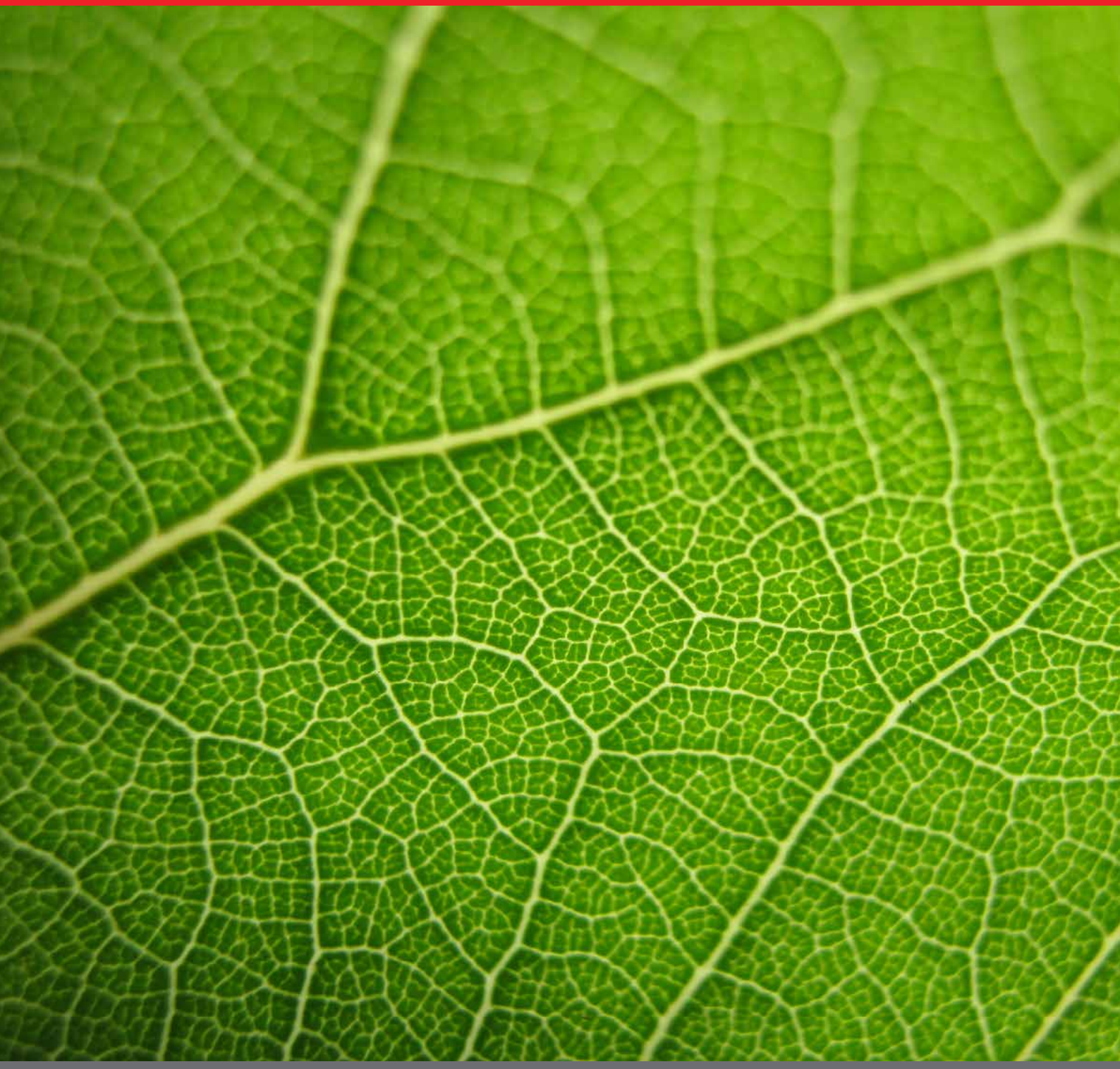
ACCOUNTING 2 (TC6)

TECHNICIAN DIPLOMA IN ACCOUNTING



ICAM THE INSTITUTE OF CHARTERED ACCOUNTANTS IN MALAWI

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PREFACE

INTRODUCTION

The Institute noted a number of difficulties faced by students when preparing for the Institute's examinations. One of the difficulties has been the unavailability of study manuals specifically written for the Institute's examinations. In the past students have relied on text books which were not tailor-made for the Institute's examinations and the Malawian environment.

AIM OF THE MANUAL

The manual has been developed in order to provide resources that will help the Institute's students attain the needed skills. The manual has been developed in such a way that even those who would like to study on their own can do that. It is therefore recommended that each student should have their own copy.

HOW TO USE THE MANUAL

Students are being advised to read chapter by chapter since subsequent work often builds on topics covered earlier.

Students should also attempt questions at the end of the chapter to test their understanding. The manual will also be supported with a number of resources which students should keep checking on the ICAM website.

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SYLLABUS

AIMS OF THE COURSE

i. To develop the student's understanding of the fundamental principles and concepts of accounting.
ii. To develop the student's ability to apply accounting principles in various practical accounting environments in line with regulatory and statutory framework.
iii. To develop the student's ability to prepare, analyze and interpret financial statements.

OBJECTIVES

By the end of the course the student should be able to:-

i. Prepare financial statements for a variety of organizations within the regulatory framework.
ii. Analyze the performance of a business using financial statements through ratio analysis.
iii. Prepare basic consolidated financial statements for simple group accounts.

FORMAT AND STANDARD OF THE EXAMINATION PAPER

The paper will consist of two sections; section A and section B. **Section A** will be compulsory with one question. The question will be on **preparation of final accounts for various forms of businesses with some adjustments**. This section will carry 40 marks. **Section B** will have **4 questions,** each carrying 20 marks. Candidates will be required to answer **any three** questions from section B.

SPECIFICATION GRID

This grid shows the relative weightings of topics within this course and should provide guidance regarding the study time to be spent on each.

Syllabus Area	Weighting (%)
Adjustment to accounting records and financial statements.	25
Accounting and reporting for various business organizations.	65
Consolidated financial statements.	10
Total	100

Learning Outcomes

1 Overview of accounting procedures and systems

1.1 Types of business organizations and general purpose of financial statements, users and their needs.

(a) Identify and explain general purposes of financial statements
(b) Identify and define different forms of business organization sole trader, partnership, limited company and non-profit making organizations
(c) Recognize legal differences in respect of formation, ownership, capital and liability in different forms of business organization
(d) Define, understand and apply qualitative characteristics: relevance, faithful representation, comparability, verifiability, timeliness and understandability
(a) Identify various users of financial statements and their information needs

1.2 Documents used in business transactions including documents for stores and payment preparation.

(a) Identify and explain documents used in credit sales or revenue systems and credit purchase systems, cash transactions both sales or revenue and payments such as quotations, requisition, local purchase order, supplier tax invoice, payment voucher, petty cash voucher, petty cash return, cash receipts, customer tax invoice, sales orders cheque books etc
(b) Identify and explain documents used in stores systems: requisitions, stores issue notes, good received notes, goods returned notes, delivery notes, dispatch notes

1.3 Systems of internal checks in bank accounting, reconciliation, payables reconciliation and receivables reconciliation.

(a) Identify documentation needed to perform a bank and petty cash reconciliation: bank statement, cheque stubs, deposit slips, expenses vouchers
(b) Understand bank reconciling items: un-presented/outstanding cheques, outstanding lodgments and bank or cash book errors
(c) Prepare bank and petty cash reconciliation
(d) Prepare both accounts receivables and payables control accounts
(e) Use accounts receivables control account to determine sales figure
(f) Use accounts payables control account to determine purchases figure
(g) Explain how bank reconciliation, petty cash and control accounts for receivables and payables perform internal check function

1.4.1 Basic final accounts and interaction of statement of profit or loss and the statement of financial position including period end adjustments.

(a) Revise preparation of simple statement of profit or loss and statement of financial position with emphasis on main elements in each statement and recognized formats
(b) Explain the interaction of statement of profit or loss and statement of financial position using the accounting equation
(c) Prepare statement of profit or loss with periodic adjustments

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2 Conceptual, regulatory and statutory framework of accounting

2.1 Accounting concepts, principles and policies

(a) Define, understand and apply accounting concepts and principles: materiality, substance over form, going concern, business entity concept, accruals, fair presentation, consistency, materiality and historical cost

2.2 Overview of the International Financial Reporting Standards.

(a) Define, understand and apply accounting convention and generally accepted accounting principles (GAAP)
(b) Understand the role of the regulatory system including the roles of the IFRS Foundation (IFRSF), the International Accounting Standards Board (IASB), the IFRS Advisory Council (IFRS AC) and the IFRS Interpretations Committee (IFRS IC)
(c) Understand the role of the local regulatory system including Institute of Chartered Accountants in Malawi (ICAM) and Malawi Accountants Board (MAB)
(d) Understand the role of International Reporting Standards

2.3 Overview of the Malawi Companies Act.

(a) Understand and explain the role of the Companies Act relating to governance issues in respect of financial reporting

3 Application of selected accounting standards

3.1 Accounting for tangible noncurrent assets

The main reference is International Accounting Standard (IAS) 16, Property, Plant and Equipment. The other relevant accounting standards are IAS 36 Impairment of Assets and IAS 40 Investment Property

(a) Define the following: property, plant and equipment, carrying amount, depreciable amount, depreciation, fair value, impairment loss, recoverable amount, residual value and useful life of noncurrent asset
(b) Explain when cost of an item qualifies to be recognized as an asset
(c) Explain how the value of property, plant and equipment is measured and its elements
(d) Recognize costs that are not costs of an item of property, plant and equipment
(e) Explain the difference between property, plant and equipment under IAS 16 and investment property under IAS 40
(f) Understand and apply the cost measurements: cost model and revaluation model
(g) Recognize examples of separate classes of property, plant and equipment
(h) Explain basis for choosing a depreciation method
(i) Explain the circumstances an item of property, plant and equipment cost should be depreciated separately
(j) Record the revaluation of a non-current asset in ledger accounts, the statement of profit or loss and other comprehensive income and in the statement of financial position.
(k) Calculate the profit or loss on disposal of a revalued asset.

(l) Illustrate how non-current asset balances and movements are disclosed in financial statements.
(m) Explain the purpose and function of an asset register.
(n) Identify the circumstances where different methods of depreciation would be appropriate.
(o) Calculate depreciation on a revalued noncurrent asset including the transfer of excess depreciation between the revaluation reserve and retained earnings.
(p) Calculate the adjustments to depreciation necessary if changes are made in the estimated useful life and/or residual value of a noncurrent asset.
(q) Explain circumstances that would be the basis for derecognition of an asset
(r) Explain and identify minimum requirements that should be considered in assessing any indication that an asset may be impaired
(s) Prepare disclosure note for each class of property, plant and equipment

3.2 Accounting for intangible noncurrent assets and amortisation

The main reference is International Accounting Standard (IAS) 38 Intangible Assets

(a) Define intangible asset
(b) Identify intangible asset with reference to identifiability, control and future economic benefits criterion
(c) Recognize the difference between tangible and intangible non-current assets with examples
(d) Explain the basis for recognition of intangible assets
(e) Identify and explain the treatment of intangible assets based on whether it is acquired, or internally generated intangible asset
(f) Define and calculate amortization and explain their treatment for intangible assets with finite and indefinite useful life
(g) Explain and apply the cost and revaluation model options to measurement approach of intangible asset after recognition
(h) Identify and explain circumstances that would be the basis for derecognition of an intangible asset
(i) Prepare disclosure note for each class of intangible assets

3.3 Accounting for inventories

The main reference is International Accounting Standard (IAS) 2 Inventories

(a) Define inventories, and net realizable value
(b) Understand the measurement of inventories
(c) Understand the elements of cost of inventories
(d) Identify and apply cost formulas for cost of inventories; first-in, first-out (FIFO) and weighted average cost formulas
(e) Explain when inventories are recognized as an expense
(f) Prepare a disclosure note for accounting policy for inventory cost measurement and the cost formula used in preparation of financial statements

3.4 Accounting for leases

The main reference is International Accounting Standard (IAS) 17 Leases

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(a) Define lease
(b) Identify and define classes of lease : a finance lease and operating lease
(c) Understand the concepts of minimum lease payments and interest rate implicit in the lease
(d) Explain the recognition of operating lease and finance lease in financial statements
(e) Record transactions of leases in the ledger accounts and financial statements for both the lessor and the lessee
(f) Understand and explain sale and leaseback transaction

3.5 Accounting for agriculture

The main reference is International Accounting Standard (IAS) 41 Agriculture

(a) Define agricultural activity and biological transformation
(b) Identify agricultural produce and a biological asset
(c) Identify types of biological transformation outcome
(d) Explain when a biological asset or agricultural produce should be recognized
(e) Classify biological assets into mature and immature assets

4 Final accounts for various forms of business

4.1 Accounts for non-profit making organizations.

(a) Explain the difference between accrual and cash basis accounting non-profit making organisations
(b) Calculate income from independent fund raising activities such as competition, canteen, bars
(c) Make periodical adjustments including income in arrears and in advance
(d) Understand and calculate accumulated fund
(e) Prepare statement of income and expenditure and statement of financial position for non-profit making organisations such as clubs and societies

4.2 Accounting aspects relating to partnership agreements changes.

(a) Give reasons why a partnership agreement may be changed
(b) Account for revaluation of assets and goodwill that may arise during partnership changes
(c) Record introduction of new partners, dissolution of partnership and any changes in partnership agreement in statement of financial position

4.3 Conversion of partnership into limited company

(a) Calculate consideration for each partner for conversion of their interest in the partnership into shares
(b) Calculate and record goodwill during the conversion process
(c) Identify share capital conversion ratios
(d) Calculate number of shares into which partnership individual capital accounts are converted
(e) Prepare a statement of financial statement for new limited company from partnership

5 Accounting for special transactions

5.1 Capital structure of limited companies (share capital, including equity and loan capital).

(a) Understand the capital structure of a limited liability company including:
  (i) Ordinary shares
  (ii) Preference shares (redeemable and irredeemable)
  (iii) Loan notes.
(b) Explain advantages and disadvantages of different types of capital with reference to ownership, control of the company and distribution of profits
(c) Compare capital structure of a limited company, partnership and sole trader

5.2 The issue and redemption of shares and debentures.

(a) Explain the advantages and disadvantages of different shares
(b) Understand and explain the process of issue of shares and debentures for both private and public limited companies
(c) Explain the advantages and disadvantages of using Malawi Stock exchange in issue of shares
(d) Understand the concepts of market price and nominal or par value of shares and debentures
(e) Record issue of issue shares and debentures at nominal or par value, premium and discount in ledger accounts and financial statements
(f) Record forfeited shares in ledger accounts and the financial statements
(a) Explain why shares may be redeemed
(b) Record redemption of shares at par value and premium in ledger accounts and financial statements

5.3 Treatment of taxation in Malawi Companies

(a) Identify and explain types of taxes payable by limited companies
(b) Identify and explain taxes that companies collect on behalf of the government
(c) Record taxes that a limited company collects on behalf of the government in ledger accounts and financial statements
(d) Record taxes payable by a limited company in the ledger accounts and financial statements

6 Final accounts- limited companies

6.1 Preparation of final accounts for internal use:

(a) Classify expenses by function; distribution expenses, administrative expenses, and finance expenses.
(b) Calculate and record finance costs in ledger accounts and the financial statements.
(c) Record other income and taxation
(d) Calculate and record dividends in ledger accounts and the financial statements.

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(e) Record profit transfers to various reserves in ledger accounts and the financial statements.
(f) Prepare statement of profit or loss and statement of financial statement
(g) Define a bonus (capitalization) issue and its advantages and disadvantages.
(h) Define a rights issue and its advantages and disadvantages.
(i) Record and show the effects of a bonus (capitalization) issue in the statement of financial position.
(j) Record and show the effects of a rights issue in the statement of financial position

6.2 Preparation of final accounts for publication

(a) Prepare statement of profit or loss and statement of financial position according to International Financial Reporting Standards, Companies Act and Generally Accepted Accounting Practice
(b) Calculate earnings per share according to IAS 33

6.2 Statement of changes in equity.

(a) Identify the components of the statement of changes in equity
(b) Record movements in the share capital, share premium accounts and other equity components

6.4 Cash flow statement for a single company.

The reference is IAS 7 Statement of Cash Flows

(a) Differentiate between profit and cash flow
(b) Understand the need for management to control cash flow.
(c) Recognise the benefits and drawbacks to users of the financial statements of a statement of cash flows.
(d) Classify the effect of transactions on cash flows
(e) Calculate the figures needed for the statement of cash flows including:
  (i) Cash flows from operating activities
  (ii) Cash flows from investing activities
  (iii) Cash flows from financing activities
(f) Understand different treatments of interest and dividends
(g) Calculate the cash flow from operating activities using the indirect and direct method.
(h) Identify the elements of cash and cash equivalents

7 Introduction to consolidated accounts

Reference standard is IFRS 10

7.1 The definition of various investments (trade investment, subsidiary, an associate and joint ventures.

(a) Define and describe the following terms in the context of group accounting: Parent, Subsidiary, Control, Consolidated or group financial statements, Non-controlling interest, Trade / simple investment

(b) Identify subsidiaries within a group structure.

7.2 Preparation of basic consolidated financial statements for a company with one subsidiary.

(a) Define and describe the following terms in the context of group accounting:
  (i) Parent
  (ii) Subsidiary
  (iii) Control
  (iv) Consolidated or group financial statements
  (v) Non-controlling interest
  (vi)Trade / simple investment

(b) Identify subsidiaries within a group structure.

(c) Calculate goodwill (excluding impairment of goodwill) using the full goodwill method only as follows:

Fair value of consideration	X
Fair value of non-controlling interest	X
Less fair value of net assets at acquisition	(X)
Goodwill at acquisition	X

(d) Describe the components of and prepare a consolidated statement of financial position or extracts thereof including:
  (i) Elimination of inter-company trading balances (including cash and goods in transit)
  (ii) Removal of unrealized profit arising on inter-company trading
  (iii) Acquisition of subsidiaries part way through the financial year taking into account pre and post- acquisition profits.

8 Interpretations of financial statements

8.1 Importance and purpose of analysis of financial statements

(a) Describe how the interpretation and analysis of financial statements is used in a business environment.

(b) Explain the purpose of interpretation of ratios

8.2 Ratio Analysis.

(a) Calculate key accounting ratios: profitability, liquidity, efficient use of resources and financial position ratios

(b) Deduce elements of financial statements from given ratios

8.3 Analysis of financial statements

(a) Calculate and interpret the relationship between the elements of the financial statements with regard to profitability, liquidity, efficient use of resources and financial position.

(b) Draw valid conclusions from the information contained within the financial statements and present these to the appropriate user of the financial statements.

(c) Recognize limitations of ratio analysis in interpretation of financial statements

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CHAPTER 1 CONCEPTUAL FRAMEWORK AND GAAP

LEARNING OBJECTIVES

The objective of this chapter is to:

- Lay down the framework of accounting
- Orient students the need for conceptual framework
- Other regulatory frameworks in Malawi

1.1 GENERALLY ACCEPTABLE ACCOUNTING STANDARDS (GAAP)

GAAP means all rules, guidelines, and directives from whatever source which govern the recognition, measurement and disclosure of accounting transactions for the purpose of the preparation of financial statements.

The bedrock of accounting is the conceptual framework which was developed by International Accounting Standards Board (IASB).

GAAP sources includes among other instruments as:

- Company law
- The Institute of Chartered Accountants of Malawi
- Malawi Accountants Board
- Malawi Stock exchange
- International accounting standards Board

1.2 CONCEPTUAL FRAMEWORK

The conceptual framework is a statement of generally accepted theoretical principles which form the frame of reference for financial reporting. Accountants need to have the framework for consistency of presentation of financial statements and also to avoid political intervention in the preparation of financial statement.

The Conceptual framework was developed by International Accounting Standards Board (IASB) in September 2010 with the following as its objectives;

a) to assist IASB in the development of future International Financial Reporting Standards (IFRS) and review of the exiting IFRSs

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

c) to assist national standard setting bodies in developing their national standards.

d) to assist prepares of financial statements in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS

e) to assist auditors in forming an audit opinion on whether financial statements comply with IFRSs;

f) to assist users of financial statements in interpreting the information contained in financial statements prepared in compliance with IFRSs and

g) to provide those who are interested in the work of the IASB with information about its approach to the formulation of IFRSs.

In short, the Conceptual Framework is supposed to be taken as a constitution guiding all accountants in recognition, presentation and disclosure of financial information. So the Conceptual Framework is considered superior to any accounting standard.

The Conceptual Framework was originally developed in 1989 by International Accounting Standards Committee (IASB) and had seven headings as follows:

a) The objectives of the financial statement
b) Underlying assumptions
c) Qualitative characteristics of financial statements
d) The elements of financial statements
e) Recognition of elements in financial statements
f) Measurement of elements in financial statements
g) Concept of capital and capital maintenance

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IASB embarked on a project to revise the conceptual framework to reflect the modern trend. The project is being conducted in phases but at the end of the project, the following will be the new chapters of the Conceptual Framework;

1. The objectives of financial information
2. The reporting entity
3. The qualitative characteristics of useful financial information
4. The definition, recognition and measurement of elements from which financial statements are constructed.
5. The concept of capital and capital maintenance.

A) Objectives of financial statements

The objectives of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

These users include lenders, investors, customers, suppliers, employees, Government and other stakeholders.

These financial statements are supposed to be the general purpose financial statements which meet the needs of all user groups.

a) Financial performance is shown by the statement of Profit or loss and other comprehensive income. Profitability is used to assess the potential changes in economic resources the entity is controlling. This information is usually useful to stakeholders like investors who would like to assess return on their investment, Government which would like to compute tax payable by the business entity, employees who uses profitability as a means of bargaining for better remuneration.

b) Changes in financial position are given by the statement of financial position. This information is more useful to the lenders as it shows the financial stability of an entity, the suppliers as it shows the credit worthiness of the business and Management of the entity to assess how they are managing the resources of an entity.

c) Details of cash generated during the year and how it has been utilized is presented through the statement of cash flows. This statement is also considered important to the lenders as it shows how the business generate its cash flows and which activities such cash flow is deployed. This stamen provide users with an insight of the future stability

of the business. Profit alone is inadequate to assess the future survival of the business but cash is considered as a good yard stick.

B. Reporting entity

Business is supposed to be treated as a separate legal entity from its owner as such business transactions should be recognized separately from the private transactions of the owner.

C. Qualitative characteristics of useful financial information

There are two fundamental qualitative characteristics of financial information which must always be checked on if the financial information is to be meaningful to the intended users and these are relevance and faithful presentation.

a) Relevance

The financial information provided should capable of affecting the decision made by users. Information should influence both the current and future direction to be adopted by the user. The information provided in the financial statements should have predictive and confirmatory role. It should be able to predict the future and confirm that a transaction took place in the past.

Materiality

Relevant information is affected by its nature and materiality. Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of financial statements. However, the determination of the materiality is subjective exercise.

An item may be material from one point of view and immaterial from the other perspective.

b) Faithful presentation

The second aspect is faithful presentation. The relevance of financial information can be recognized if such information has been presented in a form which clearly reflects the purpose for which it has been prepared. In this case, the preparer of financial information will look at aspects such as completeness, neutrality and freedom from error.

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Information must present faithfully the transaction which it is supposed to present. Though some transactions may be presented in an unfaithful way not because of bias but the inherent nature of the transaction.

Enhancing qualitative characteristics

Apart from the fundamental characteristics listed above, IASB recognized that for financial information to be very useful, there other characters which are complementary to the two and makes financial information even more meaningful.

Comparability

Financial information should be presented in a format which can easily be comparable between two different entities but also within the same entity over a number of years.

Consistent application of accounting policies enhance comparison within the same entity over a number of years while usage of agreed format enhances comparison of results for two different entities.

Verifiability

The purpose of financial information is to show the economic resources of an entity and how they have changed over the period. Financial information should be presented in such a way that any independent and reasonable user can be able to verify some figures and also relate to narratives therein.

As stated users may have different reasons for accessing financial information but this qualitative characteristic advocates that users within a similar group should at least come up with relative similar decisions out of the information presented.

Timeliness

Financial information should be presented in good time if the decision made therefrom is to be useful to the users. Decisions made out of stale information tend to result in wrong conclusions from the financial information and is misleading.

The preparers of financial information should always ensure that the information is made available to relevant stakeholders in pre-specified time in order to enhance the relevance of the information.

Understandability

Financial information is usually considered as complex as such must be presented in a simplified manner in recognition of the intended users. Care must be taken when considering simplifying the financial information as some information may lose the meaning while trying to ensure simplicity.

The relevance of financial information will strongly be measured by the way users understand the information provided.

D) The definition, recognition and measurement of elements from which financial statements are constructed.

The following are regarded as elements of financial statements; Assets, Liabilities, Equity, Revenues and Expenses

Assets

A resource controlled by an entity from past event from which future economic benefits are going to flow to the enterprise.

The definition emphasizes three main issues for an item to be an asset:

i. There should be a past event or transaction for an asset to be called an asset
ii. There should be control and not ownership. For example, if there if a finance lease, the lessee will recognize the asset in the financial position much as the item does not belong to him while the lessor will not recognize the same asset in his books much as he is the owner of the asset.
iii. There should be future economic benefit for an asset to be an asset. i.e. an asset of an enterprise may have been rendered not useful at all because of technological advancement of the item being used now. Much as the item was bought by the entity, it is now useless as the will not use it in their production process.

Liability

This is a present obligation of the entity arising from past event, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

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Obligation may be legal or constructive. It does not matter as long as an entity has a present obligation, then it has to recognize the liability.

Also note that the definition emphasizes past events or transaction, current obligation and future outflows.

Equity

This is the residual interests in the assets of the entity after deducting all its liabilities. This is derived from the accounting equation which says; **A-L=C.** Equity represents ownership interest in the business.

Income

This is the increases in the economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of the liabilities that result in increases in equity, other than those relating to equity participants.

The recognition in income occurs simultaneously with the recognition of increase in asset or decrease in liability.

Expense

These are reduction in economic activities during the accounting period in the form of outflows or depletion other than the reduction because of payments to equity participants.

The recognition in expenses occurs simultaneously with the recognition of increase in liability or decrease in asset.

Recognition of Elements in the financial statements

Recognition is the process of including as item in the financial statements. There is need for an element of financial statement satisfy two criteria for it to be recognized.

i. It is probable that there will be the future flow of economic benefits to or from a firm.
ii. The item has a cost or value that can be measured reliably.

Probable future economic benefits refers to the probability of it happening is more than not happening. In other words, the probability of happening is more than 50%.

Measurement of elements in the financial statements

Measurement is the determination of value to be included in the financial statements. Usually, these are included at the following bases:

i. Historical Cost model. Assets and liabilities are measured at the amount which an item was purchased at. The advantage of this cost is that the amount can be verified.
ii. Current cost. Assets are carried at amounts of cash and cash equivalents that would have to be paid if the same or equivalent asset was acquired now.
iii. Realizable (settlement) Value. The amount of cash that can be currently realized if an asset was sold
iv. Present value: a current estimate of the (present discounted) value of future net cash flows.

E) Capital maintenance

A business should maintain the amount of capital invested and the retained profit is the measured by the value of which capital is increased during the period. For a business to survive it has to ensure that its capital levels are maintained. The measurement of capital can either be in terms of operating (Physical) capacity or financial capacity.

i) Financial maintenance

This is the most common measure of capital. In essence capital is measured as the monetary value of capital at the beginning of the year against the value at the end of financial year.

Example if the business had a capital of K3,000,000 at the beginning of the year and at the end of the year capital is now at K3,500,000 then it is said that capital has been maintained.

ii) Operating (Physical) maintenance

This is where capital is measured in terms of the physical units of core business activities. The aim of this measurement is to ensure that the business is able to maintain its operating capacity especially in times of high inflation.

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Looking at example above on financial capital maintenance. If the business trade in various merchandize whereby the price at the beginning of the year was K400 and at the end of the year is now trading at K500

Operating capital at close of the year (K3,500,00 /500)	7,000 units
Operating capital at the beginning of the year (K3,000,000 / 400)	7,500 units

Please note that for financial capital maintenance, the business is seen to have maintained its capital while at the same time using operating capital maintenance it shows that the business was able to have 7,500 units at the beginning of the year but this has been significantly reduced to 7,000 units.

1.3 OTHER LOCAL GAAP IN MALAWI

For Accountants in Malawi, there are other General Acceptable Accounting Practice (GAAP) which are supposed to be taken into account when preparing financial statements.

