments	4,434	Balance b/f	306
Balance c/d	358	Purchases	4,486
	4,792		4,792

Subscriptions

	sh		sh
Balance b/d	25	Receipts & payments	365
Income & expenditure	345		
Balance c/d	35	Balance c/d	40
	405		405

Friendship Club
Bar, Trading Account for the year ended 31 December 2009

	sh	sh
Sales		5,227
Less: Cost of Sales		
Opening stock	272	
Purchases	4,486	
	4,758	

Less closing stock	(315)	(4,443)
Gross profit to income & expenditure a/c		784

Friendship Club
Income and Expenditure Account for the year ended 31 2009

	sh	sh
Profit from bar trading		784
Entrance fees		42
Subscriptions		345
Profit from sale of investments		250
		1,421
Expenditure		
Wages	416	
Rent	204	
Heating and lighting	131	
Postage and stationery	33	
Insurance	16	
General expenses	46	
Depreciation – furniture	56	(902)
Surplus		519

Friendship Club
Balance Sheet as at 31 December 2009

Non current Assets	sh	sh	sh
Furniture	820	(56)	764
Current Assets			
Stock	315		
Subscriptions due	40		
Prepaid expense	7		
Cash at bank	775		
	1,137		
Current liabilities			
Creditors	398		
Prepaid subscriptions	35		
Accrued expenses	55		
Creditors fixtures	70	(518)	619
			1,383
Accumulated fund b/f			864
Add surplus			519
			1,383

Example 2.5

(a) State and briefly explain any three distinguishing features between (i) a receipts and payments account and (ii) an income and expenditure account. (6 marks)

(b) The accountant of Mamba Sports Club has extracted the following information from the books of account for the year ended 31 March 2009.

Receipts		Payments	
	Sh		Sh
Balance brought forward	288,000	Salaries and wages	254,000
Subscriptions		New equipment	565,000
Year: 1999/2000	249,000	Repairs and maintenance	124,000
2000/2001	2,050,000	Office expenses	415,000
2001/2002	194,000	Printing and stationery	168,000
Dinner dance	723,000	Purchase of beverages	497,000
Beverage sales	657,000	Dinner dance expenses	315,000
Investments income	400,000	Refund of subscriptions	45,000
		Sports prizes	25,000
		Transport	248,000
		Investments	1,500,000
		Balance carried forward	405,000
	4,561,000		4,561,000

Balances as at	31 March 2000	31 March 2001
Furniture and fittings (net)	240,000	-
Equipment (net)	690,000	-
Investment at cost	3,500,000	-

Subscriptions in arrears	300,000	375,000
Salaries accrued	68,000	72,000
Stock of beverages	162,000	184,000
Subscriptions in advance	85,000	-

Additional information:

1. Subscriptions in arrears are written-off after twelve months.
2. Depreciation is provided for on reducing balance method at 10% and 20% per annum on furniture and fittings and equipment respectively.
3. Investments, which had cost Sh. 500,000, were sold on 30 March 2009 for Sh. 625,000. No entries have been made in the books in this respect.

Required:

(a) Income and expenditure account for the year ended 31 March 2009.

(b) Balance sheet as at 31 March 2009.

Solution:

Mamba Sports Club
Statement of Affairs

Assets	Sh	Sh
Furniture and fittings		240,000
Equipment		690,000
Receipts and payments		288,000
Investment at cost		3,500,000
Subscriptions in arrears		300,000
Stock of beverages		162,000
		5,180,000
Liabilities		
Subscriptions accrued	85,000	
Accrued salaries	68,000	(153,000)
		5,027,000

Mamba Sports Club
Trading Account for the year ended 31.3.2009

	Sh	Sh
Sales		657,000
Less cost of sales		
Opening stock	162,000	
Purchases	497,000	
	659,000	
Less closing stock	(184,000)	(475,000)
Profit to income and expenditure		182,000

Subscriptions

2009	Sh	2009	sh
Balance b/d	300,000	Balance b/f	85,000
Receipts and payments	45,000	Receipt and payment	2,493,000
Income & expenditure	2,465,000	Income & expenditure	51,000
Balance c/f	194,000	Balance c/f	375,000
	3,004,000		3,004,000

Mamba Sports Club
Income and Expenditure Account for the year ended 31 March 2009

Incomes	Sh
Profit from trading account	182,000
Subscriptions	2,465,000
Dinner dance	723,000
Investment income	400,000
Profit on sale of investments	125,000
	3,895,000

5.3. Review Questions

Question one

The following trial balance was extracted from the books of Literary and Philosophical Society as at 30 September 2009:

	Sh	Sh
Balance at bank: current account	724,800	
Accumulated fund 1 October 2008		5,771,200
Land and buildings, at cost	3,700,000	
Debtors for subscription	62,000	
Furniture and fittings	1,874,000	
Provision for depreciation of furniture & fittings		284,000

Subscriptions		1,450,800
Lecturer's fees	920,000	
Lecturer's travel and accommodation expenses	358,000	
Donations		108,000
Camera and projector repairs	17,000	
Projectors, cameras and audio equipment	190,400	
Depreciation of equipment		54,400
Rates and water	277,000	
Lighting and heating	367,200	
Rental of rooms		495,000
Wages – Caretaker	880,000	
- Restaurant	1,600,000	
- Bar staff	800,000	
Purchase of food	1,565,800	
Stock – bar 1 October 2009	473,600	
Bar receipts		4,032,000
Bar purchases	2,842,000	
Restaurant receipts		3,642,000
Loan		1,600,000
Deposit account – bank	1,000,000	
Interest payable and receivable		36,000
Creditors for bar and food		178,400
	17,651,800	17,651,800

Additional information:

1. The bar stock was valued at Sh. 642,800 as at 30 September 2000.
2. It is expected that, of the debtors for subscriptions, Sh. 43,600 will not be collectable.
3. The interest account is net. The loan is at a concessional rate of 4% while 10% has been earned on the deposit account. No changes have taken place all year in the principal sums involved.
4. An invoice for Sh. 43,000 of wine had been omitted from the records at the close of the year although the wine had been included in the bar stock valuation.
5. Depreciation for the year is to be provided as follows:
   Furniture and fittings Sh. 194,000
   Projectors, cameras, etc. Sh. 19,000.

Required:

(a) Bar and restaurant trading account for the year ended 30 September 2000
(b) An income and expenditure account for the year ended 30 September 2000
(c) A balance sheet as at 30 September 2000

Question two

You have agreed to take over the role of bookkeeper for the AB Sports and Social Club.
The summarized balance sheet on 31.12.08 as prepared by the previous bookkeeper contained the following items. All figures are in £s.

Assets

Heating oil for clubhouse		1,000
Bar and café stocks		7,000
New sports ware, for sale, at cost		3,000
Used sports ware, for hire, at valuation		750
Equipment for grounds person – cost	5,000	

- depreciation	3,500	1,500
Subscriptions due		200
Bank – current account		1,000
- deposit account		10,000
Claims		
Accumulated fund		23,150
Creditors – bar and café stocks		1,000
- Sports ware		300

The bank account summary for the year to 31.12.09 contained the following items:

Receipts:	
Subscriptions	11,000
Bankings – bar and sale	20,000
Sale of sports ware	5,000
Hire of sports ware	3,000
Interest on deposit account	800
Payments	
Rent and repairs of clubhouse	6,000
Heating oil	4,000
Sports ware	4,500
Grounds person	10,000
Bar and café purchases	9,000
Transfer to deposit account	6,000

You discover that the subscriptions due figure as at 31.12.08 was arrived at as follows:

Subscriptions unpaid for 2007	10
Subscriptions unpaid for 2008	230
Subscriptions paid for2009	40

Corresponding figures at 31.1209 are:

Subscriptions unpaid for 2007	10
Subscriptions unpaid for 2008	20
Subscriptions unpaid for 2009	90
Subscriptions paid for2010	200

Subscriptions due for more than 12 months should be written off with effect from 1.1.95

Asset balances at 31.12,09 include:

Heating oil for club house	700
Bar and café stocks	5,000
New sports ware, for sale, at cost	4,000
Used sports ware, for hire, at valuation	1,000

Closing creditors at 31.12.09 are:

For bar and café stocks	800
For sports ware	450

For heating oil for clubhouse	200

$^{2}/_{3}$ rds of the sportswear purchases made in 2009 had been added to stock of new sportswear in the figures given in the list of assets above, and 1/3 had been added directly to the stock of used sportswear for hire.

Half of the resulting 'new sportswear for sale at cost' at 31.12,09, to transfer these older items into the stock of used sportswear, at a valuation of 25% of their original cost.

No cash balances are held at 31.12.09. The equipment for the grounds person is to be depreciated at 10% per annum, on cost.

Required:
Prepare income and expenditure account and balance sheet for the AB Sports club for 2009, in a form suitable for circulation to members. The information given should be as complete and informative as possible within the limits of the information given to you. All workings must be shown

5. 4 REFERENCES

- Wood, Frank, *Business Accounting* (9th Edition), International Thompson. Pages 400-412
- Honrgren and Sundem, G. L, *Introduction to Financial Accounting*, (6th Edition), New York; Prentice Hall. pages 45-65

TOPIC SIX: CASH FLOW STATEMENT

6.1 INTRODUCTIONS

A business enterprise normally prepares the following two financial statements

(i) Profit or loss or income statement which helps to find out the profit or loss made as result of operations of the company over a specified period.

(ii) Balance sheet or financial position statement which reflects the state of asset and liabilities of company on a particular period.

Another required financial statement is *cash flow statement.* This is requirement of International Accounting 7 (IAS 7)

6.2 NEED FOR CASH FLOW STATEMENT

Users of financial statements, require understanding how the business generated cash and how the cash was used. Unlike the income statement where profit reported is influenced by accounting policies and estimates, cash flow indicate the performance of the business enterprise without such influences, therefore provide a better perspective to evaluating the performance.

Remember that a business enterprise can be making profits, while at the same time suffering from cash crisis. This can lead to business enterprise wind up.

6.3 COMPONENTS OF CASH FLOW STATEMENT

Cash flow statement summaries the cashbook, by reconciling the opening and closing balance of the cash and cash equivalents. Cash equivalents refer to liquid assets which can easily be transferred into cash and include;

(i) Cash

(ii) Demanded deposits in banks

(iii) Short term investments

(iv) Bank overdraft

The cash movement activities are classified into 3 categories

(i) Operating cash movement/ activities

(ii) Investing cash movement/ activities

(iii) Financial cash movement/ activities *a) Operating Activities*

These are the core activities of any business. They reflect the main or ordinary business activities. They indicate the net amount generated from business customers, after meeting all the necessary expenses to raise that revenue.

Operating cash flows are most importance because they indicate ability of the business to sustain its activities

Operating cash flow can be determined directly or indirectly

(i) Directly-

Cash received is compared with cash paid in ordinary activities of business, which can be determined from cash book or from control ledger. The format is as follows-

Cash paid for operating expense	(XX)
	XX

(ii) Indirectly

Under this method operating profits is reconciled with operating cash flow. Operating profit is profit before interest and tax (EBIT) which is adjusted with non -cash flow items. Non-cash items are as given below.

(i) Non-cash expenses

(ii) Prepayments

Cash received from customer	XX
Cash received from other operating income	XX
Cash paid to supplies	(XX)
Cash paid to employee	(XX)

These are items subtracted from P&L but do not involve payment.. As a result they should be added back. They include: depreciation, impairment losses, and losses on disposal among others

These refer to any cash paid in a period before it is recognized in the P&L statement.

Mainly entail use of cash but no effect on profit as a result they should therefore be subtracted .Examples include-

Increase in debtors

Increase in stock

Increase in bills receivables

Decrease in creditors

Decrease in bills payables

(iii) Accruals

They refer to revenues or expenses in the P&K recognized without necessary receiving /paying cash.

As result they should be added back They include

Decrease in stock-

Decrease in debtors

Decrease in bills receivables

Increase in bills payables

Increase in creditors

(iv) Investing activities

Refer to cash generated or used in relation to fixed assets. Fixed assets investments define capacity to generate revenue. The capacity should be continuously enhanced and where necessary renewed

(v) Financing activities

Refer to cash generated or used in relation to long-term source of capital due as issues of shares, repayments of lower and debtors among others.

6.4: Format of cash flow statement

Abc Ltd

Cash flow Statement For The Year Ended 30/Sept/2008

	Sh	Sh
Net cash inflow/outflow from operating activities		**XX**
Interest paid/received		XX
Divedend paid/received		XX
Net cash flow inflow/outflow from investing activities		
Sales of fixed assets	XX	
Purchase of fixed assets	(XX)	XX
Net cash flow/ outflow for financing activities		
Issues of shaves	XX	
Issue of debtors	XX	XX
Increase in cash/ cash equivalent		XX

The working for Net cash inflow/outflow for operating activities is as follows

	Sh
Retained profit for the year	XX
Add non-cash expenses	
Depreciation	XX
Tax provision	XX
Proposed dividends	XX
Add Accruals	
Decrease in debtors	XX
Decrease in stock	XX
Decrease in Bill receivable	XX
Increase in creditors	XX
Less prepayment	
Increase in stock	(XX)
Increase in bill receivable	(XX)
Decrease in creditors	(XX)
Decrease in bill payable	(XX)
Net cash flow, overflow from operating activities	**(XX**

Example 6.1

From the following balance sheet, prepare cash flow statement of Abc Ltd for the ended 31/12/2009

	31/12/2009	31/12/2009
	sh	sh
Issued share capital	18,000	23,000
Retained profit	7,500	9,200
10% Debentures	6,000	7,500
Taxation payable as at 1st Jan.	2,900	3,200
creditors	3200	3400
Proposed dividends	500	600
	38,100	46,900
Fixed asset at cost	23,000	25,000
Depreciation	(5,650)	(6,200)
	17,350	18,800

Stock	12,000	14,695
Debtors	4,200	9,255
Balance at Bank	4,550	9,255
	38,100	46,900