A Companies Act

Companies Act is an important framework in the preparation of financial statements. Companies Act 2013 among other issue specifies;

- How a company can be formed and the requirements for each form of business
- The preparation of financial statements and dates for filing such financial statements.
- The requirement for auditing financial statements
- The issues on corporate governance – roles of shareholders and directors

Specific provisions in the new Act relating to Accounting are found from Section 180.

- Every company shall maintain accounting records which shows a true and fair view –S 180
- Every company shall at the end of financial year file an annual return with the registrar of companies – S181
- The directors of every company shall, at a date not later than eighteen months after the incorporation of the company and subsequently once at least in every calendar year at intervals of not more than fifteen months, cause to be prepared

and sent to every member of the company and to every holder of debentures of the company a copy – S 182.

- Every company shall produce a profit or loss account and the balance sheet at the end of an accounting period – S183 & S184.
- Section 185 requires a company which has subsidiaries to prepare group accounts, combining the results of the subsidiary with those of the parent company.
- Requirement to produce directors report which must accompany the financial statements – S 189
- Requirement to have the financial statements of a company audited – S 1910Appintment and remuneration of the Auditors – S 191

B. Malawi Stock Exchange

Business entities which are listed on the stock exchange are subjected to extra review by the stock exchange rules. Firstly, before a company is listed, there are specific financial information which is supposed to be produced to assist potential investors in deciding whether to invest in the business or not.

Any listed company is required to prepare and publish mid-year results as opposed to only produce financial statements at the end of financial as is the case with other form of business.

C. Institute of Chartered Accountants in Malawi (ICAM)

ICAM is an accountancy profession body of Malawi responsible for overseeing accountancy professional in Malawi.

The role of ICAM include;

1) To promote the development of accountants in Malawi

2) to supervise accounting profession to the best interest of the public

3) to promote the highest order of professional ethics and business conduct of, and enhance the quality of service offered by Chartered Accountants or Diplomat Accountants

4) to protect the public interest by ensuring that members of the institute observe the highest standards of professional and ethical standards

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5) to ensure the professional independence of accountants

6) to determine the eligibility criteria to become the member of the Institute

7) to arrange for the assessment of candidates seeking certification as members

8) to promote, maintain and increase the knowledge, skill and competence of members of the institute and students

9) to ensure that members of the instate obtain necessary technical and ethical guidance that enables them to meet the needs of the community in areas in which they have special knowledge and expertise

10) to maintain and monitor high quality practical training at all levels of the profession

11) to maintain the legitimate professional rights of the members of the institute

12) to advance the theory and practice of accountancy in all aspects.

13) to promote high quality accounting, auditing and financial reporting standards and practices

14) to develop professional qualification for accountants and auditors in Malawi.

D) Malawi Accountancy Board

MAB is an accountancy regulatory board of Malawi and the responsibilities include;

1) To promote high quality reporting of financial and non-financial information by entities.

2) To promote the highest professional standards among auditors and accountants.

3) To improve the integrity, competence and transparency of professional activities in accounting and auditing.

4) To adopt and ensure compliance with and the enforcement of applicable local and international accounting and auditing standards.

5) To protect the interests of the general public and investors.

6) To encourage effective collaboration with other regulators.

7) To consider and determine applications for registration as chartered accountants and diplomat accountants.

8) To maintain the Register of chartered accountants and diplomat accountants.

9) To advise training institutions and the Institute of Chartered Accountants in Malawi (ICAM) in matters pertaining to examinations and training of accountants.

1.4 CONCLUSION

It is important for trainee accountants to understand the regulatory framework of accounting as this is regarded as the reasons why accounting as a field exist.

In this chapter, we have looked at how international and local framework affects the preparation of financial statements. This topic is important as it sets the tone on how accounting information should be recognized, the measurement criteria, presentation, disclosure and the intended users of the financial information.

END OF CHAPTER QUESTIONS

Tutorial questions

Q1. Define GAAP?

Q2. Why do accountants need a conceptual framework?

Q3 List and explain the seven headings of conceptual framework

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Q4 Define the following terms in relation to conceptual framework of accounting

i. Assets
ii. Liabilities
iii. Equity

Sample exam style questions

Financial information is considered to be useful to assist various users in making decision making in relation to the business performance and position.

a) Identify **five** users of financial information. For each user outline the kind of information they will be interested in. State the kind of information they will be interested in and the type of financial statement where they will find such information **15 marks**

b) List **five** qualitative characteristics of financial information **5 marks**

TOTAL: 20 Marks

CHAPTER 2 PREPARATIONS OF FINAL ACCOUNT

LEARNING OBJECTIVES

The objective of this chapter is:

- To help students understand what items to be included in the financial statements
- To remind the students on how to prepare financial statements in accordance to IAS 1

2.1 PRIMARY FINANCIAL STATEMENTS

The preparation of final accounts start with the trial balance. When the debit and credit sides of the trial balance agrees, then the information is used to prepare Statement of Profit or loss and Other Comprehensive Income and Statement of Financial Position.

a) Statement of Profit or Loss and Other Comprehensive Income

This starts with Income (Revenue) for the whole period and then charges to the Income, cost of making that income in the Trading account. This then calculates gross profit which we subtract all expenses of running the business.

Statement of Comprehensive Income for XYZ for the year ending 31st December 2013

		MK
Revenue		XX
Less Return Inwards		(XX)
		XX
Less Cost of Sales (COSA)		
Opening Inventory	XX	
Add Purchases	XX	
	XX	
Less: Closing Inventory	(XX)	(XX)
Gross Profit		XX
Less : Expenses		
Rent	XX	
Salaries and wages	XX	
Water and electricity	XX	

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Other operating expenses	XX	(XX)
Profit for the period		XX
Other comprehensive Income		
Revaluation Reserves		XX
Total comprehensive Income		XX

b) A Statement of Financial Position

This is a statement which shows all the list of assets and liabilities. The statement of financial position is a snapshot of what the business is wealth. This statement of financial position is not for the whole year but represents the values as at a particular date. The statement of financial position has the Asset on one side and Capital with liability on the other side. The arrangements of items in the statement of financial position starts with items which are not very liquid enough and ends with very liquid items.

Pro-forma

Statement of Financial Position of XYZ as at 31st December 2013

Non-Current Assets	Cost	Dpn	C/ Amount (NBV)
	MK	MK	MK
Property, Plant and Equipment	XX	XX	XX
Intangible Assets	XX	XX	XX
			XX
Current Assets			
Inventory		XX	
Receivables		XX	
Prepayments		XX	
Bank		XX	
Cash		XX	XX
			XX
Financed by Capital and Liabilities			
Capital			XX
Share Premium			XX
Add: Profit			XX
Other reserves			XX
			XX
Non-Current Liabilities			
Long term loan			XX

Provisions			XX
			XX
Current Liabilities			
Current portion of long term loan	XX		
Payables	XX		
Accruals	XX		XX
			XX

The capital side of a sole trader is represented as follows:

Capital	XX
Add: Profit	XX
	XX
Less: Withdrawals	(XX)
Capital	XX

While as capital side for a partnership is reflected as follows:

Capital	: A		XX
	B		XX
			XX
Current Accounts	:A	XX	
	B	XX	XX
			XX

2.2 CONCLUSION

This chapter was included as a revision on the preparation of financial statements with emphasis for the sole trader and partnerships.

Formatting is an important element in the preparation of financial statements and it is important that students should have a full understanding as to where assets, liability, Capital, income and expenditure are presented in the financial statement.

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END OF CHAPTER QUESTIONS

1. Tutorial questions

a) Apart from statement of profit or loss what are the other statements which are supposed to be produced as part of final accounts?

b) What are drawings?

c) Determine the purchases figure if the opening inventories were K130,000, closing inventories K150,0000 and cost of sales figure was K800,000

d) List items which may appear under non-current liability section in the Statement of Financial position.

2. Exam style questions

(a) The owner of the Small Enterprise noted that the income statement as prepared by a consultant for the year ended 31 December 2008 was missing.

However, the owner managed to find the following information:

Unadjusted Trail balance as at 31 December 2008

	Dr K	Cr K
Capital		240,000
Profit and loss account		30,000
Purchases	320,000	
Sales		480,000
Stocks	161,000	
Debtors	105,000	
Cash and bank	70,000	
Prepayments – insurance	5,600	
Motor vehicle	112,000	
Accumulated depreciation		37,000
Creditors		84,000
Rent	17,600	
Wages	52,000	
Advertising	27,800	
	871,000	871,000

Statement of financial position as at 31 December 2008

	K
Capital	240,000
Profit and loss account	67,600
Creditors	84,000
Accruals – wages	8,000
	399,600
Non-current assets	
Motor vehicle	112,000
Accumulated depreciation	(57,000)
	55,000
Current assets	
Stocks	166,400
Debtors	105,000
Cash and bank	70,000
Prepayments	3,200
	399,600

Required:

Prepare a Statement of profit or loss for the year ended 31 December 2008 for the Small Enterprise. **6 Marks**

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CHAPTER 3. CONTROL ACCOUNTS

LEARNING OBJECTIVES

The objectives of this chapter is to;

- Define what it means by control accounts
- Benefits of using control accounts in accounting
- Control accounts as a reconciliation for receivables and payables
- Preparation of bank reconciliation
- Importance of other controls in a business

3.1 INTRODUCTION TO CONTROL ACCOUNT

Internal control is a very important element in assessing the credibility of the financial reporting. For auditors to issue a clean report, they need to be satisfied that all controls have been working perfectly for the period under review.

Control accounts are prepared to check the accuracy of recordings in the financial statements. Control accounts are usually not part of double entry system. Controls are important especially in manual accounting system. For computerized accounting, most systems are able to have in built controls which are able to do the function of control accounts automatically.

The most common control accounts available are receivable control accounts, payable control accounts and bank reconciliation statement.

How control accounts work

Control accounts work as follows:

Both opening and closing balances are known and the accountant has the responsibility to list items which have led to the movement from opening to closing balances.

Take the previously reconciled balance of an account, then add total entries that have increased the balance. Deduct payments made or set off agreed, then you have the closing balance.

	MK
Total opening balances	XXX
Add: total entries which have increased the balance	XXX
Less: total of entries which have reduced the balance	(XXX)
Total closing balance	XXX

As the accounts are using totals, they are also referred to as "totals accounts".

As stated above it is worth noting that control accounts are not part of the double entry system but a memorandum account.

3.2 SALES LEDGER CONTROL ACCOUNT

As stated above, this account is used to cross check the balances in the receivables accounts. Thus is also known as receivables control account.

Sales ledger control account is made up of transactions from credit customers only. The sources of information for the control account include the following;

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Item	*Source*
Balances	Obtained from receivable listing (receivable accounts)
Credit sales	from sales account
Cash received	from cash book
Discount allowed	from cash book (three column cash book)
Dishonored cheques	from cash book
Bad debts	from bad debts accounts
Contra accounts	from receivable and payable listings
Return inwards	from returns accounts

Sales ledger control accounts (format)

Balance b/d	x	Cash (from receivables)	x
Credit sales	x	Discount allowed	x
Dishonored cheques	x	Contra purchases	x
		Returns inwards	x
		Bad debts	x
		Balance c/d	x
	xx		xx

Example

The following information is from accounts office relating to receivables for the month of January 2013

	MK
Accounts receivable balances 1.1. 2013	189,400
Total credit sales for the month of January 2013	1,029,000
Cash sales	320,000

Customers paid by cheques totaled	728,400
Monies received by cash from credit customers	123,600
Returns from credit customers	29,600
Closing balances. 31.1.2013	336,800

Sales Ledger Control Accounts

Balance b/f	189,400	Bank	728,400
Sales	1,029,000	Cash	123,600
		Return inwards	29,600
		Balance c/d	336,800
	1,218,400		1,218,400

3.3 PAYABLES CONTROL ACCOUNTS

The payables control accounts is prepared the same way the receivables control. It is worth noting however, that it is not always that the control accounts would always balance. Just like the Trial balance is used to detect errors in the accounts, these control accounts would do likewise.

Just as in receivables, payable control accounts draw information from the following sources;

Item	*Source*
Balances	Obtained from receivable listing (receivable accounts)
Credit purchases	from purchases account
Cash paid	from cash book
Discount received	from cash book (three column cash book)
Contra accounts	from receivable and payable listings
Return outwards	from returns accounts

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The following information is available from the accounts of Jimmy limited

	MK
Accounts payable balances on 1 Jan 2013 was	38,900
Cheques paid to suppliers during the month	36,200
Returns to suppliers in the month	950
Total purchases from suppliers in the month was	49,360
Accounts payable balances on 31st Jan. 2012 was	51,510

Prepare payables control account

Payable control account

Bank	36,200	Balance b/d	38,900
Returns outwards	950	Purchases	49,360
Balance c/d	51,510		
	88,660		88,260

Please note that the control account above is not balancing. This will require investigations and make sure that the correct amounts had been entered in the control account before concluding that the ledgers are not incorrect. This will call for investigations for the difference because it means that the trial balance will as well not balance.

3.4 RECONCILIATION OF CONTROL ACCOUNT

When control accounts are not balancing, it means something is wrong somewhere. This will call for a reconciliation of the control accounts. The control accounts reconciliation would be able to detect the errors in our accounting entries.

Example of purchases ledger control account reconciliation:

		MK
Original purchases ledger control account balance		XXX
Add	Invoices omitted from control account, but entered in Purchases a/c	XXX
	Suppliers balance excluded from Purchases ledger and included accidentally sales ledger account	XXX
	Credit sales posted in error to debit of purchases account instead of the debit of an account in the sales ledger	XXX
	Under casting error in calculation of total end of period creditor's bal.	XXX
Less	Customer account with a credit balance included in the purchases that should have been included in the sales ledger	(XXX)
	Return inwards posted in error to the credit of purchases ledger account instead of the credit of an account in the sales ledger	(XXX)
	Credit note entered in error in the Return Outwards day book as 435 instead of 453	(XXX)
Revised purchases ledger control account balance		XXX

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3.5 BANK RECONCILIATIONS

In almost all the months, the balance which is depicted by the cash book is very different from the bank account amounts. This cause for a reconciliation of the cash book and bank statement.

Reasons for the differences

The amounts recorded in the bank column of the cash book, do not in most of the times tarry with the amounts in the bank account. This is mainly because of the following reasons:

- The bank may have charged bank charges which the accountant may not have been aware of
- The bank may have given credited the bank account with the interest which the accountant has not realized.
- Standing orders. The company may have instructed the bank to pay for some monthly payments which may have been effected and not yet recorded by the accountant
- The company may have issued some cheques which the supplier may not have presented at the bank.
- The company may have deposited the cheques which the bank has not yet cleared.
- Mispostings by the bank.
- Refer to the Drawer cheques

When this happens, the company can control its own cash book but can not have control of the bank statement. The accountant should take the bank statement and cash book and check the items which are similar in the bank statement and cash book.

Pro-forma of bank reconciliation

Balance as per cash book	xx
Add: Un presented cheques	xx
	xx
Less: bank lodgments not on the statements	xx
Balance as per bank account	xx

Example of bank reconciliation

Cash book (bank colunm)					
Date-11		MK	Date-11		MK
1-Jan	Balance b/d	250,000.00	4-Jan	Jessie	65,000.00
20-Jan	P. James	100,000.00	27-Jan	King	175,000.00
25-Jan	Dick	190,000.00	30-Jan	John	20,000.00
27-Jan	Bob	35,000.00			
			Bal. c/d		315,000.00
		575,000.00			575,000.00

Bank statement					
		withdrawls		Deposits	Balance
1-Jan	Balance b/d				250000
7-Jan	102	65000			185000
22-Jan	Deposit			100000	285000
26-Jan	Deposit			190000	475000
28-Jan	103	175000			300000
30-Jan	Bank credit			70000	370000
31-Jan	Bank charges	50000			320000

Since we have control over our cash book, it means we can now revise our cash book to take account of the amounts.

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Cash book

Balance c/d	315,000	Bank charges	50,000
Bank credit	70,000	Revised balance	335,000
	385,000		385,000

Bank reconciliation statement

Balance per cash book	335,000
Add: Unpresented cheques	
John	20,000
Less: Bank lodgments	(35,000)
Balance per bank statement	320,000

3.6 CONCLUSION

Control accounts are crucial statements in ensuring that financial statements are accurate and do not contain material arithmetical errors. Despite not being part of double entry accounting system, control accounts are necessary and should be prepared before finalizing the financial statements.

The other part of the chapter looked at bank reconciliation. Bank reconciliation is also a control account as it is used to check accuracy in recordings between what has been recorded in accounts with what is showing at the bank.

END OF CHAPTER QUESTIONS

1. Tutorial questions

a) Why are control accounts important in accounting?

b) Which items appear on the bank statement but may not appear in the cash book.

c) What are bank lodgments?

2. Exam type questions

Fire broke out at Shumba Groceries' offices during the night of 30 November 2010. The drawers holding the daily takings, the cashbook and the ledgers were completely destroyed. However, the following pieces of information were available from the other books and records that survived the fire.

	K
Total debtors at 1 January 2010	60,000
Total debtors at 30 November 2010	108,000
Total creditors at 1 January 2010	23,100
Total creditors at 30 November 2010	29,190
Purchases from 1 January to 30 November 2010	398,475
Sale from 1 January to 30 November 2010	675,525
Expenses from 1 January to 30 November 2010	129,750
Acquisition of non-current assets up to 30 November 2010	14,400
Salaries paid from 1 January to 30 November 2010	72,300
Drawings made on 1 November 2010	5,000
Cash balance at bank on 1 January 2010	10,800

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It was established that the balance at the bank on the 30 November 2010 was K12,450. All cash sales takings had been banked by the day of the fire, 30 November 2010.

Required:

Prepare:

(i)	Debtors Control Account	**2 Marks**
(ii)	Creditors Control Account	**2 Marks**
(ii)	Shumba's Cashbook Account	**5 Marks**
		(TOTAL: 20 MARKS)

CHAPTER 4: PARTNERSHIPS

LEARNING OBJECTIVES

At the end of this chapter, students should be able to:

- Outline how to prepare accounts for partnership
- Accounting for changes in partnership – admission of new partner
- Understanding steps taken in dissolution of partnership
- Prepare statements for the conversion of a partnership into a limited company.

4.1 PARTNERSHIP ACCOUNTS – GENERAL OUTLOOK

A partnership is where two or more people doing business with an intention of making profits.

Partnerships obey the Partnership Act 1890. If there is a limited Partner, then it must comply with the Limited Partnership Act 1907. There should be at least two partners and at most twenty partners except if they are banks, where there could not be more than ten partners and there is no maximum for the firm of Accountants, lawyers, solicitors, surveyors, auctioneers and insurance brokers.

Limited Liability Partnership is a partnerships which contains one or more limited partners. This type of partnership must be registered with the Registrar of Companies. Limited partners are not liable for partnership debts which the partnership fails to pay,

Limited partners have the following characteristics and restrictions:

- Their liability to debts is limited to the capital they introduced to the partnership
- They are not allowed to take out their capital or receive back any part of their contribution to the partnership

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- They are not allowed to take part in the management of the partnership or have they powers to make partnership take a decision
- All the partners cannot be limited.

In any partnership, partners are supposed to agree terms on how they are going to conduct their business. In a situation where the partnership has no agreement, the Partnership Act 1890 dictates that:

- Profit or losses are to be shared equally,
- There is to be no interest allowed on capital
- No interest is to charged on drawings
- Salaries are not allowed
- Partners who put in capital in excess of the agreed capital are entitled to interest at the rate of 5% per annum on such and advance.

Because ownership rights in a partnership are divided among two or more partners, separate capital and drawing accounts are maintained for each partner.

If a partner invested cash in a partnership, the Cash account of the partnership is debited, and the partner's capital account is credited for the invested amount.

If a partner invested an asset other than cash, an asset account is debited, and the partner's capital account is credited for the market value of the asset. If a certain amount of money is owed for the asset, the partnership may assume liability. In that case an asset account is debited, and the partner's capital account is credited for the difference between the market value of the asset invested and liabilities assumed.

Capital Interest

A capital interest is an interest that would give the holder a share of the proceeds in either of the following situations:

- The owner withdraws from the partnership.
- The partnership liquidates.
- The mere right to share in earnings and profits is not a capital interest in the partnership.

This determination generally is made at the time of receipt of the partnership interest.

Capital account

Capital account of each partner represents his equity in the partnership.

Capital account of a partner is increased in the following situations:

- The owner made additional investments during the year.
- The owner received guaranteed payments from the partnership.
- Partnership earned profits, and a share of profits was allocated to the partner.
- The increased in the capital will record in credit side of the capital account.
- Salary and interest allowances are guaranteed payments, discussed later.
- Capital account of a partner is **decreased** when the owner makes withdrawals of cash or property

The partnership agreement may specify that partners should be compensated for services they provide to the partnership and for capital invested by partners.

For example, one partner contributed more of the assets, and works full time in the partnership, while the other partner contributed a smaller amount of assets and does not provide as much services to the partnership.

Compensation for services is provided in the form of salary allowance. Compensation for capital is provided in the form of interest allowance. Amount of compensation is added to the capital account of the partner.

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To illustrate, assume that a partner received MK500 as an interest allowance. The entry is:

Dr.	Partner A, Capital	MK500	
Cr.	Account payable		MK500

As a result of the above entry Accounts Payable, which is a liability account, is reduced by MK500, and the capital account is increased by the same amount.

When the partner makes a cash withdrawal of moneys he received as an allowance, it is treated as a withdrawal, or drawing.

	Debit	**Credit**
Partner A, Drawing	MK500	
Cash		MK500

As a result, Drawing account increased by MK500, and the Cash account of the partnership is reduced by the same account.

At the end of the accounting period the drawing account is closed to the capital account of the partner. The capital account will be reduced by the amount of drawing made by the partner during the accounting period.

4.2 CHANGES IN PARTNERSHIP - ADMITTING A NEW PARTNER

A new partner may be admitted by agreement among the existing partners. When this happens, the old partnership is automatically dissolved and a new partnership is created, with a new partnership agreement.

A new partner may be admitted into the business in three ways:

- By purchasing an interest directly from existing partners
- By making an investment in the business, or
- By contributing assets from an existing business.

Assume that Partner A and Partner B admit Partner C as a new partner, when Partner A and Partner B have capital interests MK30,000 and MK20,000, respectively.
Partner C pays, say, MK15,000 to Partner A for one-third of his interest, and MK15,000 to Partner B for one-half of his interest. These payments go to the partners directly, not to the business. The following entry is made by the partnership.

	Debit	**Credit**
Partner A, Capital	MK10,000	
Partner B, Capital	MK10,000	
Partner C, Capital		MK20,000

The extra MK5,000 Partner C paid to each of the partners, represents profit to them, but it has no effect on the partnership's financial statements.

Now, assume instead that Partner C invested MK30,000 cash in the new partnership. In this case, the following entry would be made to admit Partner C.

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	Debit	Credit
Cash	MK30,000	
Partner C, Capital		MK30,000

Finally, let's assume that Partner C had been operating his own business, which was then taken over by the new partnership. In this case the financial Position for the new partner's business would serve as a basis for preparing the opening entry. The assets listed in the financial position are taken over, the liabilities are assumed, and the new partner's capital account is credited for the difference.

There is always need to analyze the impact of introducing a new partner to the business as this will result in reduction of the capital share for the existing partners. The impact and of the change in partnership is usually different depending on whether the exiting partners have equal holding or have different capital holding ratios.

Where the partners have equal holding.

Example 1. Assume that a sole proprietor agreed to admit a single equal partner for a certain amount of money. The sole proprietor, Partner A, will give the new partner, Partner B, an equal share in the partnership. 100% interest of the sole proprietor will be divided in half, so that each of the two partners will have 50% interest in the partnership. In effect, Partner A sold 50% of his equity to Partner B.

Example 2. Assume that Partner A and Partner B have 50% interest each, and they agreed to admit Partner C and give him an equal share of ownership. Each of the three partners will have 33.3% interest in the partnership. Interests of Partner A and Partner B will be reduced from 50% each to 33.3% each. In effect, each of the two partners sold 16.7% of his equity to Partner C.

Example 3. Assume there are three equal partners, who have 33.3% interest each, and they agreed to admit a forth equal partner. Each of the four partners will have 25% interest in the partnership. Interests of the three partners will be reduced from 33.3% each to 25% each. In effect, each of the three partners sold 8.3% of his equity to the new partner.

In either case, all partners must agree to the specific way to realign their partnership interests as a result of admitting a new partner.

Unequal partners.

Example 1. Assume there are two unequal partners in the partnership. Partner A owns **60% equity**, Partner B owns **40% equity**, and they agreed to admit a third partner. Partner C has several options to join the partnership.

- He can buy equity from Partner A.
- He can buy equity from Partner B.
- He can buy equity from Partner A and Partner B.

Partner A and Partner B may both agree to sell 50% of their equity to Partner C. In that case, Partner A will have 30% interest, Partner B will have 20%, and Partner C will own (30% + 20%) 50% interest in the partnership.

Partner A and Partner B may both agree to sell 25% of their equity to Partner C. In that case, Partner 3 will own (15% + 10%) 25% interest in the partnership.

Partner A may decide to sell 25% of his equity to partner C. Partner B may decide to sell 50% of his equity to partner C. Partner C will own (15% + 20%) 35% of the partnership equity.

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Example 2. Assume now that there are three partners. Partner A owns 50% interest, Partner B owns 30% interest, and Partner C owns 20% interest. Collectively, they own 100% interest in the partnership.

They agreed to admit a fourth partner, Partner D. As in the previous case, Partner D has a number of options. He can buy shares of interest from one of the partners, or from more than one partner.

Assume that the three partners agreed to sell 20% of interest in the partnership to the new partner. There are more than one way to realign partnership interests.

4.3 GOODWILL IN PARTNERSHIP

a) Goodwill due to old partners

A new partner may pay a bonus in order to join the partnership. Bonus is the difference between the amount contributed to the partnership and equity received in return.

Assume that Partner A and Partner B have balances MK10,000 each on their capital accounts. The partners agree to admit Partner C to the partnership for MK16,000. In return, Partner C will receive one-third equity in the partnership. The following table illustrates calculation of the bonus.

Equity of Partner A	MK10,000
Equity of Partner B	MK10,000
Contribution of Partner C	MK16,000
Total equity	MK36,000
Equity contribution of partner C was	MK12,000

In this case, Partner C paid MK4,000 bonus to join the partnership. This amount is known as good will. The amount of any such goodwill paid to the partnership is distributed among the old partners. The following table illustrates the distribution of the bonus.

	Debit	Credit
Cash	MK16,000	
Capital C		MK12,000
Capital A		MK2,000
Capital B		MK2,000

b) Goodwill paid to a new partner.

Assume now that Partner A and Partner B have balances MK10,000 each on their capital accounts. The partners agree to admit Partner C to the partnership for MK7,000. In return, Partner C will receive one-third equity in the partnership.

Why would the existing partners allow a new partner to buy an equal share of equity with smaller contribution? It might be because the new partner brings something very valuable to the partnership. It might be special skills.

The following table illustrates calculation of the bonus.

Equity of Partner A	MK10,000
Equity of Partner B	MK10,000
Contribution of Partner C	MK7,000
Total equity after admitting Partner C	MK27,000

Equity of Partner C	MK9,000
Contribution of Partner C	MK7,000

In this case, Partner C received $2,000 bonus to join the partnership. The amount of the bonus paid by the partnership is distributed among the partners according to the partnership agreement.

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The following table illustrates the distribution of the bonus. Debit to Cash increases the account, while debit to a capital account of a partner decreases the account.

	Debit	**Credit**
Cash	MK7,000	
Partner C, Capital		MK9,000
Partner A, Capital	MK1,000	
Partner B, Capital	MK1,000	

In an equal partnership bonus paid to a new partner is distributed equally among the old partners. In an unequal partnership bonus is distributed according to the old partnership agreement.

Assume that Partner A is a 75% partner, and Partner B is a 25% partner. Partner C was admitted to the partnership. He paid MK5,000 cash. In return, he received MK9,000 equity in the partnership. A MK4,000 (MK9,000 - MK5,000) bonus paid to Partner C would be distributed as follows:

Partner A will pay (MK4,000 * 75%) MK3,000. His capital account will be debited MK3,000.
Partner B will pay (MK4,000 * 25%) MK1,000. His capital account will be debited MK1,000.