Solution

Abc Ltd

Cashflow Statement For The Year Ended 31/12/2009

	Sh	Sh
Cash flow from Operating Activities		
Net profit after tax & interest	1,700	
Add non-expenses		
Depreciation	2,650	
Proposed taxation	3,200	
Proposed dividends	600	
Less non-cash income		
Profit on sale of fixed asset	(1000)	
Add Accruals		
Decrease in debtors	50	
Increase in creditors	200	
Less Prepayment		
Increase in stock	(2695)	
Cash inflow from operations	**4705**	
Interest paid	(2900)	
Dividend paid	(500)	1305
Net cash generated from investments		
Disposal of fixed assets	2,500	
Purchase of fixed assets	(5,600)	(3,100)
Net asset generated for financial activities		
Issue of shaves capital	5000	
Issue of 10% debentures	1,500	6,500
Changes in cash & cash equivalent		4,705

Reconciliation of opening and closing balances

	Sh
Cash at bank as on 1st Jun 2009	4,550
Increase in cash/cash equivalent	4,705
Cash at bank as 31/Dec/2009	9,255

Workings & notes to the question

i) Determining if there was purchase or disposal of fixed asset

Fixed Asset a/c

2009	Sh	2009	Sh
Jan Bal Ltd	2,300	Disposal Acc	3,600
Bank A/c	5,600	31 Dec Bal c/d	2,500
	28,600		28,600

ii) Determining profit made on disposal of fixed assets

Disposal a/c

2009	Sh	2009	Sh
Fixed asset Acc	3,600	Depreciation profit Acc.	2,100
P&LA/C	1,000	Bank Acc	2,500
	4,600		4,600

iii) Accumulated depreciation a/c

2009	Sh	2009	Sh
		Jan 1 Bal b/f	5,650
Disposal	2,100		
Bal C/d	6,200	P&C Acc	2,650
	8,300		8,300

iv) Stock

	sh
Stock as at 31/Dec/2009	14,695
Stock as at 31/Dec/2008	12,000
Increase	2,695

v)Debtors

Debtors as at 31/Dec/2009	4,150
Debtors as at 21/Dec 2008	4,200
Decrease	(50)

vi)Trade& Expense creditors

Creditors as at 21/Dec/2009	3,400
Creditors as at 31/jan/2009	3,200
Increase	200

vii) Deprecations is an expense which reduces profit, but does not involve cash outflow, hence added back

viii) Taxation is paid in arrears i.e. tax for 2008 is paid in 2009, and for 2009 paid in 2010
As a result, tax expenses for 2009 do not involve cash in 2009; hence it is not cash flow in 2009.
But tax for 2008 is cash flow in 2009, hence that why it is subtracted

Propose dividable like tax are paid in arrears hence proposed divided for 2008 are cash flow in 2009. Proposed deciduas for 2009 will be cash.
Outflow: 2010 due to this we add back proposed divided for2008 as they are paid in 2009
The items taxation, interest and divided are normally shown separately after net cash flow from operating activities but before net cash flow from investment.

Example 2.6

J& R Ltd is balance sheets for the year ended 30/Sept/2008

	2008	2007
	Sh "000"	Sh "000"
Non- current Assets		
Fixed assets	8,520	7,000
Current Asset		
Stock	6,000	5,000
Debtors	1,750	1,800
Bank balance	2,630	1,550
	10,380	8,350
Current liabilities		
Creditors	1,400	1,300
Tax	1,200	1,100
Proposed dividends	400	350
	3,000	2,750
Net current Assets	7,380	5,600
Net assets	15,880	12,600
Financed by		
Quity & revenue	9000	7,000
Ordinally shaves capital	3,880	3,200
Retained earns	3,000	2,400
Debtors loan	15,880	12,600

The following additional information is given

i) During the year ended 30th September 2008 fixed assets were purchased at a cost of Sh.2700,000 while fixed assets whose original cost was Sh.1000,000 were disposed for Sh 750,.000 The net book value of the assets disposed were Sh.400, 000 and the profit on sale of the fixed asset has been included in the retained profits

ii) Accumulated depreciation at 30 September 2008 was Sh.2500, 000 and Sh 2300,000 at September 20

Solution

J & R td

Cashflow Statement for the Year ended 30/September/2008

	Sh "000"	Sh "000"
Net cash flow from operating activities (w1)		1880
Tax (2007)		(1100)
Divideds (2007)		(350)
		430
Net cash flow from investing activities		
Disposal of fixed asset	750	
Purchase of fixed assets	(2,700)	(1,950)
Net cash flow from financing activities		
Issues of shares	2000	
Issues of debtors	600	2,600
Increase in cash and equivalent		**1080**

Reconciliation of opening cash balance and closing cash balance

	Sh"000"
Opening cash balance	1550
Add increase in cash & cash equivalent	1080
Closing cash balance	**2630**

Workings

	Sh"00"
i) Retained earns for the year (3880-3200)	680
Add back non – cash expense	
Depreciation (w1)	800
Tax provision	1,200
Proposed divided	
Less Non-cash income	
Profit on disposal of fixed assets (w3)	(350)

Add Accruals

Decrease in debtors	50
Increase in creditors	100
Less prepayment	
Increase in stock	(100)
Net cash inflow from operating activities	**(1880)**

ii) Depreciation changed for 2008

Provision for depreciation A/c

2008	Sh'000'	2008	Sh'000'
Disposal A/c	600	Bal b/f	2,300
Bal c/d	2,500		
	3,100		3,100

iii) Profit on sale of fixed assets

Disposal of fixed Asset A/c

	Sh'000'		Sh'000'
Fixed Asset Acc	1000	Accum Dep.Acc	600
Profit &loss A/C	350		750
	1,350		1,350

6.5: Uses of Cash Flow Statements

Cash flow statements have many uses other than the legal need for some companies to prepare them. A few cases where a business might find them useful is answering such questions as below- Small businessman may want to know why he now has an overdraft. He started off the year with money in the bank, he has made profit and yet he now has a bank overdraft. Another businessman may want to know why the bank balance has risen even though the business is losing money. The partners in a business have put in additional capital during the year. Even so, the bank balance has fallen dramatically. They may want explanation as to how this has happened. A study of the final accounts themselves would not give them the information that they may needed. However, a study of the cash flow statement in each case will reveal the answer to their questions.

Besides the answers to such specific queries, cash flow statement should also help businesses to assess the following.

- The cash flows which the business may be able to generate in the future;
- How far the business will be able to meet future commitment, e.g tax due, loan repayments, interest payments, contracts that could possible lose quite a lot of money;
- How far future share issues may be needed or additional capital in the case of sole trader or partnership;
- A valuation of the business

6.6: REVISION QUESTIONS

Question one

The balance sheets of M Daly, a sole trader, for two successive years are as shown below. You are required to draw up a cash flow statement for the year ended 31Decemeber 2009

Balance sheet at 31 December 2009	**sh.'000'**	**sh '000'**
Fixed asset		
Land and premises (cost 3,000)	2,600	2,340
Plant and machinery		
(Cost 2,000)	1,500	-
(Cost 3,000)	-	2,300
	4,100	4,640
Current Assets		
Stocks	660	630
Trade debtors	1,780	1,260
Bank	-	710
	2,440	2,600
Current liabilities	840	
Trade creditors	1,200	
Bank overdraft	640	-
	(1,840)	(840)
	600	1,760
	4,700	6,400
Loan (repayable December (20x9)	-	(1,000)
	4,700	**5,400**

Represented by

Capital account;		
Balance at 1st January	4,200	4,700
Add Net profit for the year	1,800	2,200
	6,000	6,900
Less drawings	(1,300)	(1,500)
	4,700	**5,400**

Question two

The balance sheet below relates Monk man, aSole trader in West- gate centre.

Balance sheets as at 31April

Fixed assets	15,500		18,500	
Less provision for depreciation	(1,500)		(1,700)	
	14,000		16,800	
Current assets				
Stocks	3,100		5,900	
Trade debtors	3,900		3,400	
Bank	1,500		-	
	8,500		9,300	
Current liabilities				
Trade creditors	2,000		2,200	
Bank overdraft	-		900	
	(2,000)		(3,100)	
		6,500		6,200
		20,500		23,000
Represented by				
Capital accounts:				
Balance at 1 May		20,000		20,500
Add Net profit for the year		7,000		8,500
Additional capital introduced		-		2,000
		27,000		31,000
Less Drawings		(6,500)		(8,000)
		20,500		23,000

6.7: REFERENCES

Wood, Frank, *Business Accounting* (9th Edition), International Thompson. Pages 440-462

Honrgren and Sundem, G. L, *Introduction to Financial Accounting*, (6th Edition), New York; Prentice Hall. pages 114-160

TOPIC SEVEN: INCOMPLETE RECORDS

Learning Objectives

Upon completion of this topic you should be able to:

- Outline the approaches used in preparing final accounts where there insufficient records
- Apply the approaches to determine missing items
- Deduce the figures of sales and purchases from incomplete records

7.1 INTRODUCTION

An incomplete record situation is whereby, the accounting system falls short of the double entry. This may be due to:

– Lack of records at all; or
– Insufficient records that will facilitate the preparation of final accounts.

Reasons for incomplete records:

a) Managers or owners may not have the *skills* or expertise in preparing and maintaining an accounting system (records and procedures).
b) It may not be *economical* for the business to maintain accounting records due to the volume or/and nature of transactions (small scale businesses)
c) Records are destroyed (e.g. through fire), stolen or misplaced.

There are 4 main approaches in preparing final accounts where there are insufficient records.

a) Estimating income from the net assets.
b) Estimating income from the use of ratios.
c) Use of a simple cashbook and bank statement.
d) Use of control accounts.

N/B: approach number c and d are normally used together

7.2 ESTIMATING INCOME FROM NET ASSET

Where the available records are so deficient (i.e. it is impossible to compile a reasonable complete cash summary, the only method of estimating the profits or loss for the period, is to prepare *statement of affairs* showing the net worth of the business at the beginning and at the end of the period.

The profit/loss is estimated by use of the following formulas:

$$\text{Profit or loss} = \text{Closing Capital} - \text{Opening Capital} + \text{Drawings} - \text{Additional Capital}$$

Or where there are no non current liabilities then this optional formula can be used

$$\text{Profit or loss} = \text{Closing Net Asset} - \text{Opening Net Asset} + \text{Drawings} - \text{Additional Capital}$$

Example: 1.7

A sole trader's capital position is as follows:

	31 December	
	2009	2010
	Sh.	Sh.
Motor vehicle:		
Cost	7,500	7,500
Depreciation	3,000	4,500
	4,500	3,000
Stock	2,960	3,450
Debtors	1,150	2,060
Bank	925	2,125
Cash	263	54
	9,798	10,689
Creditors	2,860	3,340
Net assets	6,938	7,349

He has estimated his drawings for 2010 at £12,500. Estimate his net profit for the year.

Solution:

Net profit = Closing Net Asset - Opening Net Asset + Drawings - Additional Net assets

= 7,349 – 6,938 + 12,500

= £12,911

7.3 Use of Ratios

There are 3 important ratios to be looked at:

a) Gross profit margin
b) Mark up
c) Stock turnover

If a firm has a uniform Gross Profit for all the items sold then any information available on sales or purchases can be used to derive the total Gross Profit for the period and incase there is sufficient information on expenses, then the Net Profit can also be derived.

The above ratios are computed as follows:

a) **Gross Profit Margin** = $\frac{\text{Gross Profit}}{\text{Sales (selling price)}} \times 100$

E.g. If the selling price of a unit is £100 and Gross Profit made per unit is £25, the Gross Profit Margin will be:

$$= \frac{25}{100} \times 100$$

$$= 25\%$$

If a firm sells 1,000 units in a financial period, then the Gross Profit will be:

= 25% (£100,000)

= £25,000

b) Mark up

$$= \frac{\text{Gross Profit}}{\text{Cost of Sales (cost price per unit)}} \times 100$$

In the above example, the mark up will be:

$$= \frac{25}{75} \times 100$$

$$= 33.33\%$$

N/B: 75 = 100 – 25
Cost = selling price – gross profit

c) Stock Turnover

Measures the rate at which a firm uses its stocks to make sales or turnover.

The formula is: $= \left[\frac{\text{Cost of Sales}}{\text{Average Stocks}}\right]$ expressed as number of times

$$\text{Average stock} = \frac{\text{Opening Stock + Closing Stock}}{2}$$

Example: 7.1
A firm has the following data for the period:

Opening stock	sh. 20,000
Purchases	sh300,000
Closing stock	sh.30,000

Required: The Stock Turnover Ratio.

$$\text{Average Stock} = \frac{30{,}000 + 20{,}000}{2}$$
$$= 25{,}000$$

Cost of sales = (20,000 + 300,000) – 30,000
= 290,000

Stock Turnover = $\frac{300,000}{25,000}$

= <u>11.6 times</u>

Example 2.7

M Jones gives you the following information as at 30 June2009

	£
Stock 1 July 2001	6,000
Purchases	54,000

Jones's mark-up is 50% on cost of goods sold. His average stock during the year was £12,000. Draw up a trading and profit and loss account for the year ended 30 June 2002

a) Calculate the closing stock as at 30 June 2009

b) State the total amount of profit and loss expenditure Jones must not exceed if he is to maintain a net profit on sales of 10%.

Solution

a) Average Stock = $\frac{\text{Opening Stock + closing stock}}{2}$

$12,000 = \frac{6,000 + C}{2}$

C = 24,000 – 6,000

= 18,000

Gross profit = 50%

Cost of Sales = 42,000

$\frac{\text{Gross Profit}}{42,000} = 50\%$

Gross Profit = 21,000.

Memorandum Trading Account

	Sh.
Sales	63,000
Less cost of sales	(42,000)
Gross profit	21,000
Expenses	(14,700)
Net profit	6,300

Example 3.7

W White's business has a rate of turnover of 7 times. Average stock is sh12,600. Trade discount (i.e. margin allowed) is 33¼% off all selling prices. Expenses are 66 ¾% of gross profit.