	Debit	**Credit**
Cash	MK5,000	
Partner C, Capital		MK9,000
Partner A, Capital	MK3,000	
Partner B, Capital	MK1,000	

4.4 WITHDRAWAL OF A PARTNER

By agreement, a partner may retire and be permitted to withdraw assets equal to, less than, or greater than the amount of his interest in the partnership. The book value of a partner's interest is shown by the credit balance of the partner's capital account.

The balance is computed after all profits or losses have been allocated in accordance with the partnership agreement, and the books closed.

If a retiring partner withdraws cash or other assets equal to the credit balance of his capital account, the transaction will have no effect on the capital of the remaining partners.

To illustrate, assume that several years after the formation of "A,B, & C" partnership Partner C decided to retire. The partners agreed to the withdrawal of cash equal to the amount of Partner C's equity in the assets of the partnership. Assume that the partners' capital accounts had credit balances as follows:

Partner A	MK60,000
Partner B	MK40,000
Partner C	MK30,000

If Partner C withdraws MK30,000 in cash, the entry on the books is as follows:

	Debit	**Credit**
Partner C, Capital	MK30,000	
Cash		MK30,000

If a retiring partner agrees to withdraw less than the amount in his capital account, the transaction will increase the capital accounts of the remaining partners.

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For example, if Partner C withdraws only MK20,000 in settlement of the interest, the difference between Partner C's equity in the assets of the partnership and the amount of cash withdrawn is MK10,000 (MK30,000 - MK20,000).

This difference is divided between the remaining partners on the basis of profit sharing ratios stated in the partnership agreement.

Assume that the partnership agreement specifies that in such a case the difference is divided according to the ratio of their capital interests after allocating net income and closing their drawing accounts. On this basis, Partner A's capital account is credited with MK6,000 and Partner B's is credited with MK4,000.

The entry in the books of the partnership is as follows:

	Debit	**Credit**
Partner C, Capital	MK30,000	
Cash		MK20,000
Partner A, Capital		MK6,000
Partner B, Capital		MK4,000

If a retiring partner withdraws more than the amount in his capital account, the transaction will decrease the capital accounts of the remaining partners. The excess of the amount withdrawn over retiring partner's equity in the partnership is divided between the remaining partners on the profit sharing ratio basis stated in the partnership agreement.

The partnership may also ask the retiring partner to withdraw part of their capital and be paid the other balance in future instalments. In this situation, the remaining balance of capital is treated as a loan to the partnership.

4.5 REVALUATION OF ASSETS DUE TO CHANGES IN PARTNERSHIP

The assets of a business may be revalued because of the following reasons:

- A new partner joins the partnership
- A partner leaves the partnership
- The partners change profit or loss sharing ratios
- The partner dies.

Accounting treatment on revaluation of assets

You first have to open a revaluation account where all the profit or loss on the revaluation will be recorded as follows:

Any asset that gains in value,

Debit The asset account

Credit The revaluation account with a profit.

Any asset that losses value:

Debit The revaluation account

Credit The Assets account with a loss

If the net effect of the above transaction is a profit (or a credit balance), then:

Debit The Revaluation account

Credit The Partners' capital accounts.

While as if it is a loss (debit balance in the revaluation account)

Debit The Partners' Capital accounts

Credit The Revaluation Reserves

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The amounts to be debited or credited to partners' capital accounts should be in the partners profit or loss sharing ratios.

4.6 PURCHASING OF PARTNER'S INTEREST

When a partner retires from the business, the partner's interest may be purchased directly by one or more of the remaining partners or by an outside party. If the retiring partner's interest is sold to one of the remaining partners, the retiring partner's equity is merely transferred to the other partner.

For example, assume that Partner C's equity is sold to Partner B. The entry for the transaction on the books of the partnership is as follows:

	Debit	**Credit**
Partner C, Capital	MK30,000	
Partner B, Capital		MK30,000

The amount paid to Partner C by Partner B is a personal transaction and has no effect on the above entry. Any gain or loss resulting from the transaction is a personal gain or loss of the withdrawing partner and not of the business.

If the retiring partner's interest is purchased by an outside party, the retiring partner's equity is transferred to the capital account of the new partner, Partner D.

	Debit	**Credit**
Partner C, Capital	MK30,000	
Partner D, Capital		MK30,000

The amount paid to Partner C by Partner D is also a personal transaction and has no effect on the above entry.

4.7 DEATH OF A PARTNER

The death of a partner dissolves the partnership. On the date of death, the accounts are closed and the net income for the year to date is allocated to the partners' capital accounts. Most agreements call for an audit and revaluation of the assets at this time. The balance of the deceased partner's capital account is then transferred to a liability account with the deceased's estate.

The surviving partners may continue the business or liquidate. If the business continues, the procedures for settling with the estate are the same as those described earlier for the withdrawal of a partner.

Financial statements of a partnership

The financial statements are prepared in the same way as those of a sole trader with the exception of the following:

Statement of Profit or loss

- The partners salary of the partnership will be included as part of the appropriation account
- Interest on drawings for partners
- Interest on capital for the partners
- Sharing of profits

Statement of Financial Position

- There will be partners current accounts
- The partners capital accounts.

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4.8 DISSOLUTION OF A PARTNERSHIP

Dissolution of a partnership generally means that the assets are sold, liabilities are paid, and the remaining cash or other assets are distributed to the partners.

When normal operations are discontinued, adjusting and closing entries are made. Thus, only the assets, liabilities and partners' equity accounts remain open.

If non cash assets are sold for more than their book value, a gain on the sale is recognized. The gain is allocated to the partners' capital accounts according to the partnership agreement.

If non cash assets are sold for less than their book value, a loss on the sale is recognized. The loss is allocated to the partners' capital accounts according to the partnership agreement.

As the assets are sold, the cash is applied first to the claims of creditors. Once all liabilities are paid, the remaining cash and other assets are distributed to the partners according to their ownership interests as indicated by their capital accounts.

Example.

Peter and Pious are in partnership sharing profits in the ratio of 2:5. On the date of dissolution, the statement of financial position was as below:

Non Current assets			MK
Property, Plant and equipment			4,000,000.00
Motor vehicles			2,000,000.00
			6,000,000.00
Current Assets			
inventory		30,000.00	
Accounts payable		65,000.00	
Bank		120,000.00	215,000.00
			6,215,000.00
Capital and liabilities			
Capital	Peter	750,000.00	
	Pious	1,620,000.00	2,370,000.00
Current accounts	Peter	1,539,000.00	
	Pious	1,440,000.00	2,979,000.00
			5,349,000.00
Payable			866,000.00
			6,215,000.00

Account for the dissolution of the partnership if Pious took over the motor vehicle at MK1,800,000. The buildings were sold for MK7,000,000. All receivables were collected in full and payables were paid. Inventory was taken over by Peter at its book value. Dissolution cost were MK20,000.00

Realisation account

Buildings acc		4,000,000.00	Motor Vehicle	pious	1,800,000.00
Motor vehicle		2,000,000.00	Bank	Buildings	7,000,000.00
receivables		65,000.00	Bank	Receivable:	65,000.00
Inventory		30,000.00	Payables		866,000.00
Bank	payables	866,000.00	Peter	Inventory	30,000.00
Bank	Dissolution cost	20,000.00			
Capital	Peter	794,285.71			
	Pious	1,985,714.29			
		9,761,000.00			9,761,000.00

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Peter capital account

Inventory		30,000.00	Balance b/d	capital	750,000.00
Bank		3,053,285.71		Current	1,539,000.00
			Realisation	share	794,285.71
		3,083,285.71			3,083,285.71

Pious capital account

Realisation	M/vehicle	1,800,000.00	Balance b/d	capital	1,620,000.00
Bank		3,245,714.29		Current	1,440,000.00
			Realisation		1,985,714.29
		5,045,714.29			5,045,714.29

Bank account

Balance b/d		120,000.00	Realisation	Payables	866,000.00
Realisation	Buildings	7,000,000.00	Realisation	Dissolutior	20,000.00
Realisation	Receivables	65,000.00	Peter		3,053,285.71
			Pious		3,245,714.29
		7,185,000.00			7,185,000.00

Buildings account

Buildings account	4,000,000.00	Realisation acc	4,000,000.00
	4,000,000.00		**4,000,000.00**

Motor vehicle

Bal b/d	2,000,000.00	Realisation	2,000,000.00

Receivable

Balance b/d	65,000.00	Realisation	65,000.00

Inventory			
Balance b/d	30,000.00	realisation	30,000.00

Take note that the bank account will always balance.

4.8 CONVERSION OF A PARTNERSHIP TO A LIMITED LIABILITY COMPANY

The principle behind the conversation of a partnership into Limited Liability Company are basically the same as those of dissolution of a partnership as indicated in part 26 above. The partnership ceases to exist and a new company is formed. Partners become the holders of share capital in the new formed company. They may decide to bring in another person into a limited company, but this will be done after all the partnership has been dissolved.

Example

Peter and Pious are in partnership sharing profits in the ratio of 2:5. On the date of conversion of the partnership, the statement of financial position was as below:

Non Current assets			MK
Property, Plant and equipment			4,000,000.00
Motor vehicles			2,000,000.00
			6,000,000.00
Current Assets			
inventory		30,000.00	
Accounts payable		65,000.00	
Bank		120,000.00	215,000.00
			6,215,000.00
Capital and liabilities			
Capital	Peter	750,000.00	
	Pious	1,620,000.00	2,370,000.00
Current accounts	Peter	1,539,000.00	
	Pious	1,440,000.00	2,979,000.00
			5,349,000.00
Payable			866,000.00
			6,215,000.00

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Account for the conversion of the partnership by preparing the statement of financial position of the P&P Co Limited liability company if the motor vehicle were taken over at MK1,800,000. The buildings were revalued to MK7,000,000. All receivables were collected in full and payables were paid. Inventory was taken over by the new company formed known as P &P company at its book value. Conversion costs were MK20,000.00

In this example all other accounts were already prepared in the dissolution of partnership above. Thus we will just concentrate on the three main accounts from the dissolution. i.e. realization, bank and capital accounts of the partnership. Then we will prepare the P & P co. first statement of financial position.

Realisation account

Buildings acc		4,000,000.00	Motor Vehicle	P&P co	1,800,000.00
Motor vehicle		2,000,000.00	Buildings	P&P co	7,000,000.00
receivables		65,000.00	Bank	Receivable	65,000.00
Inventory		30,000.00	Payables		866,000.00
Bank	payables	866,000.00	Inventory	P&P co	30,000.00
	converstio				
Bank	n cost	20,000.00			
Capital	Peter	794,285.71			
	Pious	1,985,714.29			
		9,761,000.00			9,761,000.00

Peter capital account

			Balance b/d	capital	750,000.00
Capital acc	P&P	3,083,285.71		Current	1,539,000.00
			Realisation	share	794,285.71
		3,083,285.71			3,083,285.71

Pious capital account

			Balance b/d	capital	1,620,000.00
Capital acc	P&P	5,045,714.29		Current	1,440,000.00
			Realisation		1,985,714.29
		5,045,714.29			5,045,714.29

	Peter	Pious	Total
Capital	3,083,285.71	5,045,714.29	8,129,000.00

Bank account

Balance b/d		120,000.00	Realisation	Payables	866,000.00
			Realisation	Dissolution	20,000.00
Realisation	Receivables	65,000.00			
bal c/d		**701,000.00**			
		886,000.00			886,000.00
			bal b/d		701,000.00

Motor Vehicle account

Realisation acc	1,800,000.00	bal. c/d	1,800,000.00

Buildings

Realisation acc	7,000,000.00	Bal. c/d	7,000,000.00

Inventory

Realisation acc	30,000.00	bal c/d	30,000.00

Statement of Financial Position for P&P Co.	
Non Current assets	MK
Buildings	7,000,000.00
Motor Vehicles	1,800,000.00
	8,800,000.00
Current Assets	
Inventory	30,000.00
	8,830,000.00
Capital and Liabilities	
Ordinary share capital	8,129,000.00
Bank o/d	701,000.00
	8,830,000.00

Take note that the opening financial position has to balance.

4.9 CONCLUSION

This chapter looked at the preparation of financial statements for partnership and accounting treatment for changes in partnership. It is always important to note that the preparation of financial statement for partnership is similar to sole trader only that after preparing the Statement of Comprehensive Income, profit or loss, there is need to prepare an appropriation account. This statement shows how the profit generated is shared among the members.

END OF CHAPTER QUESTIONS

1. Tutorial questions

a) What are the advantages of a partnership form of business over sole trading?

b) What is the difference between a sleeping partner and a general partner?

c) Apart from sharing the profits, what are the other ways in which a partner is compensated for investing in business?

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d) Which four factors can cause the dissolution of a partnership?

2. Exam style question

Chimombo and Chapola have been in partnership for a number of years sharing profits and losses in the ratio 2:3. The following statement of financial position was extracted from the books of accounts of the partnership as at 30 September 2010:

		K'000	K'000
Non-current assets			
Land and buildings			600
Motor vehicles (net book value)			800
Fixtures and fittings (net book value)			180
			1,580
Current assets			
Inventories		80	
Accounts receivables		60	
Cash at bank		20	160
			1,740
Capital			
Capital accounts:	Chimombo		1,000
	Chapola		500
Current accounts:	Chimombo		200
	Chapola		(60)
			1,640
Current liabilities			
Payables			100
Total capital and liabilities			1,740

The partners, after being together for a long time, decided to dissolve the partnership to pursue other personal interests. Chimombo, however, was to take for his personal use the piece of land and the motor vehicle at agreed prices of K700,000 and K800,000 respectively. A customer has already been identified to purchase the inventory for K72,000. The whole amount of accounts receivables would be fully collectible during the period of dissolution. Suppliers are prepared to offer a 1% discount on full settlement of accounts payables. The partners agreed to transfer fixtures and fittings to an orphanage free of charge and share the cost in the normal profit sharing ratio. Any balance on their capital accounts will have to be settled by cash either by the partner or to the partner, as the case may be. Dissolution costs amounted to K12,500.

Required:

a) Prepare the realization account upon the dissolution of the partnership. **8 Marks**

(b) Prepare the partners' accounts and the bank account to record the closure of the partnership books. **9 Marks**

(c) Mention **three** disadvantages of a partnership, as a form of business, compared to that of a sole trader. **3 Marks**

(TOTAL: 20 MARKS)

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CHAPTER 5: ACCOUNTS FOR NON PROFIT MAKING ORGANIZATION

LEARNING OBJECTIVES

At the end of this chapter, students should be able to:

- Understand the various income sources for non-profit making organizations
- The basic differences between normal trading organization and non-profit making organization
- Outline how to prepare accounts for non-profit making organization

5.1 FORMS OF NON PROFIT MAKING ORGANISATION

Non-Profit Making Organizations (NPMOs) are institutions created to promote social activities with no profit motive. These institutions include non- governmental organizations (NGOs), clubs and societies, churches.

Examples of non-profit making organizations in Malawi

Clubs -	Blantyre sports club
	Big bullets football club
	Gymkhana club
	Farmers club
NGOs	Malawi Economic Justice Network
	Malawian Health Equity Network
	Civil Liberty Committee
	Save the Children

Associations	Law Society of Malawi
	Institute of Chartered Accountants of Malawi
	Insurance Institute of Malawi
Religious Institutes	Roman Catholics
	Muslim Association
	Church of Central African Presbyterian
Societies	Bible Society of Malawi
	Scripture Union

As observed, these institutions are there for the promotion of education, healthy, agriculture or sports activities.

Despite not having the profit motive, no profit making organizations need to generate income which is used to meet its operational costs. Some of the income sources for non-profit making organizations include the following;

I) SUBSCRIPTIONS

Usually these institutions are member based. These members are required to contribute funds towards the institutions in form of subscription or membership fees. The subscription can either be annual or life. In annual subscription, the member is required to make contribution every year based on agreed terms of the institution while in life subscription, the member is required to make a one of subscription and they will be exempted from making annual subscriptions.

In some situations, the members are required to pay registration fees in order to be admitted and thereafter required to pay annual subscriptions.

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II) DONATIONS

Another major source of income for these institutions comes from donations. Donation can either be to finance operational activities or to meet the capital acquisitions. Most NGO's, this is the major source of income.

III INTEREST FROM INVESTMENTS

The income from most non-profit making organization is often erratic as such most institutions will do maintain liquid investments to cushion in the period when there is no funding.

Interest income is slowly becoming crucial income sources for most non-profit making organization.

IV FUND RAISING ACTIVITIES

Organizations have various means of soliciting funds to supplement those from donations and subscriptions from members. The activities can be one off or a continuing trading activity.

Examples;

- Selling of raffle tickets
- Big walk functions
- Running a restaurant
- Selling of merchant.

5.2 ACCOUNTING FEATURES FOR NON-PROFIT MAKING ORGANISATION

Most NGO's, clubs and societies are not meant to do trading and their accounting structure is usually different from the normal trading organization. Some of the differences include the following;

a) Capital

For most trading organizations, capital is raised by shareholders or the owners of the business and is used as the bedrock of assessing the financial position of the business. For clubs and society, the capital is called Accumulated funds and is usually built from annual surplus realized by the organization.

On annual basis, the organization determines, opening accumulated funds by producing a statement of affairs, listing all the assets at the beginning of the financial year less liabilities at the same time.

Example;

At the beginning of the financial year, 1st January 2013, Mwai Wathu NGO had the following assets and liabilities;

Assets	MK
Motor vehicles	450,000
Bar inventories	100,000
Subscriptions in arrears	80,000
Cash and Bank	120,000
Total	750,000

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Liabilities		
Subscription in advance	60,000	
Trade payables	12,000	
Accrued expenses	28,000	100,000
Accumulated fund will there be		650,000

b) Financial statements

i) Receipt and payment

All receipts and payments for these NPMO's are recorded in a receipt and payment account which is the same as Cash book for a trading organization. The account is similar to cash book and the only difference is that while cash book has separate columns for cash, bank and discounts columns, receipt and payment has one column for the receipt and another for payment.

ii) Income and Expenditure

Income and expenditure acts as a statement of comprehensive income for an NPMO. As stated above, these organizations may conduct trading activities such as running a bar, a restaurant or a shop. For these activities, normal trading accounts are opened and profit determined which then is transferred into the Income and expenditure account.

iii) Statement of financial position

The NPMOs are required to prepare the statement of financial position at the end of financial period. The format for the statement is the same as that for trading

organizations, except that the statement for NPMOs has accumulated funds as opposed to capital and surplus instead of accumulated profit.

5.3 STAGES IN PREPARING ACCOUNTS FOR NPMOs

The following steps sets out a methodical approach in the preparation of financial statements for an NPMO. This is not a rule which all must follow but has been considered as ideal by the Authors and is aimed at preventing preparers of financial statements from skipping important data relating to the activities of an NPMO.

STAGE 1: Determination of opening accumulated funds

As stated above, accumulated funds represents the opening capital for an NPMO. At this state, a statement of affairs at the beginning of a financial year is opened which is the sum of all opening assets less the sum of all opening liabilities.

STAGE 2 Determination of net income

Most NPMOs have various ways of generating their funds. These activities are usually standalone activities like fund raising dinner dance, big walk, running a bar, subscriptions or running of a tournament.

The organization is supposed to determine the net proceeds from these activities and only the net figure included in the Income and expenditure account.

i) Profit from bar/ restaurant or any trading activity.

Some NPMOs run full time businesses to increase their financial base. These activities are supposed to be accounted separately and do follow the normal accounting as any trading organization.

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The accounting will take into account all revenues and expenditure attributable to the trading activity in order to determine the net proceeds which is included in the Income and Expenditure account for an NMPO.

Example

ABC Club runs a bar for its members and the transactions for the year ending 31st March 2014 were as follows;

	March 2014	March 2013
Bar receivables	12,000	25,000
Bar inventories	45,000	34,000
Owing to bar suppliers	32,000	24,000
Accruals for utilities	8,000	5,000

Activities during the year were as follows;

Bar cash sales	K230,000
Receipts from bar receivables	80,000
Payments to bar suppliers	140,000
Payment for wages of bar staff	40,000
Utility bills payment	18,000

Solution;

Bar trading account

	MK	MK
Bar Sales (Working 1)		297,000
Less: Cost of sales		
Opening inventories	34,000	
Purchases (working 2)	148,000	
Closing inventories	(45,000)	137,000
Gross profit		160,000
Less Expenses		

Bar wages	40,000	
Utility expenses (28,000-5,000+8,000)	31,000	(71,000)
Net profit from bar		89,000

Working 1: Determination of sales

Receivables Control account

Balance B/f	25,000	Cash	80,000
Credit Sales	67,000	Balance C/d	12,000
	92,000		92,000

Total sales is therefore MK67,000+ MK230,000 = MK297,000

Working 2: Determination of purchases

Payable control account

Bank	140,000	Balance b/f	24,000
Balance C/d	32,000	Purchases	148,000
	172,000		172,000

ii) Subscriptions

Most NPMOs are membership based. These include clubs, churches and societies. As evidence of membership, members are supposed to make annual contributions towards their organizations.

Apart from annual contributions, other organizations allow some members to make life time contributions instead of making annual payments.

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a) Accounting for annual contribution

Annual contributions received are included as income for an organization and are accounted in Income and Expenditure account. As in most transactions not all members honor their annual contribution and sometimes there are other members who will opt to pay subscriptions in advance.

Basing on accruals concept, the club is required to account the subscription which due from the members and not what has actually been received.

Subscription in arrears: subscription in arrears is treated as current assets since it is amount which is expected to be received from individual members.

Subscription in advance: this is treated as current liabilities because it represents amount which an institution has received in advance before providing services to the member.

Example:
If a club charges its members K25,000 per annum. If the club has 70 members, then the revenue recognized should be K1,750,000.

Now due to payment patterns, the club had the following transactions;
10 members failed to make payment last financial year
6 members already paid for this year
9 members have failed to pay for this year
4 members have paid for next financial year
In total 69 members paid subscription

Accruals brought forward is therefore 10 x 25,000 = K250,000

Prepayment brought forward is 6 x 25,000 = K150,000

Accruals carried forward is 9 x 25,000 = K225,000

Prepayment carried forward is 4 x 25,000 = K100,000

Subscription Account

Subscription accruals b/f	250,000	Prepayment b/f	150,000
Income and Expenditure	1,750,000	Bank	1,725,000
Subscription prepayment c/f	100,000	Subscription Arrears	225,000
	2,100,000		2,100,000

ii) Accounting for life subscription

Some club allows, the members to pay for their subscription once to cover their life time. In this case, the organization is supposed to recognize as liability any amount received and should be recognized as income over the estimated life of the members.

The organization is supposed to set an estimated life time which members under life subscription are expected to live and this is used to amortize the amount received over that period.

Amount outstanding at the end of period is carried in Statement of Financial position as liabilities.

When a member dies before the expiry of the expected life, amount accrued due to the member is supposed to be recognized as income immediately.

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Example

The club allows its members to pay MK250,000 as life time subscription. The expected life span for such members is 25 years.

The club had 30 members on this scheme as at the beginning of the year with a value of K4,800,000 and 3 new people have joined this year and settled their amount in full. Two members died during the year, one had K125,000 remaining and the other had K75,000 remaining.

Solution

Income and Expenditure Account - Extract

Amortization of subscriptions (31 x K10,000)	MK310,000
Realization for dead members (125,000 + 75,000)	200,000

Statement of Financial Position extract

Non-Current liability		
Life Subscriptions		MK5,040,000
Computed as:		
Balance b/f	4,800,000	
Additions (3 x 250,000)	750,000	
Less: Death	(200,000)	
Amortization	(310,000)	
Balance c/f	5,040,000	

iii) Fund raising activity

NPMOs sometimes do organize other fundraising activities. In preparing financial statements, the income and expenses from these activities should be netted off and only the net income included in Income and Expenditure account.

Example.

ABC Club organized a golf tournament to boost its income. The activities relating to the events were as follows;

Entry fees for each participant was K12,000 and 90 people registered

The club rented a golf course for K150,000, Tournament prize money of K500,000 and refreshments worth K30,000.

Solution

Entry fees realized	(K12,000 x 90)		1,080,000
Less:	Expenses		
	Renting of golf course	150,000	
	Prize money	500,000	
	Refreshments	30,000	(680,000)
Net surplus			400,000

STAGE 3 Computation of expenses

The next stage involves working out on some expenditure lines which require special adjustments like accruals, prepayments and depreciation.

The workings for these expenses is the same to those of trading organization.

STAGE 4 Income and Expenditure Account

Income and Expenditure account is used as the statement for the assessment of financial performance of an NPMO. The statement is the mirror image of the statement of comprehensive income for trading organization.

The end result of the Income and Expenditure account is either a surplus or a deficit as opposed to profit or loss in the statement of comprehensive income.

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Example:

Using the Examples above on ABC Club, other transactions for the year include the following;

Piece of land acquired in 2012 for future development	3,000,000
Motor vehicles (Cost K2,600,000, Depreciation K850,000)	1,750,000
Office equipment (Cost K3,500,000, Depreciation K980,000)	2,520,000
General administration expenses	230,000
Salaries – excluding bar wages	200,000
Depreciation -10% on cost for Equipment and 20% on net book value for motor vehicle	
City rates and rent	170,000
Advertisement and publicity	54,000
Maintenance costs	120,000
Bank balance (opening was K70,000)	610,000

Income and Expenditure Account

	MK	MK
INCOME		
Profit for the bar		89,000
Annual Subscription		1,750,000
Life Subscription		510,000
Proceeds from golf tournament		400,000
		2,749,000
EXPENDITURE		
General administration costs	230,000	
Salaries	200,000	
City rates and rent	170,000	
Advertisement and publicity	54,000	

Maintenance costs		120,000	
Depreciation - Equipment		350,000	
	Motor vehicles	350,000	(1,474,000)
SURPLUS			1,275,000

STAGE 5 Statement of financial position

The statement of financial position for an NPMO does not differ to that of a trading organization. The only difference is that the financed by section is represented by Accumulated funds and surplus or deficit.

Example

Using the data above for ABC Club, the Statement of Financial Position as at 31st March 2014 will be as follows;

Non current assets	MK	MK
Land		3,000,000
Motor vehicle	(K2,600,000 – 1,200,000)	1,400,000
Equipment	(K3,500,000 – 1,330,000)	2,170,000
		6,570,000
Current assets		
Bar inventories	45,000	
Bar receivables	12,000	
Subscriptions in arrears	225,000	
Bank	610,000	892,000
Total assets		7,462,000
Financed by		
Accumulated funds		1,007,000
Surplus		1,275,000

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Non-Current liabilities		
Life subscription		5,040,000
Current liabilities		
Subscription in arrears	100,000	
Payables – Bar supplies	32,000	
Accruals for utilities	8,000	140,000
Total		7,462,000

5.4 CONCLUSION

NPMOs as organization are supposed to follow the normal accounting concepts when preparing their financial statements, the only exception arise on the presentation. There are accounting terms which are particular to an NPMO and are not applicable to trading organization.

In Malawi, there having been a growing number of NGOs and non profit marking organizations. This put pressure on accountants to understand how these institutions operate and what sort of information the users of financial statements will need to assess the performance.

END OF CHAPTER QUESTIONS

1. **Tutorial questions**

a) Determine the opening accumulated funds for a club which had the following account balances at the beginning of a financial year;

Non-current assets (net book value)	K350,000
Bar Inventories	120,000
Subscription in arrears	60,000
Bar receivables	30,000

Cash at bank	45,000
Subscriptions received in advance	40,000
Owing to bar suppliers	35,000
Balance for life subscription	80,000

b) What is the recommended accounting treatment when a non-profit making organization receives life subscription from one of its members?

c) Which statement of account is used to assess the financial performance of a nonprofit making organization?

2. Exam style question

(a) Tinyama Wild Life Club charges K1,000 annual subscription fee for membership. The following are its assets and liabilities as at 1 January 2010:

Subscription fees in areas K91,500
Cash at bank K12,000
Coach hiring charges for the trip to Lengwe National park not paid for K4,000.

Further information extracted from the club's account records as at 31 December 2010 was as follows:

Receipts during the year	K
Subscription fees for 2008 financial year	6,000
Subscriptions for 2009 financial year	81,000
Subscriptions for 2010 financial year	50,000
Anonymous donations	10,000
Interest on bank balances	4,000
Receipts from members for tourism trip tickets to	

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Lengwe National Park	137,500
Receipts from members for coach hiring	62,000
	350,500
Payments during the year	
Tourism tickets	160,000
Coaching hiring	79,000
Sundry expenses	10,000
Printing, stationery and telephone	5,000
	254,000

Additional information

During an annual general meeting held on 20 November 2010 the club's executive committee passed a resolution to write off all subscription fees still in arrears by the end of the year and capitalize all donations for the year.