You are to calculate:

(a) Cost of goods sold.

(b) Gross profit margin.

(c) Turnover.

(d) Total expenses.

(e) Net profit.

Solution:
Profit schedule

	Sh.
Turnover	132,300
Cost of goods sold	88,200
Gross profit	44,100
Expenses	(29,400)
Net profit	14,700

$$\text{Turnover} = \frac{\text{Cost of Sales}}{\text{Average stock}}$$

$$\text{Margin} = \frac{\text{Gross Profit}}{\text{Sales}}$$

$$7 = \frac{\text{Cost of Sales}}{12{,}600}$$

Cost of Sales = 88,200

7.4 USE OF CASHBOOK AND CONTROL ACCOUNTS

If there is sufficient information relating to cash payments and receipts, then a simple cashbook for both cash in hand and cash at bank can be prepared in confirmation of deposits and payments made from the bank statement.

The information can then be posted to the relevant accounts e.g. any income received to the relevant income accounts, expenses to relevant expense accounts and assets and liabilities to relevant accounts.

Information relating to amounts owed to suppliers/creditors and amounts due from debtors can be posted in summary to the control accounts.

The preparation of the cashbook and control accounts will enable one to estimate any cash sales or credit sales and cash purchases or credit purchases.

Steps in Preparing the Final Accounts

1) Prepare a statement of affairs at the beginning of the period (a list of all assets and liabilities) to determine the beginning capital.
2) Open and post the balances and transactions to these 3 relevant accounts (i.e. the cashbook (for both cash in hand and bank), sales ledger control account and purchases ledger control account.
   Any other account can be opened where necessary.
3) Make adjustments for any accruals or prepayments.
4) Extract a list of the balances. (Trial balance).
5) Prepare the final accounts.

Example 4.7

Hobbs does not keep proper books of account. You ascertain that his bank payments and receipts during the year to 31 December 2009 were as follows:

Reciepts	Sh.	Payments	sh
Balance 1 Jan 2009	572	Purchases	10,007
Cheques for sales	13,179	Expenses	2,950
Cash banked	14,005	Drawings	11,250
Balance 31 Dec 2009	3,751	Delivery van	7,300
	31,507		31,507

From a cash notebook you ascertain:

	Sh.
Cash in hand 1 January 2009	62
Cash takings	16,300
Purchases paid in cash	1,850
Expenses paid in cash	375
Cash in hand 31 December 2009	65
Drawings by proprietor in cash	Unknown

You discover that assets and liabilities were as follows:

	1 Jan 2009	31 Dec 2009
	Sh.	Sh.
Debtors	1,850	2,070
Trade creditors	1,250	1,420
Stock on hand	2,650	2,990

Depreciation on the van is to be provided at the rate of 20% per annum.

Statement of Affairs as at 1 January 2009

	Sh.
CURRENT ASSETS	
Cash at bank	572
Cash in hand	62
Debtors	1,850
Stock	2,650
	5,134
CURRENT LIABILITIES	
Creditors	(1,250)
Net Assets	3,884
Capital	3,884

Sales Ledger Control Account

	Sh.		Sh.
Balance b/d	1,850	Cash Takings	16,300
Sales	29,699	Bank	13,179
		Bal c/d	2,070
	31,549		31,549

Purchases Ledger Control Account

	Sh.		Sh.
Cash purchases	1,850	Bal b/d	1,250
Bank	10,007	Purchases	12,027
	13,277		13,277

Cash in Hand Account

	Sh.		Sh.
Balance b/d	62	Creditors	1,850
Debtors/sales	16,300	Expenses	375
		Bank	14,005
		Bal c/d	65
		Drawings	67
	16,362		16,362

- The capital invested at any point of time in a business by the owner is represented by the difference between the assets and liabilities at that time.
- The difference between the capital at the end and the capital at the beginning of the trading period represents the trading profit made during that period, unless there were withdrawals or investments of additional capital.

Hobbs
Trading and Profit and Loss Account for the year ending 31 December 2009

	Sh.	Sh.
Sales		29,699
Less cost of goods sold:		
Opening stock	2,650	
Add purchases	12,027	
	14,677	
Less closing stock	(2,990)	11,687
GROSS PROFIT		18,012
Less Expenses:		
Expenses (375 + 2,950)	3,325	
Depreciation	1,460	(4,785)
NET PROFIT		13,227

Hobbs
Balance Sheet as at 31 December 2009

	Sh. Cost	Sh. Depreciation	Sh. NBV
Fixed Assets			
Delivery van	7,300	1,460	5,840
Current Assets			
Stock		2,990	
Debtors		2,070	

Cash		65	
		5,125	
Less current liabilities			
Creditors	1,420		
Bank overdraft	3,751	5,171	
			5,794
Financed by:			
Capital			3,884
Add net profit			13,227
			17,111
Less drawings (11,250 + 67)			11,317
			5,794

7.5 REVIEW QUESTIONS

Question one

Kimeu commenced his business of making furniture on 1 April 2009 Due to his limited accounting knowledge he has not maintained proper books of account. You have been engaged to examine his records and prepare appropriate accounts there from. You perform an examination of the records and from interviews with Kimeu you ascertain the following information.

1. At the commencement of business on 1 April 2009 he deposited Sh 1,200,000 into business bank account. On the same day he brought into the firm his pickup and estimated that it was worth Sh 660,000 and then that from 1 April 2009 it will have useful life of three years.
2. To increase his working capital he borrowed Sh 400,000 at 15% interest per annum on 1 July 2009 from his sister but no interest has yet been paid.
3. On 1 April 2009, Sally was employed as a clerk at a salary of Sh. 720,000 per annum.
4. He had drawn Sh 18,000 per week from the business account for private use during the year.
5. He purchased timber worth Sh 1,960,000 out of which Sh 158,000 worth of stock was retained in the workshop on 31 March 2010. He also spent Sh 960,000 on the purchase of some equipment at the commencement of the business which he estimates will last him five years.
6. Electricity bills received up to 31 January 2010 were Sh 240,000. Bills for the remaining two months were estimated to be Sh 48,000. Motor vehicle expenses were Sh 182,000 while general expenses amounted to Sh 270,000 for the year. Insurance premium for the year to 30 June 2010 was Sh 160,000. All these expenses have been paid by cheque.
7. Rates for the year to June 2010 were Sh 36,000 but these had not been paid.
8. Sally sent out invoices to customers for Sh 6,178,000 but only Sh 5,080,000 had been received by 31 March 2010. Debt totaling to Sh 17,000 were abandoned during the year as bad. Other customers for jobs too small to invoice have paid Sh 726,000 in cash for work done of which Sh 560,000 was banked. Kimeu used Sh 75,000 of the difference to pay for his family's foodstuff, bought Kenya Charity Sweepstake tickets worth 24,000 and Sally used the rest on general expenses except for Sh 30,100 which was left in the office on 31 March 2010.
9. You agree with Kimeu that he will pay you Sh 55,000 for accountancy fee.