Subscription fees in arrears amounted to K4,500 as at 31 December 2010.

Required:

i) Prepare the club's cash book as at 31 December 2010. **7 Marks**

ii) Prepare an Income and Expenditure Account for Tinyama Wild Life Club for the year ended 31 December 2010. **5½ Marks**

iii) Prepare the statement of financial position for Tinyama Wild Life Club as at 31 December 2010. **3 Marks**

Total: 15½ Marks

CHAPTER 6: TANGIBLE NONCURRENT ASSETS

LEARNING OBJECTIVES

The object of this topic is to;

- Know the definition of non-current assets
- The accounting treatment of non-current assets
- The definition and accounting treatment for depreciation.

6.1 DEFINITION OF AN ASSET

An asset is a resource controlled by an entity as a result of past event from which future economic benefits are expected to flow to the enterprise. (IASB *framework*)

For a transaction to be classified as an asset, all the attributes included in the definition should be fulfilled. An asset should be as a result of past event or transaction. If there was no past event or transaction, then it is not an asset.

As asset should be controlled by an entity. Control does not mean ownership. This means the entity should be able to secure the item and make sure that it is in good working condition.

An asset should give an entity future economic benefits. If it does not give future economic benefit to an enterprise, then it is not worthy including in the financial statements.

A non current asset is one intended for use on a continuing basis in the company's activities.

NOT FOR SALE

6.2 IAS 16 PROPERTY, PLANT AND EQUIPMENT

The principal issues are recognition of assets, the determination of their carrying amounts and depreciation charges and impairment losses to be recognized in relation with them.

Scope of IAS 16

The standard applies to property, plant and equipment.

It does not apply to:

- Assets classified as held for sale in accordance with IFRS 5
- Exploration and evaluation of assets (IFRS 6)
- Biological assets related to Agricultural Activities (IAS 41)
- Mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources

Property, plant and equipment are tangible assets which have the following:

- Is held by the entity for use in production or supply of services, for rental to others and administrative purposes
- Is supposed to be used for more than one accounting period

6.3 RECOGNITION AND MEASUREMENT

The item of property, plant and equipment should be recognized when

- It is probable that future economic benefits associated with the asset will flow to the enterprise
- The cost of the asset can be measured reliably

Initial measurement

An item of property, plant and equipment must initially be measured at cost. In this case, the cost includes the purchase price all costs incurred in bringing an item to its present location and working condition.

These costs include the following:

- Cost of site preparation
- Delivery and handling costs
- Installation costs
- Related professional fees
- Estimated costs of dismantling and removing the asset and restoring the assets

Please note that the same costs listed above if incurred after the asset is brought into use will not be capitalized but rather written off as periodic expenses

Measurement subsequent to initial

After initial measurement, the entity is required to measure the asset using either cost or revaluation model. There is no preferred method but the only requirement is that whichever method is adopted, it has to be applied over the years consistently.

Cost model

This is the cash or cash equivalent paid or fair value of other consideration given to acquire an asset or construction. The standard gives further clarifications of what it means by cost. This is the cost of bringing an item to its present location and working condition.

IAS 23 Borrowing Costs states that where a property being is being constructed using borrowed funds, any interest payable on the loan which is financing the asset should be

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included as part of capital cost for the asset until when either the loan is fully paid or when the asset is ready for use.

Under cost model, the asset is recorded cost less accumulated depreciation or any impairment loss realized.

The Revaluation Model

Revaluation model is where the asset is measured at fair value. This is the amount that an asset would be exchanged or a liability settled between knowledgeable, willing parties at an arm's length transaction.

Revaluations should be carried out regularly, so that the carrying amount of an asset does not differ materially from its fair value at the financial Position date.

If an item is revalued, the entire class of assets to which that asset belongs should be revalued. This is aimed at preventing creative accounting where entities opt to revalue only those assets where they believe the fair value is high and leaving out those where they believe will result in revaluation loss.

Revalued assets are depreciated in the same way as under the cost model.

If a revaluation results in an increase in value, it should be credited to other comprehensive income and accumulated in equity. While as a decrease arising as a result of a revaluation should be recognized as an expense to the extent that it exceeds any amount previously credited to the revaluation surplus relating to the same asset.

When a revalued asset is disposed of, any revaluation surplus may be transferred directly to retained earnings, or it may be left in equity under the heading revaluation surplus.

Example

An asset was purchased at on 1 January 2010 for MK100,000. Depreciation policy is 5 years on straight line basis. In December 2012, the asset was revalued to MK70,000 while its useful life did not change. In December 2013 there was credit crunch which affected the asset value which now was only MK15,000.

Required:
Account for the asset movements in December 2012 and December 2013?

Solution

Depreciation from 2010 to 2012
MK100,000/5= MK20,000 per year
Number of years =3 years
Thus total Depreciation =3*20,000= MK60,000.
Carrying amount = MK100000-MK60,000=MK40,000
Therefore Revaluation surplus=MK70,000-MK40,000=MK30,000

The double entry

	Dr	Cr
Non Current Asset	MK30,000	
Revaluation Surplus		MK30,000

To record the revaluation increase

In 2013 Depreciation will be MK70,000/2= MK35,000
Thus the carrying value will be MK70,000-MK35,000=MK35,000

NOT FOR SALE

Double entry will be

	Dr	Cr
Proft or loss Account	MK35,000	
Provision for Depreciation		MK35,000

Realized revaluation will be MK35,000 – MK20,000=MK15,000.

(the difference between the new depreciation based on revalued amount less the original depreciation)

Double entry will be

	Dr	Cr
Revaluation Reserve	MK15,000	
Proft or loss		MK15,000

To record the realized revaluation as the revalued asset has passed one period

When the non current asset losses value,

The non current Asset which has now the carrying of MK15,000 down from MK35,000. Thus the non current asset has reduced in value by MK20,000

With the amount of the decrease. Thus the revaluation which will now remain will be;

Original revaluation surplus	MK30,000
Less: Excess depreciation	(15,000)
Balance	MK15,000
Revaluation loss	20,000
Additional revaluation loss	(5,000)

This indicates that the loss is more than what was left of the revalued amount. Since the revaluation reserve had a balance of K15,000 and the loss was K20,000. The K5,000 will be considered as a new revaluation loss so it will be debited to profit or loss.

Double entry is therefore	Dr	Cr
Revaluation Reserve	MK15,000	
Profit or loss	5,000	
Non-Current Asset		MK20,000

6.4 DEPRECIATION (Cost and Revaluation Models)

The depreciable amount (cost less residual value) should be allocated on a systematic basis over the asset's useful life.

The residual value and the useful life of an asset should be reviewed at least at each financial year-end. The depreciation method used should reflect the pattern in which the asset's economic benefits are consumed by the entity.

The depreciation method should be reviewed at least annually and, if the pattern of consumption of benefits has changed, the depreciation method should be changed prospectively.

Depreciation should be charged to the income statement to the extent that it is a surplus over the revaluation reserve of the same asset.

Depreciation begins when the asset is available for use and continues until the asset is derecognized.

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The standard does not specify the preferred depreciation method and the entity is free to select any method considered suitable for their assets. The most common methods are as follows;

i) Straight line method – where the depreciation charge is consistent throughout the asset life computed as original cost less residual value divided by the estimated useful economic life. Straight line method is ideal for such assets which are considered to have a long useful life. The asset which shows that the capabilities does not really change with passage of time like buildings.

Residual value is the estimated amount that an entity would receive on a disposal after removing the disposal costs.

ii) Reducing balance method – where the depreciation charge is higher in the early life of the asset and reducing with passing years. Depreciation charge is based on the carrying value of an asset (which is cost less accumulated depreciation). This method is suitable for assets which have a short estimated economic life. These assets are considered more productive in early life than in later years. Example include office equipment and motor vehicles.

6.5 DERECOGNITON (Retirements and Disposals)

An asset should be removed from the financial statements on disposal or when it is withdrawn from use and no future economic benefits are expected from its disposal. The gain or loss on disposal is the difference between the proceeds and the carrying amount and should be recognized in the income statement.

When the asset is disposed, a gain or loss should be computed and recognized in the Profit or loss. The profit or loss is computed as the difference between the disposal proceeds and the net book value of the asset.

Example

A motor vehicle was acquired in January 2009 at K800,000 and is being depreciated over 5 years at 20% per annum using reducing balance method. There is no residual value for the asset.

The company decided to sale the asset on 31st December 2011 for K320,000.

Solution

	MK
Disposal proceed	520,000
Less : Netbook value of the asset	(409,600
Gain or loss	110,400

Note: Net book value of the asset

Cost	800,000
Depreciation – Dec 2009 (800,000x20%)	(160,000)
Net book value	640,000
Depreciation – Dec 2010 (640,000 x 20%)	(128,000)
Net book value	512,000
Depreciation – Dec 2011 (512,000 x 20%)	(102,400)
Net book value as at 31st December 2011	409,600.

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6.6 INVESTMENT PROPERTY –IAS 40

Investment property refers to a property which is;

- Complete as to construction
- Is being let out on commercial basis and
- Not used by the owners for manufacturing, distribution or administrative purpose.

Investment property should be differentiated from other properties (buildings) as follows;

- Any property used by business for manufacturing, distribution or administrative purpose. – Use IAS 16 – Property, plant and equipment.
- Property which is held for sale as ordinary course of business – Use IAS 2 – Accounting for inventories.
- Property which is under construction for a client – Use IAS 11 – Construction contract.
- For own use – Use IAS 16.

Accounting requirements for IAS 40.

Investment property should initially be measured at its historical cost to the business or at fair value if acquired in business acquisition.

Subsequent measurement should be at fair value- i.e. based on market value of the property.
Where market value can not reliably be measured, then subsequent measurement can be at depreciated historical cost.

Any movement in fair value should recognized through profit or loss account.

6.7 IMPAIRMENT OF ASSETS

A tangible non- current asset is considered as impaired if its carrying value is more than the amount expected to be recovered from either usage or sale of the asset.

Please note that impairment does not necessarily means that the asset is damage but that the asset is being recorded in the books of accounts at a higher than what is a realistic value.

The standard requires that is considered as impaired should be recorded at its recoverable amount. i.e. the higher of net realizable value (net selling price) and its economic value (present values of future cash flows to be generated by the asset).

The impairment loss should be charged as expense in through the profit or loss unless if they affect an asset which had been revalued, the charge against revaluation reserve. The topic is covered in detail in chapter 8.

6.7 ASSET REGISTER

It is important that every company should maintain the asset register. This is a listing of all assets which are owned by the business. Some information for the register will include;

- the identification for the asset
- if possible the location of the asset
- the description of the asset
- the date of purchase
- the cost of the asset or its revalued amount
- additions and disposal of assets during the year
- depreciation rate used for the asset
- the opening value for accumulated depreciation
- the charge for depreciation for the asset

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- the closing value for depreciation

An asset register act as a control measure in management of the assets. What is presented in asset register should agree with the ledgers for non-current asset, depreciation account and the asset disposal account.

6.8 DISCLOSURE FOR ALL NON CURRENT ASSETS

For each class of property, plant, and equipment:

- basis for measuring carrying amount
- depreciation method(s) used
- useful lives or depreciation rates
- gross carrying amount and accumulated depreciation and impairment losses
- reconciliation of the carrying amount at the beginning and the end of the period, showing:
- additions
- disposals
- acquisitions through business combinations
- revaluation increases or decreases
- impairment losses
- reversals of impairment losses
- depreciation
- net foreign exchange differences on translation
- other movements

For investment property also disclose the changes in fair value which has been recognized in profit or loss account.

6.7 CONCLUSION

Non -current assets are important elements of the financial statements. In most organization non-current asset have a significant value on the overall financial position of the business. This calls for prudent recognition and measurement of these assets.

END OF CHAPTER QUESTIONS

1. Tutorial questions

a) Define the following:

i. Non Current Asset
ii. Cost
iii. Carrying amount
iv. Depreciation
v. Revaluation

b) A non current asset was purchased for MK250,000.00 on 1 January 2008. The useful life was 4 years. At the end December 2010, the asset was revalued to MK300000.

Account for the transactions from 2008 to December 2011?

c) Outline the major differences in accounting for property under IAS 16 and IAS 40.

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2. Exam style questions

(a) Mention any **three** pieces of information contained in the non-current assets register. **3 Marks**

(b) The following information has been extracted from the books of Zilinkudza Ltd, as opening balances on 1 December 2009:

		K'000
Land and buildings, at cost		10,600
Plant and machinery, at cost		5,250
Motor vehicles, at cost		6,200
Accumulated depreciation – buildings		2,600
	plant and machinery	960
	motor vehicles	2,800

Additional information:

Land is valued at K5,000,000

One piece of plant and machinery that had originally cost K750,000 and in use for the past two years was sold for K550,000. Depreciation is provided on a straight-line basis at 10% on cost of plant and machinery.

A new piece of land was acquired for K1,100,000 during the year.

Depreciation is also provided on straight line basis on cost of motor vehicles at 25% and buildings 5%.

Required:

(i) Prepare, for Zilinkudza Ltd, for the year ended 30 November 2010, a schedule of non-current assets that would be part of notes to published accounts of a limited company. **8½ Marks**

(ii) Prepare journal entries, with narratives, for posting the additions, disposals, and depreciation charges for non-current assets for Zilinkudza Ltd for the year ended 30 November 2010. **8½ Marks**

(TOTAL : 20 MARKS)

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CHAPTER 7: INTANGIBLE ASSETS

LEARNING OBJECTIVES

The objectives of this chapter is to;

- Define of intangible asset
- The accounting treatment of an intangible asset in the accounts
- Disclosures required in the standard

7.1 DEFINITION OF INTANGIBLE ASSETS

An intangible Asset is an asset without physical substance. As the asset has no physical substance, it means it is not easy to include the asset in the financial statements.

However, though not tangible, it has to meet the measurement criteria of an asset as defined in IAS 16 in chapter 6 above.

Accounting for intangible assets is specified in IAS 38.

Scope of IAS 38

IAS 38 applies to all intangible assets other than:

- financial assets
- exploration and evaluation assets (extractive industries)
- expenditure on the development and extraction of minerals, oil, natural gas, and similar resources
- intangible assets arising from insurance contracts issued by insurance companies
- intangible assets covered by another IFRS, such as intangibles held for sale, deferred tax assets, lease assets, assets arising from employee benefits, and goodwill. Goodwill is covered by IFRS 3

Key Definitions from IAS 38

Intangible asset:

This is an identifiable nonmonetary asset without physical substance.
An intangible asset should be recognized when the three critical attributes of an intangible asset are met:

Identifiability – though not having physical substance, the asset should have the capability of being recognized and measured reliably but also be able to be identified separately.

Control – the entity is supposed to prove that it has power to obtain economic benefits associated with the asset. This include title rights to the intangible asset.
Future economic benefits- the entity is supposed to demonstrate the capability of the asset to generate benefits in form of either future revenues or reduced future costs.

Identifiability: an intangible asset is identifiable when it:

- Is separable (capable of being separated and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract) or
- Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Examples of possible intangible assets include:

- computer software
- patents
- copyrights
- motion picture films
- licenses
- franchises

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7.2 RECOGNITION OF INTANGIBLE ASSETS

IAS 38 requires an entity to recognize an intangible asset, whether purchased or self-created (at cost) if, and only if:

- it is probable that the future economic benefits that are attributable to the asset will flow to the entity; and
- the cost of the asset can be measured reliably.

This requirement applies whether an intangible asset is acquired externally or generated internally.

The probability of future economic benefits must be based on reasonable and supportable assumptions about conditions that will exist over the life of the asset.

If an intangible item does not meet both the definition of and the criteria for recognition as an intangible asset, IAS 38 requires the expenditure on this item to be recognized as an expense when it is incurred.

Initial Recognition: Research and Development Costs

IAS 38 prohibits the recognition of brands, mastheads, publishing titles, internally generated goodwill, customer lists and items similar in substance that are internally generated..
Intangible assets are initially measured at cost. Cost relates to either acquisition costs or development costs where the intangible is internally generated.

For research and development, it is important to recognize that;

- Research costs are costs in search of new ideas and with no direct business value. Research costs are supposed to be charged as expense to profit or loss

- Development costs are capitalized only after technical and commercial feasibility of the product for sale or use have been established.
- The technical and commercial feasibility is met when:
- An entity intends to use the asset and will be able to complete the project
- An entity be able to demonstrate how the asset will generate future economic benefits.

Measurement Subsequent to Acquisition:

Subsequent measurement can either be through Cost Model or Revaluation Model

After initial recognition the benchmark treatment is that intangible assets should be carried at cost less any amortization and impairment losses.

Revaluation gains (i.e. increases in an intangible asset's carrying amount) should be credited directly to 'revaluation reserve' within equity, except to the extent that this gain reverses a revaluation decrease previously recognized in the profit and loss. In this case the amount of the reversal is recognized as income and as such is credited to the income statement.

Decreases in value are recognized as expenses and are charged against the profit for the year. However, if the decrease in value is a reversal of a previous revaluation gain, the amount of the reversal should be offset against the revaluation surplus.
When considering subsequent measurement intangible assets are usually classified as:
Indefinite life: no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

Finite life: a limited period of benefit to the entity.

The cost less residual value of an intangible asset with a finite useful life should be amortized on a systematic basis over that life:

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- The amortization method should reflect the pattern of benefits.
- If the pattern cannot be determined reliably, amortize by the straight line method.
- The amortization charge is recognized in profit or loss.
- The amortization period should be reviewed at least annually.
- The asset should also be assessed for impairment in accordance with IAS 36.

An intangible asset with an indefinite useful life should not be amortized but should be assessed for impairment annually in accordance with IAS 36.

7.3 GOODWILL

Goodwill can be self-generated or purchased. IAS 38 *Intangible Assets* deals with self-generated goodwill and prohibits its recognition as an intangible asset within the financial statements.

The reason for this is the potential to alter reported figures. If companies were permitted to include self-generated goodwill in their financial statements they could manipulate the financial position of the business by including negative goodwill whenever there are signs that the asset value is weak.

IFRS 3 *Business Combinations* deals with purchased goodwill. As already noted, goodwill is a residual amount and is defined as: 'future economic benefits arising from assets that are not capable of being individually identified and separately recognized'.

Goodwill is the amount remaining after applying valuation rules to the *identifiable* assets and liabilities.

From the acquiring company's point of view, this excess amount paid over the fair value of the net assets acquired is expected to yield future benefits. The anticipation of expected future benefits effectively constitutes goodwill as an asset in the same way as any other

tangible asset that would be expected to yield future benefits. In essence, the acquiring company is paying more than the value of the net assets acquired because there is belief that the acquired business is worth more than the combined value of net assets.

Accounting treatment of purchased goodwill

Carry the purchased goodwill as an asset and amortize it over its estimated useful life through the profit or loss account. The useful economic life should be based on the expected period which the acquiring company is expected to enjoy economic benefits arising from the acquisition.

The company is required to review the value of goodwill at the end of first year of acquisition and assess if there have been significant changes to the condition for continued recognition of goodwill. This may include incorporation of any contingent consideration which was not recognized at the time of acquisition.

Where the estimated useful economic life of goodwill is considered as indefinite, the entity is supposed to conduct annual assessment of impairment.

7.4 IMPAIRMENT LOSS FOR INTAGIBLE ASSETS

Intangible assets should also be assessed if they have not been impaired. IAS 36 states that an asset is considered as impaired if its carrying value is more than its recoverable amount.

IAS 36 requires the review of intangible assets for impairment as follows;

- Goodwill should be reviewed for impairment at the 1st anniversary of its recognition and subsequent reviews should only be made if there are indications of impairments.

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- All other intangible non-current assets should be reviewed for impairment only if there are indications of impairment.
- All intangible non-current assets with indefinite useful economic life should be reviewed for impairment annually.

Impairment loss should be recognized through profit or loss as expenses unless if the loss is reversing a revaluation surplus recognized for the same intangible asset.

7.5 DERECOGNITION

Intangible non-current asset should be derecognized from the financial statements if;

The intangible asset has been disposed off separately or in business disposal
The entity no longer have the rights to economic benefits arising from the asset. i.e. it has expired, surrendered to another party or has been realized through disposal.

When removing the intangibles from the records of accounts, the entity should compute a gain or a loss on de-recognition. The gain or loss is computed as the difference between disposal value and the carrying value of the intangible asset.

7.6 DISCLOSURE REQUIREMENTS

For each class of intangible asset, disclose:

- useful life or amortization rate
- amortization method
- gross carrying amount
- accumulated amortization and impairment losses
- line items in the profit or loss in which amortization is included

- reconciliation of the carrying amount at the beginning and the end of the period showing:
    - additions (business combinations separately)
    - assets held for sale
    - retirements and other disposals
    - revaluations
    - impairments
    - reversals of impairments
    - amortization
    - foreign exchange differences
    - other changes
- basis for determining that an intangible has an indefinite life
- description and carrying amount of individually material intangible assets
- certain special disclosures about intangible assets acquired by way of government grants
- information about intangible assets whose title is restricted
- contractual commitments to acquire intangible assets

7.5 CONCLUSION

Intangible assets by their nature have no physical substance and this usually confuse many students. The most important aspect is to use the asset test; does it result in future inflow of economic benefits, is it controlled by the entity and can the benefits be measured reliably in monetary value. If all these questions can be answered, then it is an asset despite not having the physical substance.

Intangible assets are becoming significant assets of the business ahead of tangible assets. Assets such as patents, goodwill and development expenditure are considered as crucial and valuable for the success of the business.

NOT FOR SALE

END OF CHAPTER QUESTIONS

1. Tutorial questions

a) What are the conditions required to recognize an intangible non-current asset.

b) What are the difference between research and development costs.

c) What is the difference between inherent and purchased goodwill.

2. Exam type question

a) What are the conditions necessary to capitalize development expenditure as an intangible asset? **4 Marks**

b) ABC purchased a patent to manufacture Mazoe drinks in Malawi on 1 January 2011 for K900, 000. ABC has bought equipment to be manufacturing this product in Malawi but the patent has been obtained from a Zimbabwean company. At the date of acquisition, the estimated useful economic life of the patent was 10 years.

An expert conducted an assessment on 31st January 2013 and recommended that the patent should have the market value of K960, 000 and that the remaining useful economic life should be 15 years.

Financial year for ABC end on 31st December.

Required;

(i) Compute annual amortization expenses charged to statement Profit or Loss for the years 2011 to December 2013? **3 marks**

(ii) Compute revaluation surplus on the transaction and show the journal entries. **3 marks**

(iii) Show the Balance Sheet extract for 2011 to 2013 showing the net book value for the patent. **5 marks**

c) Outline the accounting requirement for goodwill in accordance to IAS 38-Accounting for Intangible assets and IAS 22 on Business combination. **4 marks**

TOTAL: 20 MARKS

CHAPTER 8: IMPAIRMENT OF ASSETS

LEARNING OBJECTIVES

The objectives of this chapter is to

- Define impairment
- Measure of impairment
- Account for impairment

8.1 DEFINITION OF IMPAIRMENT OF ASSET

Impairment is loss in value of an asset. Whether it is a tangible non-current asset or intangible one, it will suffer impairment. Sometimes people confuse between the reduction in value by way of impairment and the depreciation. The main difference is that depreciation is a systematic reduction in the value of an asset over its useful life while impairment is a one off reduction of an asset.

It should also be noted, that when an asset is said to be impaired, it does not mean that the asset is useless. Impairment is simply indicating that the value at which asset is recorded in the financial statement is rather too high than what will be realized if the asset is disposed immediately or is used till the end of its economic life.

Impairment of assets is accounted under IAS 36 and the objective of the standard is to ensure that assets are carried at no more than their recoverable amount, and to define how recoverable amount is determined.

IAS 36 applies to all assets except:

- inventories IAS 2
- assets arising from construction contracts IAS 11
- deferred tax assets IAS 12

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- assets arising from employee benefits IAS 19
- financial assets IAS 39
- investment property carried at fair value IAS 40
- agricultural assets carried at fair value IAS 41
- insurance contract assets IFRS 4
- non-current assets held for sale IFRS 5

For the assets listed above, the respective standards does specify on how to treat any impairment loss.

Important terms in IAS 36

Impairment arise when the asset carrying amount of an asset exceeds its recoverable amount.

Carrying amount is the value at which an asset is recorded in the financial statement after deducting accumulated depreciation and any recognized impairment losses

Recoverable amount is the higher of an asset's fair value less costs to sell and its value in use

Fair value: the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties

Value in use: the discounted present value of the future cash flows expected to arise from:

- the continuing use of an asset, and from
- its disposal at the end of its useful life

8.2 IDENTIFYING AN IMPAIRMENT LOSS

At each financial year end, an entity must review all assets to look for any indication that an asset may be impaired. IAS 36 has a list of external and internal indicators of impairment. If there is an indication that an asset may be impaired, then you must calculate the asset's recoverable amount.

The recoverable amounts of the following types of intangible assets should be measured annually whether or not there is any indication that it may be impaired.

- an intangible asset with an indefinite useful life
- an intangible asset not yet available for use
- goodwill acquired in a business combination

Indications of Impairment include;

External sources:

- market value declines
- negative changes in technology, markets, economy, or laws
- increases in market interest rates
- company stock price is below book value

Internal sources:

- obsolescence or physical damage
- asset is part of a restructuring or held for disposal
- worse economic performance than expected

These lists are not exhaustive.

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8.3 DETERMINING RECOVERABLE AMOUNT

The recoverable amount is the higher of:

Fair Value less costs to sale and the Value in use.

a) Fair Value less Costs to Sell

If there is a binding sale agreement, use the price under that agreement less costs of disposal.

If there is an active market for that type of asset, use market price less costs of disposal.

If there is no active market, use the best estimate of the asset's selling price less costs of disposal.

Costs of disposal are the direct added costs only.

b) Value in Use

The calculation of value in use should reflect the following elements:

- an estimate of the future cash flows the entity expects to derive from the asset
- expectations about possible variations in the amount or timing of those future cash flows
- the time value of money, represented by the current market risk-free rate of interest
- the price for bearing the uncertainty inherent in the asset
- other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset

Cash flow projections should be based on reasonable and supportable assumptions, the most recent budgets and forecasts, and extrapolation for periods beyond budgeted projections. Cash flow projections should relate to the asset in its current condition – future restructurings to which the entity is not committed and expenditures to improve or enhance the asset's performance should not be anticipated.

Estimates of future cash flows should not include cash inflows or outflows from financing activities, or income tax receipts or payments.

Discount Rate

In measuring value in use, the discount rate used should be the pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the asset.

The discount rate should not reflect risks for which future cash flows have been adjusted and should equal the rate of return that investors would require if they were to choose an investment that would generate cash flows equivalent to those expected from the asset.

The following would normally be considered:

- the entity's own weighted average cost of capital;
- the entity's incremental borrowing rate; and
- Other market borrowing rates.

8.3 RECOGNITION OF AN IMPAIRMENT LOSS

An impairment loss should be recognized whenever recoverable amount is below carrying amount. The impairment loss is an expense in the profit or loss (unless it relates to a revalued asset where the value changes was recognized directly in equity).

This means that the recoverable amount now becomes the carrying value so depreciation for subsequent years will be based on the new value and not on what was original cost or carrying amount.

Cash-Generating Units

Recoverable amount should be determined for the individual asset, if possible.

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If it is not possible to determine the recoverable amount (fair value less cost to sell and value in use) for the individual asset, then determine recoverable amount for the asset's cash-generating unit (CGU). The CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

A cash-generating unit to which goodwill has been allocated shall be tested for impairment at least annually by comparing the carrying amount of the unit, including the goodwill, with the recoverable amount of the unit:

If the recoverable amount of the unit exceeds the carrying amount of the unit, the unit and the goodwill allocated to that unit is not impaired.

If the carrying amount of the unit exceeds the recoverable amount of the unit, the entity must recognize an impairment loss.

The impairment loss is allocated to reduce the carrying amount of the assets of the unit (group of units) in the following order:

- first, reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and
- then, reduce the carrying amounts of the other assets of the unit (group of units) on pro rata basis.

The carrying amount of an asset should not be reduced below the highest of:

- its fair value less costs to sell ,
- its value in use , and
- zero.

If the preceding rule is applied, further allocation of the impairment loss is made pro rata to the other assets of the unit (group of units).

Impairment of Goodwill

Goodwill should be tested for impairment annually.

To test for impairment, goodwill must be allocated to each of the acquirer's cash-generating units, or groups of cash-generating units, that are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units. Each unit or group of units to which the goodwill is so allocated shall:

Represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and not be larger than an operating segment determined in accordance with IFRS 8

8.4 REVERSAL OF AN IMPAIRMENT LOSS

Same approach as for the identification of impaired assets: assess at each financial Position whether there is an indication that an impairment loss may have decreased. If so, calculate recoverable amount.