Required:

(a) Profit and loss account for the year ended 31 March 2010.
(b) Balance sheet as at 31 March 2010.

Question Two

Abi, a proprietor of a grocery and general store has not previously engaged an accountant. He informs you that this year his bankers have insisted on a proper set of accounts. Abi supplies you with his trading results for the year ended 30 June 2009 which are as follows:

	Sh		Sh
Payments for goods	4,747,500	Takings	5,465,000
Payments for expenses	565,000		
Profits	152,500		
	5,465,000		5,465,000

Abi instructs you to examine his records and prepare accounts. From your examination of the records and interview with your client, you ascertain the following information:

1. The takings are kept in a drawer under the counter; at the end of each day the cash is counted and recorded on a scrap of paper; at irregular intervals Mrs. Abi transcribes the figures into a notebook; a batch of slips of paper was inadvertently destroyed before the figures had been written into the notebook, but Mr. And Mrs. Abi carefully estimated their takings for that period, and the estimated figure is included in the total of Sh. 5,465,000.
2. Mr. Abi involved himself in betting for 30 weeks of the year, spending Sh. 500 per week with cash taken from the drawer. His winnings totaled Sh. 29,500.

3. The following balances are ascertained as correct:

	30 June	
	2009	2009
	Sh	Sh
Cash in hand	43,500	22,500
Balance at bank	109,500	78,000
Sales debtors	245,500	229,000
Creditors for purchases of stock	121,500	139,500
Stock at cost	950,000	975,000

4. Debts totaling Sh. 178,000 were abandoned during the year as bad; the takings included Sh 12,500 recovered in respect of an old debt abandoned in the previous year.
5. Mr. Abi rents the shop for living accommodation at Sh. 1,500 per week for 52 weeks in a year; the rent is included in expenses of Sh 565,000. The living accommodation comprises one-third of the building.
6. The total expenses also include:

    i. Sh. 17,500 running expenses of Abi's private car;
    ii. Sh. 30,000 for exterior decoration of the whole premises;
    iii. Sh. 80,000 for alterations to the premises to enlarge the storage accommodation.

7. Mr. Abi takes Sh. 5,000 per week from the business for his wife's personal expenses. This excludes the amount indicated in note 8.
8. Mr. Abi draws Sh. 750 per week for cigarettes and beer.

9. During the year, Mr. Abi bought a secondhand car (not for use in the business) from a friend; the price agreed was Sh. 175,000, but as the friend owed Mr. Abi Sh. 33,500 for goods supplied from the business, the difference was settled by cheque.
10. An insurance policy for Mr. Abi's life matured and realized Sh. 320,500.
11. Mr. Abi cashed a cheque for Sh. 50,000 for a friend; the cheque was dishonored and the friend is repaying the Sh. 50,000 by installments. He had paid Sh. 20,000 by 30 June 2009.
12. Other private payments by cheque totaled Sh. 48,000 plus a further sum of Sh. 55,000 for income tax.
13. You are to provide Sh. 21,000 for accountancy fees.

N.B. All receipts and payments of Mr. Abi are made through his business account.
Required:

(a) Mr. Abi's balance sheet for the business at 30 June 2009
(b) Mr. Abi's profit and loss account fo r the year ended 30 June 2009
(c) Mr. Abi's balance sheet for the business at 30 June 12009.

7.6: REFERENCES

- Wood, Frank, *Business Accounting* 9 Edition), International Thompson. Pages 388-392
- Honrgren and Sundem, G. L, *Introduction to Financial Accounting*, (6th Edition), New York; Prentice Hall. pages 30-36

Model Paper 1

Mt Kenya University

UNIVERSITY EXAMINATION 2010/2011

SCHOOL OF APPLIED SOCIAL SCIENCES

DEPARTMENT OF BUSINESS AND SOCIAL STUDIES

BACHELOR OF BUSINESS MANAGEMENT

UNIT CODE: BBM 125 TITLES: FUNDAMENTAL ACCOUNTNG II

TIME: 2HRS

Instructions

*Answer Question **ONE** which is **compulsory** and any other **TWO** questions*

Question One

(a) Outline the four main approaches in preparing final accounts where there are Insufficient Records (5marks)

(b) State and briefly explain any three distinguishing features between (i) a receipts and payments account and (ii) an income and expenditure account. records (5marks)

(c) .Write short notes on the following

(i) direct costs

(ii) Indirect cost (5marks)

(d) Outline and explain the contents of partnership agreement**.** (5 marks)

(e) Differentiate between non –purchased goodwill and purchased goodwill. (5 marks)

(f) Outline and explain the three (3) types of capital reserves (5 marks**)**

(Total :20 marks)

Question Two

The Chief Accountant of KK Ltd has extracted the following trial balance as at 31 October 1998.

	Sh,'000'	Sh,'000'
Authorized and issued capital (shares of Sh. 20 each fully		30,000
paid)		350
Share premium		3,500
10% premium		2,000
General reserve		2,850
Profit and loss account 1 November 1997	3,500	
Motor vehicles at cost		265
Provision for depreciation	44,500	
Freehold property	1,375	
Trade debtors		460
Trade creditor	95,650	127,450
Purchases and sales	3,478	
Stock in hand 1 November 1997	1,540	
Furniture and fittings at cost		138
Provision for depreciation	500	
Goodwill		385
Rent receivable	2,285	
Salaries and wages	358	
General expenses	2,470	
Vehicles running expenses	124	
Bad debts	568	
Telephone and postage	269	
Water and electricity	289	
Rates and insurance	10,492	
Cash at bank	167,398	167,398

Notes:

11. Credit sales amounting to Sh.165,000 were made on 31 October 1998 but no entries were made in the books.
12. Returns outwards amounting to Sh.128,000 were dispatched on 31 October 1998 but no entries were made in the books.
13. Closing stock was valued at Sh.4,398,000.
14. Accrued salaries and telephone bills amounted to Sh.134,000 and Sh.55,000 respectively.
15. Rent for the month of October 1998 amounting to Sh.35,000 had not been received from the tenant.
16. Provision for depreciation on furniture and fittings and the motor vehicles are 10% and 20% on cost respectively.
17. Provision for bad and doubtful debts of 5% on trade debtors should be made.
18. Corporation tax should be provided at 35% of the net profit before tax.
19. The directors propose a dividend of 15% on issued share capital and a transfer of Sh.2,500,000 to the general reserve.
20. The debenture interest has not yet been paid.