The increased carrying amount due to reversal should not be more than what the depreciated historical cost would have been if the impairment had not been recognized.

Example:

An asset had a carrying value of K720,000 on 1st January 2011 (Cost K900,000 and accumulated depreciation K180,000 i.e is being depreciated over 5 years on straight line basis). The asset was considered impaired as the recoverable amount on1st January 2011 was considered as K600,000. The asset had a remaining useful economic life of 4 years and had a nil residual value.

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At 31st December 2012, the condition which caused impairment reversed and the value of the asset rose to K400,000.

Determine the impact of the reversal of to profit or loss account.

Solution:

Impairment loss recognized in 2011

Carrying value	K720,000
Recoverable amount	K600,000
Impairment loss	K120,000

Impairment reversal in 2012

New carrying amount was		K600,000
Depreciation – 2011	(600,000 / 4 years)	150,000
Depreciation – 2012	(600,000/ 4 years)	150,000
Carrying value as at 31st December 2012		K300,000

The new value (recoverable amount)	K500,000
Carrying value as at 31st December 2012	(300,000)
Impairment reversal	200,000

The K200,000 is recognized in the financial statement on the following basis:

If there was no impairment, the asset value would have been K360,000 (900,000 x2/5 years) but now is new value is K500,000.

New carrying value	K300,000	
	⇨	60,000 cr to Profit or loss

Carrying value if there was no impairment K360,000

 140,000 to revaluation reserve

The new recoverable amount K500,000

As illustrated above, the reversal of an impairment loss is recognized as income in Statement of profit or loss only up to the extent of what would have been the carrying value if there was no original impairment and the excess is treated as a new revaluation and should be credited to revaluation reserve.

Depreciation for future periods should be based on the recognized new value of the asset.

Please note that reversal of an impairment loss for goodwill is prohibited by IAS 36.

8.5 DISCLOSURE

Disclosure by class of assets:

- impairment losses recognized in profit or loss
- impairment losses reversed in profit or loss
- which line item(s) of the statement of comprehensive income
- impairment losses on revalued assets recognized in other comprehensive income
- impairment losses on revalued assets reversed in other comprehensive income

Disclosure by reportable segment:

- impairment losses recognized for the cash generating unit
- impairment losses reversed

Other disclosures:

If an individual impairment loss (reversal) is material disclose:

- events and circumstances resulting in the impairment loss
- amount of the loss

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- individual asset: nature and segment to which it relates
- cash generating unit: description, amount of impairment loss (reversal) by class of assets and segment
- if recoverable amount is fair value less costs to sell, disclose the basis for determining fair value
- if recoverable amount is value in use, disclose the discount rate

8.6 CONCLUSION

Entities need to ensure that assets are recognized at correct amount. This chapter ensures that there is no overstatement of assets, thereby sending wrong information on the financial position of an entity.

END CHAPTER QUESTION

1. **Tutorial questions**

a) Define impairment?

b) What do we mean by a cash generating unit?

c) What should be the maximum amount of impairment to an asset?

2. Exam style question

Deejay Ltd has a unit which produces plastic containers. The asset base for the unit as at 1st Jan 2012 were as follows:-

	Carrying values	Economic Life
Manufacturing Machine	800,000	20 years
Bottling Equipment	650,000	10 years
Labelling Machine	500,000	10 years
Other Office Equipment	700,000	5 years

A new law was passed on 1st January 2012 discouraging the use of materials which Deejay Ltd use to produce its plastic container. The passage of this law will require changing the source of raw materials and re-setting the factory equipment.

An Engineer assessed that as a result of this law the unit as a whole lost its value such that its recoverable amount fell below the carrying amount. In the assessment he recognized the impairment loss allocated as follows:-

- Manufacturing Machine lost 30% of its carrying value
- Bottling equipment lost 30% of its carrying value
- Labeling machine lost 20% of its carrying value
- Other office equipment lost 20% on carrying value

Required;

(a) Compute the impairing loss for each equipment and the new carrying value for each asset at the unit. **5 Marks**

(b) Compute the depreciation for the year to 31 December 2012 for all the assets in the unit. **7 marks**

(c) If on 1 January 2013, the value of bottling equipment was revalued to K594, 000. The economic life remaining is 9 years. Prepare journal entry for the transaction **8 marks**

TOTAL: 20 MARKS

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CHAPTER 9: INVENTORIES

LEARNING OBJECTIVES

The objective of this chapter is to:

- Define inventory,
- Account for Inventories
- Disclosure requirements for inventories

9.1 DEFINITION OF INVENTORIES

Inventories consist of different items in the organizations. While in one organization an item may be inventory, the same would be a non-current asset of the other. For example, to a motor selling company, a motor vehicle which is about to be sold is inventory while the same vehicle which is being used by its Chief Executive is a non- current asset. In this case, the accounting treatment for the two vehicles will differ.

IAS 2 is the standards which prescribe the accounting treatment for inventories. It provides guidance for determining the cost of inventories and for subsequently recognizing them an expense, including any write-down to net realizable value.

Inventories include assets held for sale in the ordinary course of business (finished goods), assets in the production process for sale in the ordinary course of business (work in process), and materials and supplies that are consumed in production (raw materials).

However, IAS 2 excludes certain inventories from its scope:

- work in process arising under construction contracts IAS 11
- financial instruments IAS 39
- biological assets related to agricultural activity and agricultural produce at the point of harvest IAS 41.

9.2 FUNDAMENTAL PRINCIPLE OF IAS 2

Inventories are required to be stated at the lower of cost and net realizable value (NRV).

Cost in this case should include all:

i. Costs associated with purchase (including taxes, transport, and handling) net of trade discounts received.
ii. costs of conversion (including fixed and variable manufacturing overheads) and
iii. other costs incurred in bringing the inventories to their present location and condition

Inventory cost should not include:

- abnormal waste
- storage costs
- administrative overheads unrelated to production
- selling costs
- foreign exchange differences arising directly on the recent acquisition of inventories invoiced in a foreign currency
- interest cost when inventories are purchased with deferred settlement terms.

Net realizable value is the estimated selling costs of inventories less cost incurred in selling the inventories.

Example 1

The following is the information taken from the books of account of Pious ltd

Inventory	Cost	Sale less cost to Sale
Item no. 1	MK5000	MK4800
Item no. 2	MK8000	MK8700
Item no. 3	MK7440	MK7500

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How much should be the inventories is Pious Limited books?

Valuation of inventories

Item no. 1	MK4800
Item no. 2	MK8000
Item no.3	MK7440

The standard cost and retail methods may be used for the measurement of cost, provided that the results approximate actual cost.

For inventory items that are not interchangeable, specific costs are attributed to the specific individual items of inventory.

Under normal circumstances, inventory is supposed to be measured at cost since it is obvious that selling price ought to be higher than the cost. Situations where selling price will be lower than costs include;

i. where the inventory is obsolete
ii. where there is sales promotion and the price has been slashed down
iii. where there was an error in purchase that the cost incurred was higher than what is being offered on the market
iv. where there was inefficiency in production to the extent that costs attributable to internally manufactured inventory is higher that the selling price.
v. Where the inventory is damaged

9.2 VALUATION METHODS

IAS 2 allows the FIFO or weighted average cost formulas and not LIFO.

Example of inventory Valuation using FIFO and average cost method

Date	Number	Purchases (MK)	Total Cost(MK)	Issues	Total Cost	Selling Price(MK
1/1/2011	100	1000	100,000.00		100,000.00	
3/1/2011	220	1100	242,000.00		342,000.00	
5/1/2011			-	60	342,000.00	1,500.00
7/1/2011	150	1250	187,500.00		529,500.00	
12/1/2011			-	200	529,500.00	2,000.00
20/1/2011	185	1300	240,500.00		770,000.00	
28/1/2011			-	300	770,000.00	
			-		770,000.00	
Closing Inventories			95 units			

Using FIFO

Date	No. Purchased	Cost/unit	Total Cost	No. Issued	Cost of issu	Balance
1/1/2011	100	1000	100000			100,000.00
3/1/2011	220	1100	242000			342,000.00
5/1/2011				60	1000	282,000.00
7/1/2011	150	1250	187500			469,500.00
12/1/2011				40	1000	
				160	1100	253,500.00
20/1/2011	185	1300	240500			494,000.00
28/1/2011				60	1100	
				150	1250	
				90	1300	123,500.00
Closing Inventory		95	1300			123,500.00

NOT FOR SALE

Using LIFO

Date	No. Purch	Cost/unit	Total Cost	No. Issuec	Cost of iss	Balance
1/1/2011	100	1000	100000			100,000.00
3/1/2011	220	1100	242000			342,000.00
5/1/2011				60	1100	276,000.00
7/1/2011	150	1250	187500			463,500.00
12/1/2011				150	1250	
				50	1100	221,000.00
20/1/2011	185	1300	240500			461,500.00
28/1/2011				185	1300	
				110	1100	
				5	1000	95,000.00
Closing Inventory		95	1000			95,000.00

Weighted Average Method

Date	No. Purch	Cost/unit	Total Cost	No. Issuec	Cost of iss	Balance
1/1/2011	100	1000	100000			100,000.00
3/1/2011	220	1100	242000			342,000.00
5/1/2011				60	1068.75	277,875.00
7/1/2011	150	1250	187500			465,375.00
12/1/2011				200	1135.061	238,362.80
20/1/2011	185	1300	240500			478,862.80
28/1/2011				300	1212.311	115,169.54
Closing Inventory			95 units	costing		115,169.54

The same cost formula should be used for all inventories with similar characteristics as to their nature and use to the entity.

Write-Down to Net Realizable Value

NRV is the estimated selling price in the ordinary course of business, less the estimated cost of completion and the estimated costs necessary to make the sale. Any write-down to NRV should be recognized as an expense in the period in which the write-down occurs. Any reversal should be recognized in the income statement in the period in which the reversal occurs.

9.3 DISCLOSURE REQUIREMENTS

Required disclosures:

- accounting policy for inventories
- carrying amount, generally classified as merchandise, supplies, materials, work in progress, and finished goods. The classifications depend on what is appropriate for the entity
- carrying amount of any inventories carried at fair value less costs to sell
- amount of any write-down of inventories recognized as an expense in the period
- amount of any reversal of a write down to NRV and the circumstances that led to such reversal
- carrying amount of inventories pledged as security for liabilities

9.4 CONCLUSION

Inventories have a bearing on both the statement of comprehensive income and the statement of financial position. Any understatement or overstatement will have direct impact on both sets of statements.

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Inventories do carry high risk of loss in value through pilferage, theft or expiry as such proper accounting is necessary to minimize such risk.

END OF CHAPTER QUESTIONS

1. Tutorial questions

a) Define inventory?

b) Explain the three types of inventory valuation how they work and and the valuation of closing inventory.

c) What are the advantages of using FIFO valuation method over LIFO.

2. Exam style question

The inventories records for Dziko limited which sells wrist watches for the month of October 2010 was as follows;

1 October	Balance brought forward	70 units at K700 each
2 October	Sold	10 units at K1,200 each
5 October	Sold	40 units at K1,200 each
10 October	Purchased	50 units at K750 each
15 October	Purchased	30 units at K820 each
20 October	Sold	90 units at K1,200 each
25 October	Purchased	40 units at K800 each
30 October	Sold	20 units at K1,200 each

Required:

Outline three advantages of using FIFO in inventory valuation **3 marks**

From the information provided above, compute the value of closing inventories using First In First Out (FIFO) method **12 marks**

Prepare the trading accounts for the months of October 2010 **5 marks**

List any two categories for inventories found in manufacturing accounts. **2 marks**

TOTAL: 20 MARKS

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CHAPTER 10: LEASE ACCOUNTING

LEARNING OBJECTIVE

The objective of this topic is to:

- Define a lease and differentiate variance types of leases
- Prescribe the accounting treatment of leases
- The disclosures necessary for a lease

10.1 INTRODUCTION TO LEASE ACCOUNTING

There are two types of leases which are finance lease and operating lease. The main difference between the two is the time limit attached to each type of a lease. The finance lease is like buying the asset outright while as the operating lease is similar to normal rent.

Lease accounting is based on IAS 17.

IAS 17 applies to all leases other than lease agreements for minerals, oil, natural gas, and similar regenerative resources and licensing agreements for films, videos, plays, manuscripts, patents, copyrights, and similar items.

IAS 17 does not apply to:

- property held by lessees that is accounted for as investment property for which the lessee uses the fair value model set out in IAS 40
- investment property provided by lessors under operating leases (IAS 40)
- biological assets held by lessees under finance leases (IAS 41)
- biological assets provided by lessors under operating leases (IAS 41)

10.2 CLASSIFICATION OF LEASES

A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. All other leases are classified as operating leases.

Classification is made at the inception of the lease.

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form. Situations that would normally lead to a lease being classified as a finance lease include the following:

i. the lease transfers ownership of the asset to the lessee by the end of the lease term
ii. the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised
iii. the lease term is for the major part of the economic life of the asset, even if title is not transferred
iv. at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset
v. the lease assets are of a specialized nature such that only the lessee can use them without major modifications being made

Other situations that might also lead to classification as a finance lease are:

i. if the lessee is entitled to cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee
ii. gains or losses from fluctuations in the fair value of the residual fall to the lessee (for example, by means of a rebate of lease payments)
iii. the lessee has the ability to continue to lease for a secondary period at a rent that is substantially lower than market rent

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In classifying a lease of land and buildings, land and buildings elements would normally be separately. The minimum lease payments are allocated between the land and buildings elements in proportion to their relative fair values. The land element is normally classified as an operating lease unless title passes to the lessee at the end of the lease term. The buildings element is classified as an operating or finance lease by applying the classification criteria in IAS 17. However, separate measurement of the land and buildings elements is not required if the lessee's interest in both land and buildings is classified as an investment property in accordance with IAS 40 and the fair value model is adopted.

10.3 ACCOUNTING BY LESSEES

The following principles should be applied in the financial statements of lessees:

- At commencement of the lease term, finance leases should be recorded as an asset and a liability at the lower of the fair value of the asset and the present value of the minimum lease payments (discounted at the interest rate implicit in the lease, if practicable, or else at the entity's incremental borrowing rate).
- Finance lease payments should be apportioned between the finance charge and the reduction of the outstanding liability (the finance charge to be allocated so as to produce a constant periodic rate of interest on the remaining balance of the liability)
- The depreciation policy for assets held under finance leases should be consistent with that for owned assets. If there is no reasonable certainty that the lessee will obtain ownership at the end of the lease - the asset should be depreciated over the shorter of the lease term or the life of the asset.

Example on accounting for a finance lease

On 1 January 2008 Chawaka ltd bought a small machine for juice bottling from Mulanje ltd under a finance lease agreement. The cash price of the machine was MK771,000.00 while the amount to be paid under the lease agreement was MK1,000,000.00. The agreement required the immediate payment of MK200,000.00 deposit and with the balance being settled in four equal installments commencing on 31st December 2008. The

charge of MK229,000.00 represents interest of 15% per annum, calculated on the remaining balance of the liability during each accounting period. Depreciation on the plant is to be provided at the rate of 20% per annum on a straight line assuming a residual value of nil.

Solution

Interest is calculated at the end of each year of 15%.

Thus the total cash price being		771,000.00	
Less down payment		(200,000.00)	
		571,000.00	
Interest at 15%		85,650.00	
Instalment on 31st December 2008		(200,000.00)	
Closing balance		456,650.00	
interest at 15%		68,497.50	
Payment on 31st December 2009		(200,000.00)	
closing balance 31st December 2009		325,147.50	
interest at 15%		48,772.13	
Payment on 31st December 2010		(200,000.00)	
Closing balance 31st December 2010		173,919.63	
interest at 15% on 31st December 2011		26,087.94	
Payment 31st December 2011		(200,000.00)	
		7.57	

The double entry for the above transactions in the lessees books will be as follows:

Non Current Asset account is debited with the cash price of the asset and not the total repayment due to the lessor. i.e at K771,000 and not K1,000,000

		MK			MK
1-Jan-08	Mulanje	771,000			

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		Mulanje Ltd			
1-Jan-08	Bank	200,000.00	1-Jan-08	Non Current Asse	771,000.00
31-Dec. 08	Bank	200,000.00			
31-Dec. 08	Bal. C/d	456,650.00	31-Dec.08	Interest	85,650.00
		856,650.00			856,650.00
31-Dec. 09	Bank	200,000.00	1-Jan.09	Bal. Bd	456,650.00
31-Dec. 09	Bal. C/d	325,147.50	31-Dec.09	Interest	68,497.50
		525,147.50			525,147.50
31-Dec. 10	Bank	200,000.00	1-Jan. 10	Bal. B/d	325,147.50
31-Dec. 10	Bal. C/d	173,919.63	31-Dec. 10	Interest	48,772.13
		373,919.63			373,919.63
31-Dec. 11	Bank	200,000.00	1-Jan. 11	Bal. B/d	173,919.63
31-Dec. 11	Bal. C/d	7.57	31-Dec. 11	Interest	26,087.94
		200,007.57			200,007.57

		Interest Account			
31-Dec-08	Mulanje	85,650.00	31-Dec-08	Income Statement	85,650.00
		85,650.00			85,650.00
31-Dec-09	Mulanje	68,497.50	31-Dec-09	Income Statement	68,497.50
		68,497.50			68,497.50
31-Dec-10	Mulanje	48,772.13	31-Dec-10	Income Statement	48,772.13
		48,772.13			48,772.13
31-Dec-11	Mulanje	26,087.94	31-Dec-11	Income Statement	26,087.94
		26,087.94			26,087.94

Statement of financial Position as at 31st Dec.2008 (Extracts)

Assets held under finance leases

Machinery at Cost	MK771,000	
Less Depreciation at 20%	(MK154,200)	MK616,800

Non- current liabilities

Obligation under finance lease MK325,147.50 (456,650.00-131,502.50)

Current liabilities

Obligation under finance leases MK131,502.50 (200,000-68,497.50)

For operating leases, the lease payments should be recognized as an expense in the income statement over the lease term on a straight-line basis, unless another systematic basis is more representative of the time pattern of the user's benefit

Incentives for the agreement of a new or renewed operating lease should be recognized by the lessee as a reduction of the rental expense over the lease term, irrespective of the incentive's nature or form, or the timing of payments.

10.4 ACCOUNTING BY LESSORS

a) Operating lease

Under operating lease, the lessor will account for lease rentals as income in profit or loss account.

At the end of financial year, the lessor will recognize as an asset for any rentals not yet paid by the lessee and where the lessee has paid rentals in advance for the following year or years such advance receipt is treated as liability.

Example

Apex car hire has leased a new motor vehicle to DYG Construction company on 1st January 2013. The lease is for two years. The cost of the vehicle was K900,000 and has a useful economic life of 5 years. The lease agreement is to pay annual rentals of K250,000.

DYG paid K300,000 for the 2013 rentals and the balance was part payment for the 2014 rentals.

NOT FOR SALE

Solution.

In Statement of profit or loss Apex Car hire at 31st December 2013

Operating income	
Lease rentals	K250,000
In statement of financial position as at 31st December 2013	
Current liabilities	
Lease rentals received in advance	K50,000
(Annual rental should be K250,000 but Apex received K300,000)	

b) Finance lease

The following principles should be applied in the financial statements of lessors:

- The asset should be removed from the book of the lessor and recognised as an asset in the book of the lessee as outlined above.
- At commencement of the lease term, the lessor should record a finance lease in the Statement of Financial Position as a receivable, at an amount equal to the net investment in the lease. i.e. the equivalent of the fair value of the asset less any deposit received.
- The lessor should recognize finance income based on a pattern reflecting a constant periodic rate of return on the lessor's net investment outstanding in respect of the finance lease.
- The lessor should include selling profit or loss in the same period as they would for an outright sale. If artificially low rates of interest are charged, selling profit should be restricted to that which would apply if a commercial rate of interest were charged.
- Initial direct and incremental costs incurred by lessors in negotiating leases must be recognized over the lease term. This treatment does not apply to manufacturer or

dealer lessors where such cost recognition is as an expense when the selling profit is recognized.

Example

Based on the example under 10:3 on financial lease for Chawaka.
For ease of reference it is reproduced here.

On 1 January 2008 Chawaka ltd bought a small machine for juice bottling from Mulanje ltd under a finance lease agreement. The cash price of the machine was MK771,000.00 while the amount to be paid under the lease agreement was MK1,000,000.00. The agreement required the immediate payment of MK200,000.00 deposit and with the balance being settled in four equal installments commencing on 31st December 2008.

The charge of MK229,000.00 represents interest of 15% per annum, calculated on the remaining balance of the liability during each accounting period. Depreciation on the plant is to be provided at the rate of 20% per annum on a straight line assuming a residual value of nil.

If the cost of the machine to Mulanje Ltd was K600,000

Solution

Mulanje limited will have to remove the asset in its books of accounts and realize profit in 2008.

Profit realized out of the transaction will be;

NOT FOR SALE

Selling price	K771,000
Less: Cost of the machine	600,000
Profit	K171,000

Mulanje Ltd will also have to recognize the selling price (K771,000) as investment in this lease as an asset and this will be accounted over the duration of the lease life.

i.e. Dr	Investment in Lease	K771,000	
Cr	Sales		K771,000

The interest payable by Chawaka Ltd will be treated as investment income in Mulanje Ltd accounts and will be computed as follows;

Thus the total cash price being		771,000.00	
Less down payment		(200,000.00)	
		571,000.00	
Interest at 15%		85,650.00	
Instalment on 31st December 2008		(200,000.00)	
Closing balance		456,650.00	
interest at 15%		68,497.50	
Payment on 31st December 2009		(200,000.00)	
closing balance 31st December 2009		325,147.50	
interest at 15%		48,772.13	
Payment on 31st December 2010		(200,000.00)	
Closing balance 31st December 2010		173,919.63	
interest at 15% on 31st December 2011		26,087.94	
Payment 31st December 2011		(200,000.00)	
		7.57	

The interest element will be included as investment income in profit or loss account while annual balances in the investment in lease will be recognized under assets in

Statement of financial position.

Entries in the Investment in Lease account will be as follows;

Investment in Lease account

Jan 08	Asset disposal a/c	771,000	Jan 08	Bank	200,000
			Dec 08	Bank	200,000
Dec 08	Interest income	85,650	Dec 08	Balance c/d	456,650
		856,650			856,650
Jan 09	Balance b/f	456,650	Dec 09	Bank	200,000
Dec 09	Interest income	68,498	Dec 09	Balance c/d	325,148
		525,148			525,148
Jan 10	Balance b/f	325,148	Dec 10	Bank	200,000
Dec 10	Interest income	48,772	Dec 10	Balance c/d	172,920
		373,920			372,920
Jan 11	Balance b/f	172,920	Dec 11	Bank	200,000
Dec 11	Interest income	26,080			
		200,000			**200,000**

At every year end, the balance c/d figures in the Investment in lease account will be recognized as assets in Statement of Financial position while the interest income will be recognized in profit or loss account.

10.5 SALE AND LEASEBACK TRANSACTIONS

For a sale and leaseback transaction that results in a finance lease, any excess of proceeds over the carrying amount (profit) is deferred and amortized over the lease term.

For a transaction that results in an operating lease:

- If the transaction is clearly carried out at fair value - the profit or loss should be recognized immediately

NOT FOR SALE

- If the sale price is below fair value - profit or loss should be recognized immediately, except if a loss is compensated for by future rentals at below market price, then the loss should be amortized over the period of use
- If the sale price is above fair value - the excess over fair value should be deferred and amortized over the period of use
- If the fair value at the time of the transaction is less than the carrying amount - a loss equal to the difference should be recognized immediately.

For transaction that results in operating lease;

- The asset should still remain in the book of the seller since now the seller has become the lessee and in accordance with lease accounting the asset under finance lease in recognized in the book of the lessee.
- The asset is recognized at fair value so any difference between the fair value and the carrying amount should not be recognized as profit but rather recognized as a revaluation surplus.

10.6 DISCLOSURE REQUIREMENTS

a) Lessee – Finance lease

- Carrying amount of asset
- Reconciliation between total minimum lease payments and their present value
- Amounts of minimum lease payments at financial Position's date and the present value thereof, for:
    - the next year
    - years 2 through 5 combined
    - beyond five years
- Contingent rent recognized as an expense
- Total future minimum sublease income under non-cancellable subleases
- General description of significant leasing arrangements, including contingent rent provisions, renewal or purchase options, and restrictions imposed on dividends, borrowings, or further leasing

b) *Lessees - Operating Lease*

- Amounts of minimum lease payments at balance sheet date under non-cancellable operating leases for:
  - the next year
  - years 2 through 5 combined
  - beyond five years
- Total future minimum sublease income under non-cancellable subleases
- Lease and sublease payments recognized in income for the period
- Contingent rent recognized as an expense
- General description of significant leasing arrangements, including contingent rent provisions, renewal or purchase options, and restrictions imposed on dividends, borrowings, or further leasing

c) *Lessors - Finance Lease*

- Reconciliation between gross investment in the lease and the present value of minimum lease payments;
- Gross investment and present value of minimum lease payments receivable for:
  - the next year
  - years 2 through 5 combined
  - beyond five years
- Unearned finance income
- Unguaranteed residual values
- Accumulated allowance for uncollectible lease payments receivable
- Contingent rent recognized in income
- General description of significant leasing arrangements

d) *Lessors - Operating Lease*

- Amounts of minimum lease payments at balance sheet date under non-cancellable operating leases in the aggregate and for:

NOT FOR SALE

- the next year
- years 2 through 5 combined
- beyond five years

- Contingent rent recognized as in income
- General description of significant leasing arrangements

10.7 CONCLUSION

Lease accounting is one of complex accounting transactions especially when looking at aspects of sale and lease back.

When looking at accounting for lease, the issue of risk and benefits is crucial, always remember that an entity which bears the risk of an asset but also reap from economic benefits arising from the asset should account for such an asset regardless of the legal implications.

END OF CHAPTER QUESTION

1. Tutorial questions

a) What is a lease?

b) What is the difference between operating and finance lease?

c) P. co entered into a fiancé lease with M. co. on the motor Vehicle which cost MK1,800,000.00 on 1 January 2010.The agreement entails that P. Co should make a down payment of MK300,000.00 on the same day followed by two installments of MK800,000 on 31st December 2010, 31st December 2011and a final payment MK679,700 on 31st December 2012. Interest rate is calculated at 25% on the balance outstanding.

Depreciation is charged over 4 years on a straight line basis

Required

Show the entries in the Statement of profit or loss and statement of financial Position for the year ending 31st December 2010, 2011 and 2012.

2. Exam style question

Plant and machinery with a useful life of 5 years may be purchased outright for cash for K6,070,000 or obtained on finance lease arrangement. Under the arrangement, the lessee would be required to make five annual payments of K1,941,051 in arrears. Implied annual interest rate for this transaction was agreed at is 18%.

Required:

(i) Using actuarial method, calculate the annual finance charges over the period of lease agreement. **6½ Marks**

(ii) Prepare the account of the lease arrangement over the period in the books of the lessee. **5 Marks**

NOT FOR SALE

CHAPTER 11: AGRICULTURE

LEARNING OBJECTIVES

The objective of this chapter is to:

- Define Agricultural asset
- Account for Inventories
- Disclosure requirements for Agricultural Asset

11.1 AGRICULTURAL ACTIVITIES

Malawi is a country which depends on agriculture for its survival. The country has not taken positive strive on how to account for agricultural assets. Agricultural activities are distinguished by the fact that management facilitates and manages biological transformation and is capable of measuring the change in the quality and quantity of biological assets. Management of biological transformation normally takes the form of activity to enhance, or at least stabilize, the conditions necessary for the process of growth, degeneration, production and procreation that cause qualitative or quantitative changes in a biological asset to take place.

Examples of agricultural activity include:

• Raising livestock, fish or poultry
• Stud farms (for example, breeding horses or cattle)
• Forestry
• Cultivating vineyards, orchards or plantations
• Floriculture

Harvesting biological assets from unmanaged sources, such as ocean fishing, is not agricultural activity. Managing the growth of fish for subsequent slaughter or sale is agricultural activity within the scope of IAS 41.

11.2 BIOLOGICAL TRANSFORMATION?

Biological transformation is a natural change in a biological asset. It includes growth of living animals or plants, reduction in output due to age or disease and the production of new biological assets through a managed reproductive programme.

Biological assets include the following.

- Sheep, pigs, beef cattle, poultry and fish.
- Dairy cows.
- Trees in a forest.
- Plants for harvest (for example, wheat and vegetables).
- Trees, plants and bushes from which agricultural produce is harvested (for example, fruit trees, vines and tea bushes).

The produce or harvest from a biological asset (for example, milk, tea leaves and lumber) is inventory. The harvested produce is transferred to inventory at fair value less costs to sell; it is thereafter accounted for in accordance with IAS 2, 'Inventories'.

However, while the produce is still growing or still attached to the biological asset, its value forms part of the value of the biological asset.

11.3 REVENUE AND INCOME RECOGNITION

IAS 41 has two income generating activities which affect the financial statements.

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i) Revenue from sale of biological assets or produce

The sale of agricultural produce or biological asset is clearly revenue as defined by IAS 18, 'Revenue'. Revenue comprises the fair value of the consideration received or receivable only for the sale of agricultural produce and/or biological assets. It is stated net of sales taxes, rebates and discounts. IAS 18 specifically scopes out revenue arising from changes in fair value and initial.

ii) Movement in biological asset

There are usually movement in biological asset attributable to increase in changes in fair value of the assets and the other attributable to movement physical changes to the asset due to growth of the biological asset.

Changes in fair value less costs to sell of biological assets represent the difference in value from period to period, normally on an aggregated basis. It is therefore sometimes difficult to distinguish from the initial gain due to procreation. The value typically increases due to growth, procreation and higher prices, but may decrease due to degeneration, sickness and lower prices.

11.4 RECOGNITION AND MEASUREMENT

Land owned by the entity and used for agricultural activity is subject to the recognition and measurement principles of IAS 16, 'Property, plant and equipment'. Land owned by a third party and rented to the entity for the purposes of agricultural activity is likely to be the third party's investment property and is accounted for in

a) Initial recognition

IAS 41 requires biological assets to be measured on initial recognition and at each balance sheet date at their fair value less costs to sell, except in limited circumstances. The current definition of fair value in IAS 41 is the amount for which the asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. It represents a market price for the asset based on current expectations.

There are two occasions where the standard permits departure from current fair value: at the early stage of an asset's life; and when fair value cannot be measured reliably on initial recognition.

In the event that the estimate of its fair value is deemed to be clearly unreliable, that biological asset is measured at its cost less any accumulated depreciation and any accumulated impairment losses [IAS 41 para 30]. Note that determining whether an asset is impaired requires an estimate of its value.

As the exemption is only available on initial recognition, to rebut the presumption an existing preparer must either have been gifted an asset that cannot be valued or be able to demonstrate that the price paid for the asset was not an arm's length market price. A first-time adopter can only use this exemption until such time as the asset has a market price or can be valued using a valuation technique. Once the biological asset has been fair valued, the cost model no longer applies.

b) Subsequent measurement

The most important feature of biological asset is that after initial recognition, the asset changes in its physical structure. Apart from changes in their structure,

NOT FOR SALE

biological assets have the capacity for reproduction and increase in value. This usually causes headache to the accounting treatment of the assets.

Example

A farmer had one cow at the beginning of a financial year which weighed 120 kgs, the cow had a calf during the year and at the end of financial year, the cow is now weighing 160 kgs. One kilogram of beef was at K500 at the beginning of the year and is now at K640.

In this situation, the farmer will have to consider the change is weight of the animal during the year, the young calf born during the year and the changes in market value of the animal.

IAS 41 requires that subsequent measurement for biological assets should be at fair value i.e. at market value if it can reliably be determined less cost attributable to sale. The movement in value of the biological asset can be attributed to changes in physical substance and movement in fair value less cost to sale though this separation is not compulsory.

The changes in value for the biological assets should be recognized to profit or loss.

For example, with the cow mentioned above, accounting will be as follows;

Value as at the beginning of financial year (120 x 500)	K 60,000
Value as at the end of the year (160 x 640)	102,400
Movement during the year	42,400
Attributable to physical change	
(160 – 120) x 500	20,000

Attributable to fair value

(640- 500) x 160 22,400

11.5 AGRICULTURE PRODUCE

Agriculture produce are harvested biological assets ready for sale or for further processing into other products. While most biological assets are recognized as non-current assets, agriculture produce are considered as current assets unless otherwise stated that they will have to be kept for more than one accounting year.i.e. Wine.

Agriculture produce are measured initially at fair value less cost to sale at the time of harvesting. After recognition, the agriculture produce is treated same as any other inventory. The amount recognized will be adjusted for any impairment loss recognized.

Example

A farmer harvested 150 50kg bags of maize in April 2013 when maize was selling at K90 per kg. As at the end of financial year, 30th September 2013 all bags were still in warehouse and maize was selling at K120 per kg.

April 2013	Agriculture produce (150 x 50 x 90)	675,000
September 2013	Market value (150 x 50 x 120)	900,000

But since Agriculture produce are accounted just as inventories, the entity will have to recognize the produce at K675,000 which is recognized as its original cost.

NOT FOR SALE

11.6 OTHER STANDARD CONSIDERATIONS

a) Land for agriculture activity

Land which is used for agriculture product should be measured in a normal way just like any other land and the applicable standard should be IAS 16 and not IAS 41.

b) Contract farming

Some farmers do enter into contract farming whereby a price is already fixed when the produce is still at the farm. The standard recommend that even in such situation, the farmer should value biological assets and subsequently agriculture produce at fair value less estimated costs at the point of sale. The understanding is that the contracted price may not be at arm's length as such it will not be an ideal measurement value.

c) Government grant

When the farmer has been promised government grant to finance the production of biological assets, such grant should be recognized as income only when the farmer has satisfied all conditions pertaining to the grant.

Grant should be recognized as income over the period at which the biological asset is going to remain with the farmer.

d) Intangible assets

Any intangible asset attributable to the agriculture activity like trade rights, licences should be accounted in accordance with IAS 38 on intangible assets.

11.7 PRESENTATION OF BIOLOGICAL ASSETS

Biological assets are supposed to be separately presented in balance sheet under non-current assets while agriculture produce should be presented under current assets unless if they have a life more than one year.

Example

A Farmer had 20 cows at average weight of 140 kgs the beginning of the year when the fair value less cost to sale was K500 per kg. During the year 5 calves were born. The estimated fair value less cost to sale at the time of birth of each calf was K550. On average each calf weighed 10 kgs at birth. On average each cow produce 10 litres of milk every day and the fair value less cost to sale for the milk is K20 per litre.

At the end of the year the fair value less cost to sale for the cow was K600 per kg. Each cow weigh 160 kg while the calf now weigh 30 kgs.

Solution

Statement of Comprehensive income

	Mk
Fair value of milk produced (10 x 365 x K20)	730,000
Gain arising from changes in fair value of animals	582,500

Statement of Financial Position

Non-Current assets

Dairy livestock – immature (30kgs x 5 x K600)	90,000
Dairy livestock – mature (160 kgs x 20 x K600)	1,920,000
Total biological assets	2,010,000

Working

Movement in fair value less cost to sale of cows

	Mature	Calf
Closing values	1,920,000	90,000
Value at beginning		

NOT FOR SALE

Mature (140kgs x 20 x 500)	(1,400,000)	
Calf (10kgs x 5 x 550)		(27,500)
Fair value movement	520,000	62,500

11.8 DICLOSURE REQUIREMENTS

At the end of the financial year, the entity is supposed to disclose;

- accounting policy adopted for biological assets and agriculture produce
- carrying value of biological assets at the balance sheet date
- the movement in fair value less cost to sale for biological assets, where possible separately indicating movement due to physical changes and movement due to changes in fair value
- Amount recognized during the year as income
- Carrying value of agriculture produce as at the end of the year.

11.9 CONCLUSION

Biological assets have different features from the rest of other assets in that they are capable of reproduction but also changes in physical substance. The most important aspect is to remember that these are assets just like any other assets such as land, building or motor vehicle as such the recognition criteria remains the same, and the only difference is the measurement aspect. Instead of the normal, cost less depreciation measurement, biological assets are supposed to be measured at fair value.

END OF CHAPTER QUESTIONS

1. Tutorial questions

a) Define the term 'biological asset'?

b) What is the difference between biological asset and agriculture produce?

c) What is the difference between 'bearer' and 'consumables' under biological assets?

2. Exam style question.

Mapanga Diary produces milk for supply to various customers in Blantyre and surrounding towns**.** The farm has 4,000 cows and 1,500 heifers which are being raised to produce milk in future. The farm expects to produce 800,000 litres of milk per annum and milk inventory as at 1st January 2013 was 5,000 litres.

The herd as at 1st January 2013 comprised of;

4,000	3 year old cows
1,000	heifer (average 1 year old)
500	heifer (average 2 year)

The estimated price per animal based on estimated sales less point of sales costs were as follows;

	January 2013	December 2013
1 year old animal	K40,000	K46,000
2 year old animal	K60,000	K72,000
3 year old animal	K75,000	K82,000
4 year old animal	K90,000	K98,000

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During the year, the farm produced 820,000 litres of milk and sold 812,000 litres. The price of milk as at 1st January was K20 per litre and the average price selling price during the year was K25 per litre.

There were no animals born, sold or dead during the year.

Required;

a) Prepare the entries for the statement of profit or loss for Mapanga farm

8 Marks

b) Prepare the extract for the statement of financial position and include disclosure showing clearly the movement in animal value separating value attributable to physical growth and value attributable to change in estimated fair value less cost to sale.

12 marks

TOTAL: 20 MARKS

CHAPTER 12: ISSUE AND REDEMPTION OF SHARES AND DEBENTURE

LEARNING OBJECTIVES

The objective of this chapter is to:

- Describe the accounting treatment for issuing of shares and debentures
- Describe the processes of the redemption of shares and debentures.

12.1 SHARE CAPITAL

Share capital is the capital structure for limited company whereby

Share capital refers to the portion of a company's equity that has been obtained (or will be obtained) by trading stock to a shareholder for cash or an equivalent item of capital value. For example, a company can issue shares in exchange for computer servers, instead of purchasing the servers with cash.

Funds raised by issuing shares in return for cash or other considerations. The amount of share capital a company has can change over time because each time a business sells new shares to the public in exchange for cash, the amount of share capital will increase. Share capital can be composed of both common and preferred shares.

The following are important terms when looking at share capital.

a) Authorized share capital

The maximum number of shares a company is allowed by its articles of association to issue.

b) Issued share capital

The actual number of shares which have been issued by the company and are taken or available to the shareholders.

i.e. The articles of association allows the company to have a maximum of 2,000,000 K1 shares. The company however has started its operations by offering 1,500,000 shares.

In this case, the authorized share capital is K2,000,000 and the K1,500,000 is the issued share capital.

12.2 TYPES OF SHARE CAPITAL

The common types of shares are the ordinary and preference shares.

a) **Ordinary shares**

Ordinary shares are shares which are held by those considered as the owners of the business as such they rank last in dividend distribution and the sharing of liquidation proceeds.

Ordinary shareholders being the owners of the business have the mandate to appoint directors of the business. Dividend due to the shareholders is proposed by directors and is not always certain in addition these shareholders do not have the right to carry forward any unpaid dividend.

The ordinary shares are considered as very risky due to uncertainties in the determination of dividend.

NOT FOR SALE

b) **Preference shares**

Preference shares carries a predetermined dividend rate and rank ahead of ordinary shares in terms of dividend and liquidation distribution.

Preference shares may be redeemable or irredeemable. Redeemable preference shares has a specific period after which the holder will be paid off the value of shares held and will no longer become a shareholder. Irredeemable preference shares have no term limit and are expected to be held to eternity.

Apart from a having predetermined dividend rate, the preference shares do have right to carry forward any unpaid divided for the year (i.e. Cumulative preference shares). Those with no right to carry forward any unpaid dividend are call un cumulative preference shares.

Example

The company has the following capital structure;

1,000,000 K1 Ordinary shares	K1,000,000
500,000 K1.50 8% preference shares	750,000
Total	K1,750,000

Consider the dividend distributable if the profit due to shareholders is;
K40,000
K70,000
K300,000

Solution

Profit levels	K40,000	K70,000	K300,000
Preference dividend	K40,000	K60,000	60,000
	0	10,000	240,000
Ordinary dividend	0	(10,000)	(240,000)

As can be seen above, the amount to preference shareholders is always certain except in the year where profit is insufficient. In the years where the company makes more profits, the ordinary share holder will be benefit from high dividend payout.

12.3 ISSUE OF SHARES

Companies can issue or redeem shares at any time the wish as long as this is allowed by their memorandum and articles of association. A limited liability company is registered with the registrar of companies and the registration spells out the total number of shares that can be issued by the company. This amount of shares is known as authorized share capital. However, it may not be able to issue the whole of this share capital at once. Shares can also be redeemed or repurchased. The process repurchasing is the same as that of redemption. However, the two are not the same. Repurchase means shares were issued with no intention to buy the back while as redemption means share were issues with an intention to be bought back.

Shares are usually traded on a market which is called a stock exchange. In Malawi, it is called the Malawi Stock Exchange. The advantages and disadvantages of issuing shares through a stock exchange are as follows;

NOT FOR SALE

Advantages	Disadvantages
The company has a chance to raise more capital for the business	There costs which the company has to pay before selling its shares on the market
The profile/ status of the company is raised when selling shares on the market	There are rigorous financial reporting requirements on the stock market
Shares are easy to transfer between investors without the affecting the operations of the business	Where more shares are floated, there are risk of business take over
Shares traded on the market can easily be used as consideration in business take overs	There is more exposure on the operations of the business since financial statements are readily available to the public.

A limited liability company can issue shares at par or at premium or at discount.

a) Issue of share at par

This is where shares are issued at their face value (nominal values).

e.g. 1,000 K1 shares issued at K1 each

The double entry will be;

Dr. Bank	K1,000	
Cr. Share Capital		K1,000

b) Issue of shares at a premium

This is where shares are issued at a price higher than its face value. This usual entails that the company shares are more attractive than what is quoted on face value.

e.g. 1,000 K1 shares issued at K1.20

Here the company is supposed to open two accounts, one for the share capital and another to account for the share premium.

The double entry is there as follows;

Dr.	Bank	K1,200	
Cr.	Share capital		K1,000
Cr.	Share premium		200

c) Issue of shares at a discount

This is where shares are sold at a value at less than their nominal value. i.e. where K1 shares are sold at K0.80.

This is not allowed by Companies Act.

The issue of shares has an impact to the Statement of Financial Position and not the Statement of profit or loss.

NOT FOR SALE

Example

A company had decided to issue K1, 25,000 new shares at par for cash. The company before this transaction had its financial position as follows:

P's financial Position as at 1.1.2012	
Non current assets	
Buildings	40,000.00
Current assets	35,000.00
	75,000.00
Capital and reserves	
ordinary shares of MK1.00 each	60,000.00
Reserves	15,000.00
	75,000.00

Prepare P's financial position after issuing new shares.

Solution

Since the company issues the capital for cash, then current assets will increase and the same amount will increase share capital.

P's financial position after the issuing of shares	
Non current assets	
Buildings	40,000.00
Current assets	60,000.00
	100,000.00
Ordinary share capital of MK1.00 each	85,000.00
Reserves	15,000.00
	100,000.00

Issuing shares at a premium

In the example above, if the company issued the shares at MK1.35 each. Prepare the financial position.

Solution

P's Financial Position	
Buildings	40,000.00
Current assets	68,750.00
	108,750.00
Ordinary shares of MK1.00 each	85,000.00
share premium	8,750.00
reserves	15,000.00
	108,750.00

12.4 SHARES ISSUED THROUGH INSTALLMENTS

More often than not, payments of shares will be done in installments. If this is done, the accounting entries are supposed to capture such issues. The accounts affected will be as follows:

a) Application fees – this is required from all applicants for the applications which have been made. The aim is to ensure that only serious investors are allowed to apply for the shares.

b) Allotment fees – Not all applications can be successful as sometimes the entity can receive more application than the required number of shares. Allotment involves the assignment of shares to various applicants. The basis can be on first application basis, proportionate to number of shares applied or on the basis of previous holding.

NOT FOR SALE

i.e. The company has received 200,000 applications when it requires 150,000 shares.

The allotment basis can be;

i) If the company decides to allot 50,000 to an Institutional investor and allocate the remainder on 2 shares for every three applied.

ii) Allocate all the shares on equal basis on the ratio of 3 for every 4 applied

c) First call- The issuing company can decide to allow the investors to settle for their shares in instalment. Depending on the share price, the entity can allow the investors to make such payments over many stages. So there can be first call, second call and many other calls as it may be decided.

Example

A company has issued 200,000 ordinary shares with nominal value of MK 1.50 each for K2.00 each and requested that payments should be made as follows:

20% on application	K0.40
20% on allotment	K0.40
25% on first call	K0.50
35% on second (including premium of K0.50)	K0.70

There were 230,000 applications and the all paid the application fee. The company refunded application fees for those who were not allotted shares.

Show the accounting treatment for the transactions

Solution:

The following will be the accounting entries

First call	100,000.00		
Second call	140,000.00	Balance c/d	400,000.00
	412,000.00		412,000.00

Application and allottment account

Bank - refund	12,000.00	Bank account	92,000.00
Ordinary share capital	160,000.00	Bank account	80,000.00
	172,000.00		172,000.00

First call account

Ord. share capital	100,000.00	Bank	100,000.00

Second call account

Ordinary share capital	40,000.00	Bank	140,000.00
Share premium	100,000.00		
	140,000.00		140,000.00

Ordinary share capital account

		Application and allottment	160,000.00
		Ord. share captital	100,000.00
Balance c/d	800,000.00	Second call	40,000.00
	800,000.00		300,000.00

Openning financial Position

Bank	400,000.00
	400,000.00
Ordinary share capital	300,000.00
Share Premium	100,000.00
	400,000.00

12.5 FORFEITED SHARES

These are shares which the shareholders have failed to pay for them. If say the shareholders were asked to pay on application a certain amount of money and they fail to pay on the first call, the company has the right to forfeit the shares and may be issue them again to someone else if the articles of association accept. In this case, the amount issued again at can be less than the face value of the share capital but the addition of the current price and the previous forfeited price should not be less than the face value. Otherwise, the shares may have been issued at a discount.

In the example for issue of shares above, Chigo the holder of 8,000 shares has failed to pay for the second call. The company has done all what it could to collect the monies and failed. The company has used the articles of association to forfeit the shares from Chigo and reissued to Chipo at a K1.00 each. Account for the forfeiture.

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Bank account

Application	92,000.00	Application and allott. Refund	12,000.00
Allotment	80,000.00		
First call	100,000.00		
Second call	134,400.00		
Forfeiture acc	-	Balance c/d	394,400.00
	406,400.00		406,400.00

Application and allottment account

Bank - refund	24,000.00	Bank account	92,000.00
Ordinary share capital	160,000.00	Bank account	80,000.00
	184,000.00		172,000.00

First call account

Ord. share capital	100,000.00	Bank	100,000.00

Second call account

Ordinary share capital	40,000.00	Bank	134,400.00
Share premium	100,000.00	Forfeiture ac.	5,600.00

Ordinary share capital account

forfeiture acc	12,000.00	Application	160,000.00
		Ord. share captital	100,000.00
Balance c/d	288,000.00	Second call	40,000.00
	300,000.00		300,000.00
		bal b/d	288,000.00
Bal c/d	300,000.00	Chigo	12,000.00
	300,000.00		**300,000.00**

Fortfeiture acc

Second call ac	5,600.00	Ord. share cap	12,000.00
Chipo A/c -Discount	4,000.00		
Share premium	2,400.00		
	12,000.00		**12,000.00**

Chipo acc.

Ord. share capital	12,000.00	Bank	8,000.00
		forfeited shares(discou	4,000.00
		issue	
	12,000.00		**12,000.00**

12. 5 ISSUING OF DEBENTURES

Debentures are loans issued to individuals or companies. They carry a fixed interest rate. Normally when the company obtains a loan it is from one or two financial institutions while in debenture, the company is borrowing from the general public and potential lenders provide funds just as it is done in issue of shares.

The accounting entries for issuing debentures are the same as those for issuing shares. Unlike in shares where the issue allowed is either at par or at a premium, debentures can be issued at a discount. i.e. at a price less than the nominal value.

12.6 REDEMPTION OF SHARES

Shares can be redeemed when they were issued as redeemable shares. Otherwise if share were not issued as redeemable, then they have to be purchased. Thus purchasing share are those shares which were not issued with an intention of buying them back. For accounting purposes, it does not matter the accounting entries whether it is a purchase or redeemable.

Reasons why the company can opt to redeem its shares or debentures

- The shares or debentures were issued as redeemable and the redemption time has come
- The company would like to improve its financial position.i.e. where the company believes the shares are more than necessary.
- The company may want to buy out a dissident shareholder.
- The shares or debenture may be held by a deceased person and the beneficiaries have opted to cash out on the investment.
- Redemption can also be used as a means of utilizing excess cash. It is considered as a form of investment, the returns are the savings in dividend or denture interest.

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The following rules apply when a company is redeeming or purchasing its own shares. These rules are the company's act safe guard of protecting the share capital.

These are:

- Shares can only be redeemed or purchased if they are fully paid for
- Shares can be redeemed if there is a new issue of another type of shares
- If there is no new issue of shares or if the issue of shares does not provide enough cover for the redemption, then there should be enough profit reserves to be capitalized in the **capital redemption reserve account.** This capital redemption reserve is non distributable.
- If the share are redeemed at a premium which were not issued at a premium, then, the company must transfer an amount from the profit reserves to the credit of share purchase or redemption account.
- The company is not allowed to redeem all its shares.

Example

The company has decided to redeem MK120,000.00 worth of ordinary shares at par. To do this, the company has decided to issue 70,000 MK2.00 preferred shares at par. The company received 100,000 applications for the share and it issued only 70,000 and refunded the balance. The financial position before these transactions were as follows:

Financial position	
Property, plant and equipment	200,000.00
Bank	50,000.00
	250,000.00
Ordinary share capital	150,000.00
Reserves	100,000.00
	250,000.00

Prepare the journal entries for the company and revised financial position.

	Dr	Cr
Bank	200,000.00	
Pref. share applicants		200,000.00
recording receipt of monies		
Pref. share applicants	200,000.00	
Bank		60,000.00
Pref. share allotted		140,000.00
allottment of shares and refund of excess monies		
Ordinary shares	120,000.00	
ordinary shares redemption acc.		120,000.00
cancelling ordinary shares to be redeemed		
ordinary share redemption acc	120,000.00	
Bank		120,000.00
payment for the redeemed shares		

Financial position

Property, plant and equipment	200,000.00
Bank	70,000.00
	270,000.00
Ordinary share capital	30,000.00
Preferred shares	140,000.00
Reserves	100,000.00
	270,000.00

Example 2

The company has decided to redeem MK80, 000.00 worth of ordinary shares at par. There is no new issue to replace the shares. The financial position before these transactions was as follows:

Financial position

Property, plant and equipment	160,000.00
Bank	90,000.00
	250,000.00
Ordinary share capital	150,000.00
Reserves	100,000.00
	250,000.00

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Prepare the journal entries for the company and revised financial position.

to conform to campany's act		
ordinary shares	80,000.00	
bank		80,000.00
to cancell the ordinary shares to be redeemed		
Profit reserves	80,000.00	
Capital Redemption reserves		80,000.00

Financial position

Property, plant and equipment	160,000.00
Bank	10,000.00
	170,000.00
Ordinary share capital	70,000.00
Capital Redemption reserves	80,000.00
Reserves	20,000.00
	170,000.00

i) Redemption of shares at a Premium

As indicated above in rules number (d), an amount should be transferred from the profit or loss account to share redemption account.

Example:

The company has decided to redeem MK80, 000.00 worth of ordinary shares at a premium of 20%. These shares were originally issued at a par. There company is now issuing new 60,000 preferred shares of MK1.00. The financial position before these transactions was as follows:

Financial position	
Property, plant and equipment	160,000.00
Bank	90,000.00
	250,000.00
Ordinary share capital	150,000.00
Reserves	100,000.00
	250,000.00

Prepare the journal entries for the company and revised financial position.

Solution

The following are the accounting transactions:

	Dr	Cr
Bank	60,000.00	
Preferred shares acc		60,000.00
allocation of shares		
Profit or loss	20,000.00	
Capital redemption acc.		20,000.00
to record the difference between the issued share capital and the redeemed		
Profit or loss	16,000.00	
Ordinary shares redemption acc.		16,000.00
To record the premium of redemtion as shares were not issued at premium		
ordinary shares	80,000.00	
Ordinary shares redemption acc		80,000.00
to cancel the shares to be redeemed		
Ordinary shares redemption acc	96,000.00	
Bank		96,000.00
recording the paymeny of monies for redeemed share		

Financial position	
Property, plant and equipment	160,000.00
Bank	54,000.00
	214,000.00
Ordinary share capital	70,000.00
preferred shares	60,000.00
Capital redemption reserve	20,000.00
Reserves	64,000.00
	214,000.00

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ii) Redemption of share which were issued at a premium and there is a new issue at a premium

The share premium that can be transferred to share purchase account can be calculated as below:

Balance before new issue		XXX
Add: premium on new issue		XXX
Balance after new issue		XXX
Amounts that may be transferred is the lesser of:	**A**	
premium that was received on issue of redeemed shares	XXX	
Or		
Balance after new issue	XXX	
Transfer to share premium acc	**A**	(XXX)
New balance for financial position		XXX

Example

C&C Company wants to redeem its 50,000 ordinary shares of Mk1.00 each at a premium of 35%. These shares were originally issued at a premium of 30%. The company is issuing 20,000 new preferred shares of MK2.00 each at a premium of 20%.

Show the amount to be transferred to the share capital redemption account and the balance after these transactions if the current balance in share premium accounts is:

a) MK5,000.00 b) Mk10,000.00

Solution

	a		b	
balance b/d		5,000.00		10,000.00
add: Premium on new issue		8,000.00		8,000.00
		13,000.00		18,000.00
amount to be transferred lesser of				
premium on issue	15,000		15,000	
balance after new issue	13,000		18,000	
		(13,000.00)		-15000.00
		-		3,000.00

iii) Permissible share capital

Share capital can be allowed to be reduced to a certain amount if the reserves of the company are not sufficient to be to be transferred to capital redemption reserve. This reduction is known as permissible capital payment. This is included in the companies Act 1981 for private companies. However, for it to be allowed this, the following conditions must apply:

The private company must be authorised to redeem or purchase its own shares of capital by its Articles of Association.

The permissible capital is the amount which exceed the aggregate of (a) the company's distributable profit (b) the proceed of new issue

Directors must certify that after the permissible capital payment, the company will be able to carry on as a going concern during the next twelve months and be able to pay its debts immediately after they payment of permissible capital and in the next twelve months.

The company's directors make a satisfactory report.

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Example:

The company has decided to redeem MK80, 000.00 worth of ordinary shares at par. There company is now issuing new 20000 preferred shares of MK1.00. The financial position before these transactions was as follows:

Financial position	
Property, plant and equipment	160,000.00
Bank	90,000.00
	250,000.00
Ordinary share capital	200,000.00
Reserves	50,000.00
	250,000.00

Prepare the journal entries for the company and revised financial position. (highlight the permissible capital repayment)

	Dr	CR
Bank	20,000.00	
Preferred share applicants		20,000.00
receipt of monies on new issue		
Preferred share applicants	20,000.00	
Preferred share capital		20,000.00
allottment of shares		
ordinary shares	80,000.00	
Ordinary shares redemption acc		80,000.00
ordinary shares to be redeemed		
Reserves	50,000.00	
Ordinary share redemption acc.		50,000.00
to cover for the shortfall on the new issue		

	Dr	Cr
Ordinary shares redemption acc.	80,000.00	
Bank		80,000.00
Payment for the redeemed shares		

Notice that total shares to be redeemed are MK80000 while replacement is only MK20,000 and the reserves are MK50,000.00 this means it is insufficient to cover redemption hence MK10,000 (80000-(20000+50000)) is the permissible capital repayment

Financial Position

Non current assets	160,000.00
Current assets	30,000.00
	190,000.00
Ordinary shares	120,000.00
Preferred shares	20,000.00
Capital redemtion reserves	50,000.00
	190,000.00

12.6 REDEMPTION OF DEBENTURES

Debentures are loans which usually redeemable after some time. Unless they are issued as irredeemable debentures will be redeemed according to the terms agreed. The funds for financing redemption could be from:

An issue of shares or debentures for the purposes
The resources of the company

Since these are loans, their redemption does not necessarily need to be replaced by another issue of a different instrument neither does it need to transfer some amounts from Profit or Loss account. However, it has become a good accounting practice to transfer some amounts of profits to cover for the redemption in order to prevent the company from paying more dividends.