Required:

3. Trading, profit and loss account for the year ended 31 October 1998. (13 marks)
4. Balance sheet as at 31 October 1998. (7 marks)

(Total: 20 marks)

Question Three

Amis, Lodge and Pym were in partnership sharing profits and losses in the ratio 5:3:2. The following trial balance has been extracted from their books of accounts as at 31 March 19-8:

	sh	sh
Bank interest received		
Capital accounts (as at 1 April 19-7):		
Amis		80,000
Lodge		15,000
Pym		5,000
Carriage inwards	4,000	
Carriage outwards	12,000	
Cash at bank	4,900	
Current accounts:		
Amis	1,000	
Lodge	500	
Pym	400	
Discount allowed	10,000	
Discount received		4,530
Drawings:		
Amis	25,000	
Lodge	22,000	
Pym	15,000	
Motor vehicles:	80,000	
Accumulated depreciation (at 1 April 19-7)		20,000
Office expenses	30,400	
Plant and machinery:		
At cost	100,000	
Accumulated depreciation (at 1 April 19-7)		36,000
Provision for bad and doubtful debts		
(at 1 April 19-7)		420
Purchases	225,000	
Rent, rates, heat and light	8,800	
Sales		404,500
Stock (at 1 April 19-7)	30,000	
Trade creditors		16,500
Trade debtors	14,300	
	583,300	583,300

Additional information:

8. Stock at 31 arch 19-8 was valued at £35,000.
9. Depreciation on the fixed assets is to be charged as follows:
   a. Motor vehicles – 25% on the reduced balance
   b. Plant and machinery – 25% on the original cost.

   There were no purchases or sales of fixed assets during the year to 31 March 19-8.
10. The provision for bad and doubtful debts is to be maintained at a level equivalent to 5% of the total trade debtors as at 31 March 19-8.
11. An office expense of £405 was owing at 31 March 19-8, and some rent amounting to £1,5000 had been paid in advance as at that date. These items had not been included in the list of balances shown in the trial balance.

12. Interest on drawings and on the debit balance on each partner's current account is to be charged as follows:

	Sh.
Amis	1,000
Lodge	900
Pym	720

13. According to the partnership agreement, Pym is allowed a salary of sh13,000 per annum. This amount was owing to Pym for the year to 31 March 19-8, and needs to be accounted for.
14. The partnership agreement also allows each partner interest on his capital account at a rate of 10% per annum. There were no movements on the respective partners' capital accounts during the year to 31 March 19-8, and the interest had not been credited to them as at that date.

Required:

c) Prepare the Partners trading, profit and loss account for the year ended 31 March 19-8

d) The partners current accounts and a balance sheet as at 31 March 19-8

Question Four

The balance sheets of M Daly, a sole trader, for two successive years are as shown below. You are required to draw up a cash flow statement for the year ended 31Decemeber 2009

Balance sheet at 31 December 2009	**sh.'000'**	**sh '000'**
Fixed asset		
Land and premises (cost 3,000)	2,600	2,340
Plant and machinery		
(Cost 2,000)	1,500	-
(Cost 3,000)	-	2,300
	4,100	4,640
Current Assets		
Stocks	660	630
Trade debtors	1,780	1,260
Bank	-	710
	2,440	2,600
Current liabilities	840	
Trade creditors	1,200	
Bank overdraft	640	-
	(1,840)	(840)
	600	1,760
	4,700	6,400

Loan (repayable December (20x9)	-	(1,000)
	4,700	**5,400**
Represented by		
Capital account;		
Balance at 1st January	4,200	4,700
Add Net profit for the year	1,800	2,200
	6,000	6,900
Less drawings	(1,300)	(1,500)
	4,700	**5,400**

Additional information:

v. 38,000 toys at Sh.45 each were manufactured and transferred to Sales Department during the year. Tys in stock at the end of the year were to be valued at Sh. 45 each. Stock of raw materials was Sh.79.50 and work-in-progress was valued at prime cost of Sh.126, 250 at 31 March 1992.

vi. Accrued expenses outstanding at 31 March 1992:

	Factory	Sales Department
	Sh.	Sh.
Expenses	52,250	27,000
Factory wages	7,000	-

vii. Provision for depreciation is to be made as follows:
- Factory plant 10% p.a. on cost
- Delivery van 20% p.a. on cost

viii. The general provision for bad debts is to be maintained at 10% of the trade debtors.

Required:
Manufacturing, trading and profit and loss accounts for the year ended 31 March 1992 and a balance sheet as at that date. **(Total :20marks)**

Question Five

Abi, a proprietor of a grocery and general store has not previously engaged an accountant. He informs you that this year his bankers have insisted on a proper set of accounts. Abi supplies you with his trading results for the year ended 30 June 2009 which are as follows:

	Sh		Sh
Payments for goods	4,747,500	Takings	5,465,000
Payments for expenses	565,000		
Profits	152,500		
	5,465,000		5,465,000

Abi instructs you to examine his records and prepare accounts. From your examination of the records and interview with your client, you ascertain the following information:

1. The takings are kept in a drawer under the counter; at the end of each day the cash is counted and recorded on a scrap of paper; at irregular intervals Mrs. Abi transcribes the figures into a notebook; a batch of slips of paper was inadvertently destroyed before the figures had been written into the notebook, but Mr. And Mrs. Abi carefully estimated their takings for that period, and the estimated figure is included in the total of Sh. 5,465,000.
2. Mr. Abi involved himself in betting for 30 weeks of the year, spending Sh. 500 per week with cash taken from the drawer. His winnings totaled Sh. 29,500.

3. The following balances are ascertained as correct:

	30 June	
	2009	2009
	Sh	Sh
Cash in hand	43,500	22,500
Balance at bank	109,500	78,000
Sales debtors	245,500	229,000
Creditors for purchases of stock	121,500	139,500
Stock at cost	950,000	975,000

4. Debts totaling Sh. 178,000 were abandoned during the year as bad; the takings included Sh 12,500 recovered in respect of an old debt abandoned in the previous year.
5. Mr. Abi rents the shop for living accommodation at Sh. 1,500 per week for 52 weeks in a year; the rent is included in expenses of Sh 565,000. The living accommodation comprises one-third of the building.
6. The total expenses also include:

    iv. Sh. 17,500 running expenses of Abi's private car;
    v. Sh. 30,000 for exterior decoration of the whole premises;
    vi. Sh. 80,000 for alterations to the premises to enlarge the storage accommodation.

7. Mr. Abi takes Sh. 5,000 per week from the business for his wife's personal expenses. This excludes the amount indicated in note 8.
8. Mr. Abi draws Sh. 750 per week for cigarettes and beer.
9. During the year, Mr. Abi bought a secondhand car (not for use in the business) from a friend; the price agreed was Sh. 175,000, but as the friend owed Mr. Abi Sh. 33,500 for goods supplied from the business, the difference was settled by cheque.
10. An insurance policy for Mr. Abi's life matured and realized Sh. 320,500.
11. Mr. Abi cashed a cheque for Sh. 50,000 for a friend; the cheque was dishonored and the friend is repaying the Sh. 50,000 by installments. He had paid Sh. 20,000 by 30 June 2009.
12. Other private payments by cheque totaled Sh. 48,000 plus a further sum of Sh. 55,000 for income tax.
13. You are to provide Sh. 21,000 for accountancy fees.

N.B. All receipts and payments of Mr. Abi are made through his business account.
Required:

(d) Mr. Abi's balance sheet for the business at 30 June 2009
(e) Mr. Abi's profit and loss account fo r the year ended 30 June 2009
(f) Mr. Abi's balance sheet for the business at 30 June 12009. **(Total: 20 marks)**

Model Paper 2

Mt Kenya University

UNIVERSITY EXAMINATION 2010/2011

SCHOOL OF APPLIED SOCIAL SCIENCES

DEPARTMENT OF BUSINESS AND SOCIAL STUDIES

BACHELOR OF BUSINESS MANAGEMENT

UNIT CODE: BBM 125 TITLES: FUNDAMENTAL ACCOUNTNG II

DATE: AUGUST 2010SUPPLIMENTARY EXAM TIME: 2HRS

Instructions

*Answer Question **ONE** which is **compulsory** and any other **TWO** questions*

Question one

a) Explain the following terms using a suitable illustration

i) Subscription in arrears
ii) Issued share capital
iii) Prime costs
iv) Partnership deed
v) Capital expenditure

(10 marks)

The following list of balances as at 30 September 2009 has been extracted from the books of Brick and Stone, trading in partnership, sharing the profits and loss in proportions 3;2 respectively

	Ksh
Printing, stationery and postages	3,500
Sales	322,100
Stock in hand at 1 October 2008	23,000
Purchases	208,200
Rents and rates	10,300
Heat and light	8,700
Staff salaries	36,100
Telephone charges	2,900
Motor vehicle running costs	5,600

Discounts allowable	950
Discounts receivable	370
Sales returns	2,100
Purchases returns	6,100
Carriages inwards	1,700
Carriages outwards	2,400
Fixtures and fittings; at cost	26,000
Provision for depreciation	11,200
Motor vehicles; at cost	46,000
Provision for depreciations	25,000
Provision for doubtful debts	
Drawings; Brick	300
Stone	11,000
Current accounts balances at 1st October 2008	
Brick	3,600(Cr)
Stone	2,400(Cr)
Capital accounts balances at 1st October 2008	
Brick	33,000
Stone	
Debtors	
Creditors	
Balance at bank	

Additional information;

a) Kshs. 10,000 is to be transferred from Brick capital account to a newly opened brick loan account on 1st July 2009, interest at 10% per annum on the loan is to be credited to brick.
b) Stone is to be credited with a salary at the rate of Kshs. 12,000 per annum from 1st April 2009.
c) Stock in hand at 30 September 2009 has been valued at cost Kshs 32,000
d) Telephone charges accrued due at 30th September 2009 amounted to Kshs. 400 and rent of Kshs. 600 prepaid at that date.
e) During the year ended 30 September 2009 stone has taken goods costing Kshs 1,000 for his own use.
f) Depreciation is to be provided at the following annual rates on the straight line basis
   Fixtures and fittings 10%
   Motor vehicles 20%

Required

1. Prepare trading profit and loss account for the year ended 30th October 2009 (10 marks)

2. Prepare partners balance sheet as at 30th October 2009 (10 marks)

Question two.

Following financial information relates two similar types of retails store A and B

Financial statements

	A		B	
	Kshs	Ksh	Kshs	Ksh
Profit and loss accounts				
Sales		80,000		120,000
Less: Cost of goods sold				
Opening stock	25,000		22,500	
Add purchases	50,000		91,000	
	75,000		113,500	
Less closing stock	15,000	60,000	17,500	96,000
Gross profit		20,000		24,000
Less; Depreciation	1,000		3,000	
Other expenses	9,000	10,000	6,000	9,000
Net expenses		10,000		15,000
Balance sheets				
Fixed assets				
Equipment at cost	10,000		20,000	
Less depreciation to date	8,000	2,000	6,000	14,000
Current assets				
Stock	15,000		17,500	
Debtors	25,000		20,000	
Bank	5,000		2,500	
	45,000		40,000	
Less current liabilities				
Creditors	5,000	40,000	10,000	30,000
		42,000		44,000
Financed by;				
Capitals				
Balance at start of year		38,000		36,000
Add Net profit		10,000		15,000
		48,000		51,000
Less Drawings		6,000		7,000
		42,000		44,000

Required;

Calculate the following ratios

(i) Gross profit as percentage of sales

(ii) Net profit as percentage of sales

(iii) Expenses as percentage of sales

(iv) Current ratio

(v) Rate of return of net profit on capital employed

(vi) Current ratio

(vii) Acid test ration
(viii) Debtor/sales ratio
(ix) Creditors/purchase ratio

(20 marks)

Question three

The following information relates to T. Howe traders Ltd for the year ended 31 December 2009.

	Dr	Cr
	£	£
Bank	6,723	
Debtors	18,910	
Creditors		12,304
Stock at 31 December 2008	40,360	
Buildings at cost	100,000	
Equipment at cost	45,000	
Profit and loss account at 31.12.2008		15,286
General reserve		8,000
Foreign exchange reserve		4,200
Authorized and issue share capital		100,000
Purchases	72,360	
Sales		135,486
Carriage inwards	1570	
Carriage outwards	1390	
Salaries	18310	
Rates and occupancy expenses	4235	
Office expenses	3022	
Sundry expenses	1896	
Provisions for depreciation at 31.12.2009		
Buildings		32000
Equipment		16000
Director's remuneration	9500	
	323,276	323,276

Notes at 31 December 2009:

(i) Stock at 31 December 2009 £52,360
(ii) Rates owing £280; Office expenses owing £190
(iii) Dividend of 10 per cent proposed.
(iv) Transfers to reserves: General £1,000; foreign exchange £ 800.
(v) Depreciation on cost: Buildings 5 per cent; Equipment 20 per cent.

Required;

Draw;
1. Trading, profit and loss account (10 marks)
2. Balance sheet (10 marks)

Question four

a) i. Explain five uses of financial ratios (5 marks)
ii. Discuss the limitations of financial ratios in using them to evaluate business performance. (10 marks)

b) Apart from ratios explain other two measures of performance which can be used by a Business. (5 marks)

Question five
The following are the records of the County Cricket Club which has not kept a full set of accounts;

Assets and liabilities	£	£
	01 03 06	28 02 07
Fixed assets (book value)	85,000	?
Investments (long term)	20,000	20,000
Debtors	1,000	1,000
Creditors (bar purchases)	600	800
Bar stock	3,000	3,500
Wages owing	400	600
Prepaid insurance	100	200
Balance at bank	2,000	?
Subscriptions outstanding	300	350

Summary of the bank transactions in the year:

	Payments £	Receipts £
Purchase of new fixed assets	15,000	
Wages (bar staff)	26,000	
Insurance	10,000	
Rent and rates	6,000	
Postage and stationery	2,800	
Payments to suppliers (bar)	67,000	
Sundry expenses	1,500	
Bar sales		136,000
Subscriptions received		15,500
Investment income		1,000

It has been decided to depreciate fixed assets by 25%.

TASKS

a) Calculate
(i) The accumulated fund as at 01 03 06.
(ii) The bank balance as at 28 February 2007.
(10 marks)

b) Prepare the
(i) Bar trading account for the year ended 28 February 2007.
(ii) Prepare the income and expenditure account for the year ended 28 February 2007.
(iii) Balance sheet as at 28 February 2007. (10 marks)