Redemption of debentures can be done in of the following ways

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By annual transfers of profits.

By purchase on the open market when the price is low.

In a lump sum to be provided by the accumulation of **sinking fund.**

Example 1

Zili Co. want to redeem $20,000 debentures which were issued long time ago. Zili co. has not its financial statement as below:

Zili co financial position as at 31st Dec. 2012

Non Current Assets	200,000.00
Current Assets	100,000.00
	300,000.00
Ordinary share capital	100,000.00
Profit or loss	100,000.00
Debentures	100,000.00
	300,000.00

Solution

	Dr	Cr
Debentures	20,000.00	
Debentures redemption acc		20,000.00
Profit or Loss	20,000.00	
Debenture Redemption reserve		20,000.00
Debenture redemption acc	20,000.00	
Bank		20,000.00

Zili Co. Financial Position 31st Dec. 2012

Non Current Assets	200,000.00
Current Assets	80,000.00
	280,000.00
Ordinary share capital	100,000.00
Profit or loss	80,000.00
Debenture Redemption reserve	20,000.00
Debentures	80,000.00
	280,000.00

If the debentures were issued at a discount, then the discount can be spread of the life of the debenture. The spreading of the discount can be done in one of the two ways below:

a) spreading the discount the discount equally over the years

b) spreading the discount taking into account the outstanding capital at the start of each year.

Redemption of debentures example 2

S co. issued Mk100,000 of the debentures at a discount of 5%. The debentures are redeemable over 4 years time. The redemption is at par at a rate of MK25,000 a year.

Show how much of the discount is allocated each year?

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Solution

Discount spreading		5,000.00
	100000	2,000.00
	75000	1,500.00
	50000	1,000.00
	25000	500.00
	250000	**5,000.00**

Redemption of debenture using a sinking fund

A sinking fund is an investment. In terms of debenture redemption, it means a company making an investment outside the company itself. The sinking fund is created to the extent that the amount invested over the term of the debenture plus the interest earned, will be sufficient to pay for the redemption of the debenture.

The double entry for a sinking fund is as follows:

	DR	CR
Profit or loss	XXX	
Debenture redemption reserve		XXX
With the annual installment		
Debenture sinking fund Investment	XXX	
Bank		XXX
Investment of installments into a sinking fund		
Bank	XXX	
Debenture redemption reserve		XXX
With the interest or dividend earned on a sinking fund		

12.7 CONCLUSION

Companies need to more capital for the business expansion. Financing from borrowed capital is expensive for the business and raises financial risk.

Accounting for the issue of share and debenture requires good understanding of double entry system especially on issue by instalments and several accounts are supposed to be created. Capital is one of the significant account balances in statement of financial position and proper accounting and disclosure is very critical.

END OF CHAPTER QUESTION

1. **Tutorial questions**

a) What is the difference between ordinary and preference shares?

b) What are some of the features of preference shares which makes it attractive than ordinary shares.

c) What is a debenture?

d) List four conditions which must be satisfied before shares can be redeemed.

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2. Exam style question

In order to undertake business expansion projects, Directors of Galu Ltd decided to issue shares on the stock market to raise funds to finance the expansion. The company issued 500,000, K1.00 ordinary shares to the public at K10.00 each. The shares were fully paid up on issue. The whole transaction was as follows:

- 1 March 2010, applications were received together with 60% of the nominal value of the shares applied for.
- 1 April 2010, shares were allotted and shareholders fully paid for their allotment by the end of the month.
- Shares were allotted on pro-rata basis after turning down 10,000 of the 510,000 applications received.

The company has an authorized share capital of 1,000,000 K1 ordinary shares and at the time of the new issue, there were already 250,000 K1 ordinary shares issued at K7.50.

Some account balances brought forward before the shares were issued were as follows:

Profit and loss	K2,345,673
Cash and bank	K1,234,000

Required:

a) Prepare the following accounts to record the issue of shares:

(i)	Share application account;	**2½ Marks**
(ii)	Share allotment account;	**3½ Marks**
(iii)	Bank account;	**3½ Marks**
(iv)	Ordinary share capital account;	**3 Marks**

(v) Share premium account. **2½ Marks**

b) Calculate the paid-up share capital after the issue of the shares. **1 Mark**

c) Prepare an extract of the statement of financial position after the issue of shares. **2 Marks**

d) Mention any **two** types of register that a company should keep. **2 Marks**

(TOTAL : 20 MARKS)

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CHAPTER 13: TAXATION IN MALAWI

LEARNING OBJECTIVES

By the end of this chapter, students will be able to:

- identify various forms of tax in Malawi
- understand the accounting treatment for various forms of tax
- outline the disclosure requirements in relation to tax

13.1 TYPES OF TAX IN MALAWI

Tax is defined as an imposition of … by Governing bodies in oerder to collect revenue for the running of Government.

According to Taxation Act, the purpose of tax is therefore recognized as;

a) Source of revenue for running the Government

b) A system used to redistribute wealth

c) Prevent / reduce consumption of certain products or services considered harmful

d) Protect infant home industries from foreign dominance

Tax affecting business is classified as direct and indirect tax.

1. **Direct Tax**

   This is tax which is based on income or wealth of a person and is payable out of the associated income or wealth.

a) Corporate tax

This is tax based on companies' profits or sometimes based on the turnover of the business. This tax is only payable by business entities which are registered as companies and not sole traders or partnerships.

b) Income tax

This is tax payable by individuals based on income which they have generated in a year. This is tax which is charged on income made by sole traders and partners in a partnership.

c) Pay As You Earn.

This tax which is levied on all income generated through employment and is borne by individuals. In essence PAYE is regarded as an advance charge for income tax and individuals are supposed to declare their annual income and any income tax computed should be netted off against the PAYE which salaries individuals have been deducted through-out the year.

d) Fringe benefit tax

This is tax charged on the business/ company for providing additional benefits to the employees on top of their salaries. This tax act as a deterrent measure to prevent salaried employees from reducing their tax liabilities by increasing their income through remunerative benefits rather than salary.

e) Withholding tax

This is tax which is deducted on income due to an individual or a business upon provision of services or sale of goods. Withholding tax is not a complete tax per se but it is an advance payment of tax because at the end of the tax period any amount withheld during the year is used to offset the tax liability of an individual or the business.

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2. Indirect Tax

This is tax which is borne by consumers or goods or services and is usually collected and remitted to the Tax Authority by a third party.
Such tax include;

a) Value added tax

This is tax which is suffered by consumers and the registered business collects through sale of goods and services. The tax is charged on top of the normal price of the goods and services and the business only act as a collecting agent on behalf of Malawi Revenue Authority.

b) Exercise duty

This is tax which is charged on certain products which are considered as posing health hazard and the Government is trying to discourage consumption of such goods or services. Such products include beer and tobacco.

c) Import duty

This is tax which is charged on the value of goods or services which are being brought into the country. This tax act as one way of promoting local production by making goods acquired from outside more expensive. This tax though it is paid by the business on their imports but such costs are usually passed on to the consumers who bears the cost of such taxes to the business.

d) Estate duty

This is tax which is based on the wealth of a deceased person before it passes on to the beneficiaries. As indicated earlier, tax is a charge on income or wealth for a business or an individual, so any income which is due to an individual either through a gift or inheritance is also subjected to tax hence the need for estate duty.

13.2 ACCOUNTING FOR TAXATION.

As stated not all taxes are payable by the business or taxes are purely individual tax which do not affect the business. For the business, whether tax is direct or indirect but in one way this does affect the cash flow of the business and as such the company need to properly account tax implication on the business.

a) Corporate tax

Tax is computed based on taxable profit and not necessarily on accounting profit. There are some accounting expenses which when computing tax are not allowed as expenses and therefore not included. These expenses differs depending on determination by the tax authorities but the most common example is expenses incurred to entertain customers.

In addition, accounting profit is computed by subtracting depreciation as an expense while for tax purpose it is the capital allowance which is deducted. Both are based on the cost of an asset but differs in the period of recognition.

The tax authority requires the business to pay advance tax during the year (provision tax) and pay the final tax at the end of the year once the amount is agreed with the tax authority.

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Example

The business had the following statements relating to accounting and taxation profit.

	2012	2013
Accounting profit	3,400,000	4,800,000
Taxation profit	3,200,000	5,200,000
Tax rate was	30%	30%

In all the years the company paid provision tax on quarterly basis.

Tax based on accounting	2012	3,400,000 x 30%	K1,020,000
	2013	4,800,000 x 30%	K1,440,000
Quarterly payments were therefore	2012	K1,020,000/4	K255,000
	2013	K1,440,000/4	K360,000
Tax based on taxable profit	2012	K3,200,000 x 30%	K960,000
	2013	K5,200,000 x 30%	K1,560,000

Corporate tax Account

	2012		
Bank (1st Quarter)	255,000	Profit or loss charge	1,020,000
Bank (2nd Quarter)	255,000		
Bank (3rd Quarter)	255,000		
Balance c/d	225,000		
	1,020,000		1,020,000

Please note that the actual tax is not usually known at the year end as the Tax authority has 180 days to determine the actual tax payable after the end of the year. So at the time

of preparing financial statements, the business is usually allowed to remit tax provision only for the three quarters and the final payment is usually made in the next financial year after establishing whether what was charged last year was more or less than the actual tax payable.

Corporate Tax

	2013		
Bank – 2012 (Balance)	195,000	Balance /bf	255,000
Bank (1 st Quarter)	360,000	Profit or loss	1,380,000
Bank (2 nd Quarter)	360,000		
Bank (3rd Quarter)	360,000		
Balance c/d	360,000		
	1,635,000		1,635,000

Please observe that the amount charged based on accounting profit was K1,020,000 while the actual tax computed for that year was only K960,000. This mean the charge was higher in 2012 by K60,000. This over charge will be reflected in 2013 where instead of charging tax of K1,440,000 which was the tax estimate for the year, the charge will only be K1,380,000 (K1440,000 – 60,000).

The extracts for Profit or loss and the statement of Financial Position will therefore be as follows;

Profit or loss extract

	2012		2013	
Profit for the year		3,400,000		4,800,000
Less: Tax for the year	1,020,000		(1,440,000)	
Prior year adjust	0	(1,020,000)	60,000	(1,380,000)
Profit after tax		2,380,000		3,420,000

Statement of Financial Position extract

	2012	2013
Current liabilities		
Corporate tax payable	255,000	36,000

b) Value added tax

As indicated above, value added tax is a tax which is suffered by the consumers and the business is only used as a collecting agent on behalf of the tax authority. Unless where the business is made to suffer VAT itself on items such as acquisition of non-current asset then the tax can be recognized by the business as part of its cost.

VAT paid by the business through supplies must be separated from the actual cost of the supplies. The cost of supplies will be recorded in purchases while the VAT on the supplies is accounted separately in the VAT account.

VAT is categorized as input and output. In put VAT is the tax the business pays on its purchases while the output VAT is the tax collected by the business on sales. In accounting, the business is supposed to record both the sales and the purchases net of VAT.

At the end of the period, the business is supposed to net off the input and output VAT. When output VAT is higher, the business is supposed to remit the excess to MRA, while if input VAT is higher, the business is supposed to get a refund from MRA

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Example

The Company bought raw materials for its factory. The cost was K943,000 which was inclusive of a 15% VAT. The company made sales of K1,265,000 inclusive of a 15% VAT.

Therefore;

Input VAT

Total supply cost	K943,000
VAT (15/115 x 943,000)	123,000
Net supplies	K820,000

Output VAT

Total sales	K1,100,000
VAT (15/115 x 1,265,000)	165,000
Net sales	K935,000

Dr.	Purchases	820,000	
Dr	VAT Account	123,000	
Cr.	Bank (Creditors)		943,000

The double entry for sales;

Dr.	Bank (Receivables)	1,265,000	
Cr.	Sales		1,100,000
Cr.	VAT		165,000

At the end of the month, the business is supposed to balance the VAT on supplies with that deducted from sales. If the dividend from supplies is more than the business is allowed to claim the excess VAT or carry forward to be offset against future VAT.

If the VAT on sales is more as is the case with the example above, then the business is supposed to remit the balance to MRA. i.e. K165,000 less K123,000 (K42,000) is payable to MRA.

VAT Account

Purchases	123,000	Sales	165,000
Balance c/d	42,000		
	165,000		165,000

The entries in the Statement of Financial Position will be based on what is outstanding at the end of a period. If the business is yet to remit any VAT deducted on sales, the amount is recognized as current Asset while if the business was over deducted on its supplies and MRA has confirmed that this amount with either be refunded or will be used to offset future VAT payable then the amount should be recognized in the Statement of Financial Position as an asset.

c) **Pay As You Earn tax**

As outlined, above PAYE is tax which is deducted on the salary of the employees by the business and remitted to the MRA. When accounting for the cost of engaging an employee, the business is supposed to base on the gross salary due to an employee.i.e. Including even the tax element.

Example

The payroll for the business for the month of October 2013 showed the following totals;

Gross Salaries	9,340,000
PAYE	2,850,000
Net Salaries	6,490,000

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The journal entries will therefore be;

Dr.	Staff costs	9,340,000	
Cr.	Bank (Net salaries payable)		6,490,000
CR	PAYE		2,850,000

PAYE does not appear separately in the Profit or Loss but rather it is included in the gross salary figure. In the Statement of Financial Position, PAYE will only appear if the amount has not been settled as at the period end.

d) Other taxes (Duties)

i) Import duty

The duty which the company pays on its materials or any non-current asset is supposed to be included as part of the costs of the items and therefore not shown separately in the Profit or loss. In Statement of Financial Position, the amount which has not yet been settled should be presented as part on current liabilities.

ii) Fringe benefit tax

As indicated above, fringe benefit tax is tax which is borne by the business for providing additional benefits to the employees.

Usually the rate for fringe benefit tax is the same as that for Corporate tax and the tax is payable on quarterly basis.

Since FBT is borne by the business it is supposed to be included as an expenses in the profit or loss. In the Statement of Financial Position, only outstanding tax payable is included as liability.

iii) Exercise duty

Exercise duty is a tax which is borne by the consumers to discourage them from consuming services or products which are considered as harmful to people like tobacco or beer.

The business is a collecting agent, as such it account for the net sales in the accounts while a separate account is used to record the exercise duty collected.

The treatment is the same as in VAT mentioned above.

13.3 DISCOSURE REQUIREMENTS

Disclosure requirements in relation to taxation issues;

i) Taxation charges in the statement of profit or loss

ii) The adjustments in relation to prior year under or over provision.

iii) Charges in tax rates during the year

iv) Amount outstanding at the end of the year in relation to;

- Corporation tax
- Fringe benefit tax
- Withholding tax
- Value added tax

13.4 CONCLUSION

Taxation is an important topic but usually do not receipt attention by most students. It is important to understand that one of the role of an Accountant is to advise the business on tax planning issues, and this extend as to the proper accounting for tax.

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This chapter concentrated on tax payable by entities rather than individual taxes. The major emphasis was to discuss the double entry aspects of taxation.

END OF CHAPTER QUESTIONS

1. **Tutorial questions**

a) What is taxation?

b) List three examples of direct tax and three examples of indirect tax.

c) What are some of the causes in difference between accounting profit and profit for taxation purposes?

d) If the cash sales for the month of December 2013 K760,000 net of VAT amounting to K89,000. What will be the double entry?

2. Exam style question

KD limited is a registered company for corporate tax purposes. Information relating to accounting profit and taxation profit for a five year period from 2009 to 2013 was as follows;

	Accounting	**Tax**	**Tax paid**
2009	600,000	400,000	180,000
2010	720,000	800,000	216,000
2011	810,000	950,000	243,000
2012	850,000	720,000	255,000
2013	870,000	890,000	261,000

The company submit its tax returns to MRA at the end of its financial year and usually the actual tax payable basing on taxable profit is known into the next financial year and any adjustment in regard to over or underpayment of tax is made in subsequent year.

The assumption is that the company started remitting tax in 2009 and the year end is 31st December. Tax rate has been maintained at 30%.

Required;

a) Prepare a Corporate tax account for the year 5 years clearly showing adjustments to the prior year tax charge. **10 marks**

b) Show the entries to statement of profit or loss for the all the years **5 marks**

c) Prepare the extract for the statement of financial position **5 marks**

TOTAL: 20 MARKS

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CHAPTER 14: PREPARATION OF FINAL ACCOUNTS FOR LIMITED COMPANIES

LEARNING OBJECTIVES

By the end of this chapter, students will be able to:

- Classify different types of expenses associated with limited companies
- identify how profit of a limited company is appropriated
- prepare statement of profit or loss and statement of financial position for internal use
- Understand the difference between bonus and rights issue and how they impact of the financial statements.

14.1 REVENUE SOURCES FOR THE BUSINESS

Limited companies are created to make profits for their shareholders through trading activities by selling products or provision of services.

Revenue recognition is accounted in accordance with IAS 18 and is defined as the gross inflow of economic benefits during the period arising in the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contribution from equity participant.

Conditions for recognition revenue from sale of goods include;

i) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods.
ii) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the gods sold.
iii) the amount of revenue can be measured reliably

iv) it is probable that economic benefits associated with the transaction will flow to the entity and

v) the costs incurred or to be incurred in respect of the transaction can be measured reliably.

The company is supposed to recognize revenue generated in the statement of profit or loss on accrual basis i.e. when all the conditions for recognition mentioned above are satisfied rather than when cash is actually received.

Revenue for the year should be offset against goods which have been returned to the business by the customers. This may result from over supplying the customers, sending wrong products, customer not being satisfied with the quality and the condition of the goods.

Example

The sales for the month of October 2013 were K4, 600,000 but the customer returned goods worth K200,000 for various reasons.

Statement of Profit or loss	
Sales revenue	K4,600,000
Less: sales returns (Return inwards)	(200,000)
Turnover	K4,400,000

14.2 CLASSIFICATION OF EXPENSES

For a sale to be realized, the company should have spent to acquire or produce the goods to be sold. Proper classification of expenses in very critical for the interpretation of the performance of the business.

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Major classification of expenses for the statement of profit or loss include;

- Cost of goods sold
- Distribution expenses
- Administration expenses
- Finance costs

i) Cost of goods sold

The cost of goods sold is an analysis of the actual costs for the items which have been sold. This section include opening inventories, purchases and closing inventories. Any cost incurred to bring the inventories to the business in form of carriage costs is also included as part of purchases.

Goods returned to the supplier for various reasons is deducted to arrive at the cost of goods sold.

Example

The company purchased goods worth K2,3000,000 in the month of October 2013. Transport cost incurred on the purchases was K300,000. At the beginning of the month the company had inventories worth K800,000 and at the end of the month there were inventories worth K950,000 outstanding.

Cost of goods sold will therefore be computed and presented as;

		MK
Opening inventories		800,000
Purchases	2,300,000	
Add: carriage inwards	300,000	2,600,000
Less: Closing inventories		(950,000)
Cost of goods sold		2,550,000

ii) Distribution expenses

These are expenses incurred by a company in selling and distributing goods to the customers. The expenses under this category include warehousing costs, delivery van expenses, sales commissions, salary of sales personnel and general distribution costs.

iii) Administration expenses

These are expenses incurred in the running of the business. These expenses are usually not directly attributable to the goods which are sold. These expenses include salary of administration staff, rental expenses, utility bills, office rentals, depreciation of office equipment and many more.

Example

The company incurred the following expenses in the month of October 2013.

Rentals	300,000
Salaries	600,000
Utility expenses	100,000
Depreciation expenses	600,000
Transport costs	200,000
General administration expenses	500,000
Sales commissions	50,000
Insurance expenses	150,000

The company allocates the expenses between administration and distribution functions as follows;

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Rentals - equally, salaries, Utilities, depreciation and insurance 60% to administration, transport costs and insurance costs 70% to distribution; Sales commission 100% to distribution.

The analysis of the expenses will there be as follows;

Distribution expenses	
Rental (300,000/2)	150,000
Salaries (600,000 x 40%)	240,000
Utilities (100,000 x 40%)	40,000
Depreciation (600,000 *40%)	240,000
Transport costs (200,000 x 70%)	140,000
Sales commission (100%)	50,000
Insurance costs (150,000 x 70%)	105,000
	965,000

Administration expenses	
Rental (300,000/2)	150,000
Salaries (600,000 *60%)	360,000
Utilities (100,000 x 60%)	60,000
Depreciation (600,000 x 60%)	360,000
Transport costs (200,000 x 30%)	60,000
General administration expenses	500,000
Insurance costs (150,000 x 30%)	45,000
	1,535,000

iv) Finance costs

Finance costs relate to costs incurred as a charge for obtaining funding from other external financiers. Under this section, the expenses include;

Bank interest on loan

Debenture interest payable

Finance costs in finance lease

14.3 OTHER COMPREHENSIVE INCOME

Revised IAS 1 requires the inclusion of other gains or losses which previously were supposed to be transferred directly to equity.

a) Revaluation surplus

The revaluation surplus of a non-current asset is supposed to be included in other comprehensive income section while a revaluation loss is recognized directly as expenses in the statement.

b) Translation gain or loss

Translation gain or loss occurs when an entity has a receivable or payable denominated in foreign currency as at the end of the financial period. In extreme cases, an entity may own a subsidiary in another country which use another currency than that in a home country.

Translation gain or loss on an account balance is supposed to be recognized as a normal gain or loss in the statement of comprehensive income while translation gain or loss on consolidation of a subsidiary is supposed to be recognized as movement in equity and therefore as a transaction to be recognized as other comprehensive income.

14.4 PROFIT APPROPRIATIONS

The profit generated by the company is supposed to be shared by shareholders and the remainder used for the growth of business.

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a) Dividend payment

Dividend is regarded as a return to the shareholders for investing their money in the business. Dividend paid during the year is called interim dividend while that at the end of the financial year is called a final dividend.

Preference shareholders usually have predetermined dividend receivable through the nature of shares they are holding while ordinary shareholder rely on the declaration by the directors.

Example

The company has the following capital structure;
- 1,000,000 K1 Ordinary shares
- 7% 700,000 K1 preference shares

The company has K600,000 profit available for distribution and the directors have proposed K200,000 as dividend to ordinary shareholders.

Profit for the year		K600,000
Less:	Preference dividend (7% of 700,000)	(49,000)
	Ordinary dividend	(200,000)
Retained profit for the year		351,000

b) Capital redemption reserve

Capital redemption reserve is created whenever the company redeem shares out of the profit reserves. Normally the understanding is that the company will issue new shares in order to redeem old shares but if this is not the case then the company will use the profit reserve.

Example

The company is to redeem 40,000 K1 preference share using own resources.

Dr.	Preference shares	K40,000
Cr.	Bank	K40,000
Dr.	Profit reserves	K40,000
Cr.	Capital redemption reserve	K40,000

With the nominal value of shares redeemed out of internal resources (retained profit)

14.5 STATEMENT OF PROFIT OR LOSS

Having looked at the components of the statement of comprehensive income and profit or loss, the information is hereby summarized in the standard format

a) For Internal use

Statement of Comprehensive Income and other Profit or loss

	MK	MK
Sales		xx
Less: Returns inwards		(x)
Turnover		xx
Less: Cost of sales		
Opening inventory	xx	
Purchases	xx	
Carriage inwards	xx	
Return outwards	(x)	
Closing inventories	(x)	(xx)
Gross profit		xx

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Distribution expenses			
Sales expenses		x	
Warehousing costs		x	
General distribution expenses		x	(xx)
Administration expenses			
Salaries and wages		x	
Rent and rates		x	
General administration expenses		x	
Advertisement costs		x	(xx)
Operating Profit for the year			xx
Finance costs			
Debenture Interest		x	
Finance costs for lease		x	xx
Profit before tax			xx
Corporation tax			(x)
Profit after tax			xx
Other comprehensive income			
Revaluation surplus		x	
Translation surplus		x	xx
Total profit for the year			xx
Appropriations			
Transfer to general reserve		x	
Capital redemption reserve		x	
Dividend –	Preference shares	x	
	Ordinary shares	x	(xx)
Retained profit for the year			xx

b) For Publication

A statement of profit or loss for publication provides summaries for major transactions. The aim is to to show broader information which is considered more practical and useful for external information as opposed to detailed presentation for internal use.

Statement of Profit or loss and other Comprehensive income

	MK	MK
Turnover		xx
Cost of sales		(xx)
Gross profit		xx
Distribution costs		(x)
Administration expenses		(x)
Operating profit		xx
Finance costs		(x)
Profit before tax		xx
Taxation		(x)
Profit after tax		xx
Other comprehensive income		xx

14.6 STATEMENT OF FINANCIAL POSITION

The statement of financial position is used to outline the financial base of the business, its standing in terms of assets and liabilities. It is a crucial statement as it provide information needs for various stakeholders.

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a) For internal use

	MK	MK	MK
Non-current assets			
	Cost	**Depreciation**	**NBV**
Land and buildings	xx	(x)	xx
Motor vehicles	xx	(x)	xx
Equipment	xx	(x)	xx
Intangible assets			
Goodwill			xx
Other intangibles			xx
Investments			xx
Total non-current assets			xx
Current assets			
Inventories		xx	
Receivables		xx	
Prepayments		xx	
Cash and bank		xx	xx
Total assets			xx
Capital and liabilities			
Capital			xx
Revaluation reserves			xx
Profit reserves			xx
Total capital and reserves			xx
Non- current liabilities			
Bank loan		xx	
Finance lease		xx	

Debentures	xx	xx
Current liabilities		
Payables	xx	
Accruals	xx	
Proposed divided	xx	xx
Total capital and liabilities		xx

b) For external use

	MK	MK
Non-current assets		
Property plant and equipment		xx
Intangible assets		xx
Investments		xx
Total non-current assets		xx
Current assets		
Inventories	xx	
Receivables	xx	
Prepayments	xx	
Cash and bank	xx	xx
Total assets		xx
Capital and liabilities		
Capital		xx
Revaluation reserves		xx
Profit reserves		xx
Total capital and reserves		xx

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Non- current liabilities		
Bank loan	xx	
Finance lease	xx	
Debentures	xx	xx
Current liabilities		
Payables	xx	
Accruals	xx	
Proposed divided	xx	xx
Total capital and liabilities		xx

14.7 STATEMENT OF CHANGES IN EQUITY INTEREST

Statement for changes in equity interest is used to record the movement in reserves during the year. It is an important statement as users are provided with vital information on how the profit generated and other reserves have moved during the financial year.

Statement of changes in equity interest

	Profit Reserve	**Revaluation Reserves**	**Translation Reserves**	**Total**
Balance b/f	xx	xx	xx	xx
Prior year adjustment	xx			xx
Restated balances	xx	xx	xx	xx
Revaluation surplus		xx		xx
Profit for the year	xx			xx
Dividend	(x)			(x)
Excess depreciation	x	(x)		
Translation gain			x	x
Balance c/f	xx	xx	xx	xx

14.8 EARNINGS PER SHARE

As part of presentation for profit or loss for the year, an entity is supposed to present the earnings per share (EPS) for the current year and prior year. EPS is important measure of the performance of the business as such it is presented always at the foot of the Statement of profit or loss.

EPS is computed as $\frac{\text{Profit after tax and preference dividend}}{\text{Number of ordinary shares}}$

Higher EPS figure attracts more inventors to the business as it indicates that the business is able to generate more profit for the shares it hold.

14.9 CONCLUSION

Financial statements are considered as the end product of accounting. All the recognitions, measurement and presentation of transactions end up in a summary form through the financial statements. Financial statements presents the only window at which the other stakeholders may be able to assess the performance and the position of the business.

In preparing financial statements, it is important to note that presentation is the major key. Financial statement is supposed to follow pre-scribed format and departure of which will render the financial statements not to show a true and fair view of the business.

END OF CHAPTER QUESTION

1. Tutorial questions

a) Mention three expenses which can be classified under finance expenses

b) What are the major headings in statement of financial position?

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c) List three transactions which are record in Statement of changes in equity interest.

2. Exam style question

The following is a trial balance extracted from the book of accounts for Chitukuko Ltd as at 31 December 2010.

	K	K
Ordinary Share Capital		950,000
Share premium		165,722
Returned Income		145,550
Inventories (1/01/10)	323,000	
Sales		4,484,000
Purchases of goods for sale	2,360,750	
Returns outwards		117,372
Returns inwards	129,342	
Carriage outwards	40,641	
Warehouse wages	384,028	
Salesmen's salaries	289,750	
Administrative wages and salaries	228,000	
Plant and Machinery	608,000	
Plant and machinery – accumulated depreciation		207,376
Motor vehicle hire	78,612	
General distribution expenses	120,873	
General administrative expenses	140,277	
Accounts receivables	1,539,000	
Accounts payables		343,491
Cash at bank	171,238	
	6,413,511	6,413,511

Additional information:

- Inventories were valued at K392,018 as at 31 December 2010.
- Straight line depreciation is provided on plant and machinery at 20% on cost.
- For the purpose of reporting, depreciation on plant and machinery is allocated to distribution cost category at 40% and to administration cost category at 60%.
- K51,841 audit fees had not been paid as at 31 December 2010.
- Motor vehicle hire expenses are for administrative purposes.
- Based on previous year's tax return, the income tax is estimated at K181,659 for the financial period.
- Ordinary dividends valued at 25% on normal share capital were declared for the year but payable in July 2011.

Required:

(a) Prepare the Income Statement for Chitukuko Ltd for the year ended 31 December 2010 for internal use (operating expenses should be grouped into administration and distribution. **10¼ Marks**

(b) Prepare the statement of financial position for Chitukuko Ltd as at 31 December 2010. **7 Marks**

(c) Briefly explain the difference between drawings and dividends. **2¾ Marks**

(TOTAL : 20 MARKS)

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CHAPTER 15: STATEMENT OF CASH FLOWS

LEARNING OBJECTIVES

By the end of this chapter, students will be able to:

- Prepare the statement of cash flow
- Interpret the statement of cash flow

15.1 WHY CASH FLOW STATEMENT

Production of Statement of Profit or loss and the Statement of Financial Position is considered as incomplete if the entity does not produce statement of cash flows. The statement of cash flow is a statement which recognizes the cash flowing to the organization. Unlike profit for the period, cash can easily be managed and used by the organization. Sometimes organizations make profits while they are failing to survive as they lack cash.

Cash is the survival of every company. The company's ability to generate cash is very key as it pronounces going concern of the organization. So the statement is considered important because of the following;

- The survival of the company is dependent on cash flow.
- Most users of financial statements will be interested in the company's ability to generate cash
- Unlike statement of profit or loss statement, cash flow statement is easily understood by most users of financial statements
- It is easy to forecast cash flow than the Profit or loss.

Statement of Cash flows is accounted basing on IAS 7 and it applies to all entities as part of the integral part of the financial statement.

KEY DEFINITIONS

Cash –comprises cash on hand and demand deposits. Those deposits that you could ask the banks to give you monies immediately.

Cash equivalents- are short term highly liquid investments that are readily convertible to known amounts of cash and are subject to an insignificant risk of changes in value

Cash flow- these are inflows and outflows of cash and cash equivalents.

Operating activities- These are principal revenue producing activities of the entity and activities that are not investing or financing activities

Investing activities- are the acquisition and disposal of long term assets and other investments not included in cash equivalents.

Financing activities - are activities that result in changes in the size and composition of the equity capital and borrowings of the entity.

HEADINGS OF THE STATEMENT OF CASH FLOWS

IAS 7 requires that a statement of cash flow should have three headings. These headings are:

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Operating activities

These activities show to what extent the company is able to generate revenue from the normal activities. This heading will normally comprise of most activities that make part and parcel of the Statement of income or profit or loss account.

Examples from the standards are as follows:

- Cash receipts from the sale of goods and the rendering of services.
- Cash receipt from royalties, fees commissions and other revenues.
- Cash payments to suppliers for goods and services.
- Cash payments to and on behalf of employees.
- Cash payments/refunds of income taxes unless they can be specifically identified with financing or investing activities.
- Cash receipt and payments from contracts held for dealing or trading purposes.

Investing activities

Investing activities deal with the activities which will generate future profits or cash flows. Examples from the standards are as follows:

- Cash payments to acquire property, plant and equipment, intangibles and other long term assets
- Cash receipts from sale of property, plant and equipment, intangibles and other long term assets
- Cash receipts from sales of shares and debentures of other entities which forms part of investment for the entity.
- Cash advances and loans made to other parties
- Cash receipts from the repayment of advances and loans made to other parties

Financing activities

This part of statement of cash flow deals with capital providers to the entities. Examples from the standards are as follows:

- Cash proceeds from the issuing of shares
- Cash payments to owners to acquire or redeem the entity's shares.
- Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short or long term borrowings
- Cash repayments of amounts borrowed
- Cash repayments by a lessee for the reduction of outstanding liability.

15.4 METHODS USED IN STATEMENT OF CASH FLOWS

The standard give an option of choosing one method out of the two advocated.

These are:

- Direct method
- Indirect method

The difference in presentation of information in the two above is cash flows from operating activities.

a) Direct method of statement of cash flows

In this method cash flows from operating activities are included in total for receipts and payments. E.g. if the sales in a particular period was MK120,000.00 and MK20,000.00 was not paid, then the cash flow to be included would be MK100,000.00. The

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concentration on this method is on the actual receipts from customers and what is paid out in normal operating business transactions.

Example

A company had opening balance of cash as MK2,000.00. During period the following transaction took place:

i. Sales for the month were MK45,000.00 out of which MK3,500.00 was in receivables.
ii. Purchases for the month came to MK25000.00 out of which MK2,100.00 was not yet paid.
iii. Salaries for the month amounted to MK4,000.00
iv. Other cash operating expenses came to MK1,300.00
v. The company purchased a non current asset worth MK5,000.00
vi. It issued debt to the tune of MK12,500.00
vii. There were bonus shares issued in the month which increased share capital by MK8,000.00.

Prepare a statement of cash flow for the month using direct method?

Solution

Operating activities	
Cash sale	41,500.00
Cash payment to suppliers	(22,900.00)
Salaries for the month	(4,000.00)
Other cash operating expenses	(13,00.00)
Cash flows from operating activities	13,300.00

Investing activities	
Purchase of noncurrent asset	(5,000.00)
Financing activities	
Issue of debt finance	12,500.00
Cash inflows in the year	20,800.00
Opening cash balance	2,000.00
Closing cash balance	22,800.00

Sales 45000.00 less 3500.00 =41,500.00

Cash payments 25000.00 less 2100.00 = 22,900.00

Direct method is considered as being good in providing more information will be available to the users of financial statements.

The disadvantage of the method is that information is not readily available and the preparer will need to track down information on all cash receipts and payments

b) Indirect method of statement of cash flow:

The preparation of this statement starts with the net profit from operations

The following are the content of the statement of cash flows;

Operating activities	
Profit before interest and tax	x
Depreciation	x
Provision for doubtful debt	x
Loss on disposal of non current asset	x
	X

Adjustment for working capital

Increase in inventories	(x)
Increase in receivables	(x)
Increase in payables	x
Cash flow from operations	x
Tax paid	(x)
Interest paid	(x)
Total cash flow from operating activities	xx

This method is based on working backwards by looking at profit then adjusting it with non- cash transactions which are included in statement of Profit or Loss.

This starts from profit before interest and tax and then adjusts for the following

Non-cash items charged to net profit. I.e. Depreciation/ impairment of assets, loss or profit on disposal of non-current asset, increase in provision for doubtful debts

After the above adjustment, you adjust for net working capital. Working capital is the current asset minus current liabilities.

The adjustments include;

- Movement in inventories – an increase in inventories implies more cash has been tied up in form of inventories as such it is shown as a deduction for cash flows. If it is a decrease then it is a positive to the cash flows.
- Movement in receivables – an increase in receivables implies that more sales have been made on credit therefore less cash flow collected. Decrease in cash flow implies the business has been rigorous in debt collection as such it is recorded as a positive cash flow.
- Movement in payables – an increase in payables implies that more supplies were acquired on credit therefore less cash outflow as such it is shown as positive in the

statement. A decrease in payables implies the business has been settling its liabilities as such it is recorded as a negative in the statement.

ii) Investing activities

This heading includes

- The buying and selling of noncurrent assets
- The buying and selling of investments
- The buying and selling of subsidiaries
- The selling of shares of another entity.

iii) Financing activities

Under this heading, the following will be included:

- The issuing of shares by an entity
- The issuing of debentures and other loans
- The redemption of shares
- The repayment of loans

PLEASE NOTE:

Unlike a limited liability company, a statement of cash flow for a sole trader or a partnership, will include sole trader's or partners withdrawals or additional cash given to the business by the owners. In a limited liability companies, these amounts are included as dividends and issue of shares.

15.5 CONCLUSION

Cash flow statement though not popular like statement of comprehensive Income and Statement of Financial position is another primary statement which is supposed to be produced by every entity at the end of the financial year.

This chapter looked at two methods of determining cash flow from operating activities. Together with return on capital employed (ROCE), cash flow from operational activities provide useful information to the users of the financial statements in understanding how the business is able to use its core business to generate cash flow for financing business expansion and meet obligations due to external stakeholders.

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END OF CHAPTER QUESTIONS

1. Tutorial questions

a) What are the three major headings in statement of cash flows?

b) What are the implications of having a positive figure on cash flows from operations?

c) Mention four items which appears under the 'Cash flows from financing activities' section

2. Exam style questions

Below are statements of financial position for two years ended 31.12.09 and 31.12.10, and a summarized income statement for the year ended 31.12.10.

	2009	2010
	K	K
Plant and Machinery, at cost	600,000	650,000
Less: accumulated depreciation	(200,000)	
	400,000	(215,000)
Current assets		435,000
Inventories	250,000	
Accounts receivables	200,000	300,000
Cash and bank	20,000	235,000
	470,000	15,000
		550,000
Total assets	870,000	
		985,000
Ordinary share capital	325,000	
Share premium	50,000	340,000
Profit and loss	250,000	50,000
10% debenture	15,000	360,000
	640,000	10,000
Current liabilities		760,000
Accounts payables	135,000	
Taxation	45,000	125,000
Dividends	50,000	40,000
	230,000	60,000
Total assets	870,000	225,000
		985,000

The summarized income statement for the year ended 31 December 2010 is as follows:

	K
Gross profit	400,000
Operating profit	280,000
Interest payable	5,000
Profit before tax	275,000
Taxation	50,000
Profit after tax	225,000
Dividend	110,000
Profit for the year	115,000

Additional information:

A piece of machinery which was bought for K75,000 with a net book value of K50,000 was sold during the year at a loss of K4,000.

The company issued bonus shares from profit and loss reserves.

Required:

Prepare a statement of cash flows for the year ended 31 December 2010.

(TOTAL: 20 MARKS)

CHAPTER 16: RATIO ANALYSIS

LEARNING OBJECTIVES

The objective of this chapter is to:

- Calculate the accounting ratios
- Interpret the ratios

16.1 INTRODUCTION TO RATIO ANALYSIS

Information in the financial statements is organised so as to enable users to draw conclusions concerning the well-being and performance of the entity. Independent auditors also review the accounts to see whether they are reliable. While Tax authorities will also review the accounts if they are a reflection of reality. Additionally Banks will review the accounts of prospective borrowers to see if they are reliable so as to assist them make investment decisions.

One of the key instruments used to analyse accounts is the use of ratios or ratio analysis. Ratios can be used in the following:

- Accounting ratios can also be used to compare;
- Ratios are used to review trends, and compare entities with each other.
- Ratios can help to plan for the future.
- Current year results with the previous year
- Current years results with those of comparable companies in the same business
- Current performance against budget or standard or benchmark of performance.
- Comparison of one segment or division of a business with others.

16.2 RATIO CATEGORY AND THEIR INTERESTED GROUPS

a) Profitability ratios

These are ratios usually used by Sshareholders, management, employees, creditors, competitors, potential investors in order to assess the financial performance of the business.

i) Return on Capital Employed

The most important profitability ratio is Return On Capital Employed (ROCE). It is impossible to assess profits or profit growth without relating them to the amount of funds (capital) employed in making them. ROCE states the profit as a percentage of the amount of capital employed.

The formulae to calculate ROCE is

$$\text{ROCE} = \frac{\text{profit before interest and tax}}{\text{capital employed}} \times 100\%$$

Capital employed = shareholders' equity plus non-current liabilities (or total assets less current liabilities)

Why Profit before interest and tax (PBIT)?

Profit before tax is used because there may be unusual variations in the tax charge from year to year which would not affect the underlying profitability of the company's operations. Profit before interest is used to reflect the profit earned before having to pay interest to providers of loan capital.

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- What does a company's ROCE tell us?
- What should we be looking for?
- Change in ROCE from one year to the next.
- The ROCE being earned by other companies in the same industry.
- Comparison of the ROCE with current market borrowing rates.

ROCE can be sub-analysed to find more about why the ROCE is high or low, or better or worse than last year.

Two factors contribute to a return on capital employed both related to sales revenue which give rise to two secondary ratios for ROCE i.e.

Profit Margin which is a measure of how much profit is made on every kwacha of sales (return on sales)

Asset Turnover Ratio which is a measure of how well the assets of the company are used to generate sales.

Profit margin and asset turnover ratios (formulae)

$$\text{Profit margin} = \frac{\text{profit before interest and tax}}{\text{sales}} \quad (\%)$$

$$\text{Asset turnover} = \frac{\text{sales}}{\text{Capital employed}} \quad \text{(no. of times)}$$

If we combine the two we have

Profit margin x asset turnover =ROCE

PBIT x sales

sales capital employed

This can be proved through cross multiplication (cancel the two sales)

ii) Gross and net profit margin

Gross profit margin shows the return on profit before operational expenses.
Net profit margin shows the return after taking into account the operational expenses.

These ratios may assist in keeping truck of a company's operational expenses.

Gross profit margin = gross profit x 100%

sales

Gross profit= sales less cost of sales

b) Lliquidity ratios

These ratios are used mainly by shareholders, suppliers competitors to assess the ability of the business to settle short term liabilities.

Liquidity is the cash a company can put its hands on quickly to settle its debts.
It consists of cash, short-term investments, fixed term deposits, trade receivables, bills of exchange.

The standard test for liquidity is the ***current ratio*** which can be obtained from the balance sheet.

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i) Current ratio

A ratio of 2: 1 should be expected but what is compatible varies between different types of businesses. The 2:1 ratio indicates a good mix of current assets to current liabilities. Any ratio above 2:1 usually indicates holding of unnecessary current assets which may lead to overtrading. In the same way, having a ratio of less than 2:1 indicates that the company is holding less current assets and it may face difficulties to settle its current liabilities.

$$\text{Current ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

ii) Acid test ratio

Where inventory turnover is slow, most inventories are not very *'liquid'* assets because the cash cycle is so long an additional liquidity ratio known as the ***quick ratio*** is calculated.

Quick ratio /Acid test ratio

$$\text{Quick ratio} = \frac{\text{current assets less inventory}}{\text{current liabilities}}$$

This ratio should ideally be at least one for companies with a slow inventory turnover. For companies with a fast inventory turnover a quick ratio can be comfortably less than one without suggesting that the company could be in cash flow trouble.

c) Efficiency ratios

These ratios are usually used by shareholders, potential investors and the competitors to assess how the working capital of the business is being managed.

These ratios measure the average length of time it takes a company to:

- Receive its receivables
- Pay its payables
- To sell its inventories

These ratios include:

i) **Accounts receivable collection period**

Gives us a rough estimate of time it takes for a company's customers to pay what they owe.

Sales are usually made on normal credit terms of payment within 30 days.
A collection period in excess of this might represent poor management of funds of a business.

The trend of the collection period over time is probably the best guide.
An increasing trend is indicative of a poorly managed credit control function.

Collection period

The average accounts receivable collection period is calculated as

$$\frac{\text{Trade receivables}}{\text{Sales}} \times 365 \text{ days}$$

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ii) Inventory turnover period

This ratio indicates the average number of days that items of inventory are held.
Generally the higher the inventory turnover the better i.e. the lower the turnover period the better.

Both receivable collection period and inventory turnover period give a company an indication of its liquidity

The inventory turnover period is calculated as

$$\frac{\text{Cost of sales}}{\text{Inventory}} \quad \text{(times)}$$

iii) Accounts payable period

Payment period helps to asses a company's liquidity.
An increase is often a lack of long-term finance or poor management of current assets resulting in the use of extended credit from suppliers, increase bank overdraft and so on.
Accounts payables is calculated as follows

$$\frac{\text{Trade accounts payables}}{\text{Credit sales}} \times 365 \text{ days}$$

d) **Long term solvency ratios**

These ratios measure the level of a company's borrowing position. There are mainly two types of capital ratios and these are

Debt ratio which is the ratio of a company's total debts to its total assets

Gearing or leverage which is concerned with a company's capital structure i.e. what proportion of its capital is financed by borrowing

i) Debt equity ratio

This ratio measures the ratio of debt to equity capital. A ratio of over 100% indicates that the business over dependent on borrowed capital and this is considered a financial risk for the business.

$$\text{Debt equity ratio} = \frac{\text{Total debts}}{\text{Shareholders equity}} \times 100\%$$

ii) Gearing ratio

This is complementary to the debt equity ratio and is also used to assess the financial risk of the business.

$$\text{Gearing} = \frac{\text{total prior charge capital}}{\text{shareholder's equity + total prior charge capital}} \times 100\%$$

Prior charge capital include all sources of capital which rank ahead of equity shareholders in dividend and liquidation distribution.

A company with a gearing ratio of more than 50% is said to be high-geared

Gearing also attempts to quantify the degree of risk involved in holding shares in a company

The more highly geared the company the greater the risk

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e) Shareholders' ratios

These ratios assist equity shareholders and other investors to assess the value and quality on their investments in the ordinary shares of a company.

The value of an investment in ordinary shares in a company listed on the stock exchange is its market value.

The ratios must therefore reflect the same

i) Earnings per share (EPS)

This is the amount of net profit for the period that is attributable to each ordinary share.

$$EPS = \frac{\text{net profit}}{\text{no. of ordinary shares}}$$

High EPS ratio attracts more investors to acquire shares in the business.

ii) Price/ earnings ratio (P/E)

This ratio measures the return on the market price of share. The high P/E ratio indicates investors' confidence in the business.

$$\text{P/E ratio} \quad \frac{\text{Market Price of share}}{\text{EPS}}$$

iii) Dividend Cover

This ratio measures the number of times the company can pay out dividend of the profit which has been earned. More number of times indicates a safe investment as it shows that the business is able to retain more profits for business expansion.

$$\text{Dividend cover} \quad \frac{\text{Profit after tax and interest}}{\text{Dividend to ordinary share holders}}$$

iv) Dividend yield

This is an important ratio to potential shareholders to assess how much the investors in the business will earn out of their investment.

$$\text{Dividend Cover} \quad \frac{\text{EPS}}{\text{Dividend per share}} \times 100$$

16.3 LIMITATIONS OF RATIOS ANALYSIS

i. Ratios are based on historical data which may not be relevant for future decision making.
ii. The ratios are usually affected by the timing in terms of when the financial statements is produced.
iii. There should be availability of comparable information in order to understand the performance. Ratios on their own may not make sense unless there is adequate comparable information.
iv. Ratios not definitive - they are only a guide.
v. It is a subjective exercise
vi. Can be subject to manipulation due to choice of accounting policy.

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16.4 CONCLUSION

As indicated in the limitation of ratios section, the financial statements themselves are prone to manipulation through various means and users of financial information should be cautious when relying on the results of the ratio analysis.

Ratios analysis are regarded as a window at which users can have a glimpse of what is happening in the business. Ratio analysis simplifies the understanding of the financial statements and is ideal in the wake of increasing complex presentation and disclosures of financial information.

END OF CHAPTER QUESTION

1. Tutorial questions

a) What does the term ROCE stand for?

b) Mention two ratios computed when assessing efficiency of working capital management.

c) List four ratios which falls under shareholder/ investors ratio.

2. Exam style question

The following extracts are from Chitute Ltd's published accounts.

The income statement

	K'000
Sales	22,400
Cost of sales	15,920
Profit before taxation	970

This is after charging:

Depreciation	720
Debenture interest	120
Bank loan interest	10
Audit fees	24

The statement of financial position

	K'000		K'000
		Ordinary share capital	1,600
Non-current assets	3,300	Reserves	2,490
			4,090
Current assets			
Inventory	1,260	10% debentures	1,200
Accounts receivable	2,440		
Cash	200		
	3,900		5,290
		Current liabilities	
		Bank overdraft	220
		Accounts payable	1,500
		Taxation	60
		Dividends	130
			1,910
Total Assets	7,200	Total equity and liabilities	7,200

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Required:

a) Calculate the following ratios:

i.	Gross margin	**2 Marks**
ii.	Return on capital employed	**2 Marks**
iii.	Current ratio	**2 Marks**
iv.	Asset turnover	**2 Marks**
v.	Inventory turnover	**2 Marks**
vi.	Gearing ratio	**2 Marks**

(b) Comment on Chitute Ltd's financial performance given the following acceptable ratios:

i.	Gross margin 30%	**1 Mark**
ii.	Current ratio 2	**1 Mark**
iii.	Gearing ratio 25%	**1 Mark**

(c) Explain, by giving **three** reasons, why comparing the performance of two companies using ratios may not be very useful. **5 Marks**

(TOTAL: 20 MARKS)

CHAPTER 17 GROUP ACCOUNTS

LEARNING OBJECTIVES

The objectives of this chapter are to:

- Define the groups and subsidiary
- Understanding adjustments done before consolidation
- Prepare consolidated statement of financial position

17.1 DEFINTIONS RELATING TO GROUP ACCOUNTS

- **Group.** Is the parent and its subsidiaries. (IAS 27)
- **Parent** .This is an entity which controls another entity.(IAS 27, IFRS 3)
- **Subsidiary**. This is an entity which is controlled by another entity. (IAS 27, IFRS 3)
- **Control.** Power to govern the financial and operating policies of an enterprise so as to obtain economic benefit. (IAS 27, IAS 28, IAS 31),
- **Acquirer** The entity that gets control in a business combination.
- **Acquiree.** The businesses that the acquirer obtains control.
- **Fair value**. The amount at which an asset can be exchanged and liability settled between knowledgeable, willing parties at an arm's length transaction.
- **Non- Controlling Interest** The part of equity in a subsidiary which is not bought directly or indirectly by the parent.

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17.2 TYPES OF INVESTMENTS

Investment in shares may take different forms and the accounting treatment depends on the type of investment. The major determining factor in classifying investments is the control aspect though the shareholding also plays a crucial role in the classification.

Investment	Holding	Control	Accounting
Subsidiary	Over 50%	Dominant influence	Full consolidation
Joint venture	50 – 50	Mutual influence	Proportional method or Equity method
Associate	20 – 49%	Significant influence	Equity method of consolidation
Simple Investment	Less than 20%	No influence	cost method

17.3 INVESTMENT IN SUBSIDIARIES

IAS 27 and IFRS 3 emphasize that if an entity is to be classified as a subsidiary undertaking, it means there is **control.** In other words no control, no subsidiary exists.

IAS 27 revised assumes that the holding of more than 50% of the equity share capital means that there is control unless proved otherwise.

However, IAS 27 recognizes some circumstance where control exists without the entity having more than 50% of voting powers of share capital. The circumstances below are the examples given by the standard:

- The parent entity has voting power of more than 50% by agreement with other shareholders or law

- The parent entity has power to govern the financial and operating policies of another entity by agreement with other shareholders
- The entity has power to appoint or remove more than 50% of the board of directors.
- The parent has power to cast the majority of votes at meetings of board of directors.

Consolidation requirements,

i) Method of consolidation

Subsidiaries are consolidated with the parent undertaking
Consolidation means adding together of the parent and subsidiary entities as if they were one entity. Notice that this is a departure from the **entity concept.**

ii) The date of including a subsidiary or removing a subsidiary

A subsidiary will be included in the group account when the parent obtains control over it. Conversely, the subsidiary will be excluded form group accounts where there is loss of control by the parent undertaking.

iii) Accounting Policies

Parent and subsidiary need to present there accounts using the same accounting policies. If they use different accounting policies, then the subsidiaries accounts should be restated first before consolidating them.

iv) Available exemptions from consolidation

The IAS 27 gives exemptions to the parent not to consolidate in the following circumstances:

- If the parent itself is a wholly owned subsidiary of another company.

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- A parent itself is a partially owned by other people known as non- controlling interest.
- In this case, the non-controlling interest should own less than 10% of voting powers of the subsidiary. It is also important to note that the exemption will be granted if the non-controlling interest accepts that the parent undertaking can be exempted and the parent should provide to them the additional information of the registered office of the consolidating parent.
- The shares or debts of the entity are not traded at the stock exchange
- The parent has no intention of issuing shares and debt to the public through stock exchange
- The company is an intermediate parent

v) Exclusion from consolidating the subsidiary

There is no exclusion of the subsidiary undertaking. This is so because companies would be encourages to have **off balance sheet transactions.** This is a departure from the previous IAS 27 where it provide for exclusion of a subsidiary from consolidation.

vi) Consolidating Statement of Financial Position

The following represents the principles about consolidation

- Consolidation is about like cancels like
- Consolidation is about adding like together,
- Even though not all shares are bought by the parent undertaking, all the assets, liabilities are added to the group accounts and only include in one line to the extent that you do not own everything by way of non-controlling interest figure.

Consolidation is about like cancelling like

Example.

G Company acquired all the shares of a subsidiary S company. Their financial position are as at 31st December 2008 are as below:

	G	S
	MK	MK
Investment in subsidiary 10 shares	10,000	
Net Assets	20,000	10,000
	30,000	10,000
Ordinary Share capital $1 each	25,000	10,000
Retained Profit	5,000	…..
	30,000	10,000

G Company acquired all the shares of S company since incorporation.

Prepare consolidated accounts.

Solution

G. company invested in the subsidiary S Company by paying K10,000 which represents all shares in the subsidiary undertaking.. Thus like cancels like. This means the rest will be added together.

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The consolidated account is as below:

P and S consolidated accounts as at 31st December 2008

Net Assets	20 + 10	30,000
		30,000
Ordinary Share Capital		25,000
Reserves		5,000
		30,000

Please note that in consolidating, it is the assets and liabilities which are supposed to be added while share capital is only that of the parent which is included. The share capital of the subsidiary is netted off with the ' cost of investment' in parent accounts.

17.4 CONSOLIDATION ADJUSTMENTS

a) Pre-acquisition and Post-acquisition Reserves

Pre- acquisition means reserves which were there at the time of buying the subsidiary. Unless where the subsidiary was acquired since its incorporation, when consolidating only the reserves which were generated by the subsidiary after acquisition should be consolidated. Pre- acquisition reserves should be used in goodwill calculations.

Example

Parent acquired 75% of the subsidiary on 1st July 2012 when the reserves in the subsidiary were K150,000. The groups financial year end on 31st December and at 31st December 2013, the reserves in subsidiary was K400,000.

Determine the parents share of pre- acquisition and post- acquisition profit

Pre- acquisition reserves	
75% of K150,000	112,500
Post-acquisition reserves	
75% of (K400,000 – 150,000)	187,500

b) Unrealized profit on intercompany transactions

When there is a sale between parent and subsidiary un profit realized is considered as unrealized if the buying company has not sold the goods to outsiders. Un realized profit is supposed to be removed from the consolidated profit reserve since it is recognized as not a true profit.

The adjustment required is therefore to debit the profit reserve with the element of the unrealized profit. In the same vein, the inventory of the buying company is considered as being measured at selling price and the same unrealized profit is used to reduce the value of inventories.

So the double entry is;

Dr	Consolidated reserve	x	
Cr	Inventories		x

Example

Parent controls 80% of a subsidiary. During the year, Parent sold goods to the subsidiary worth K30,000 making a K8,000 profit. As at the year end the subsidiary sold only a quarter of the goods.

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Determine unrealized profit from the transaction.

Solution

Un realized profit will be based on the proportion not yet sold i.e.(75% of K8,000) K6,000

The accounting entry will be;

Debit	Consolidated profit reserves	K6,000	
Credit	Inventories		K6,000

c) Intercompany balances

There could be part cancellation in parent and subsidiary relationship in the following cases:

When there is sales of goods between parent and subsidiaries and the buying company has not yet received the goods. In this case goods in transit will be included in the consolidated accounts

When there are intra company balances and one has settled the account and the other company has not received the monies as at the last day of the financial Position. This will be cash in transit.

When the parent undertaking has acquired less than 100% of the subsidiary undertaking, then the rest will be non-controlling interest.

Example

Consolidation with intra-company balances

	P	S
	MK	MK
Investment in subsidiary 10 shares	15,000	
Net assets	30,000	20,000
Total Assets	45,000	20,000
Ordinary share capital of MK1 each	20,000	10,000
Reserves	15,000	5,000
Payables	10,000	5,000
Total Equity and liabilities	45,000	20,000

Notes

P acquired all the shares of S company since incorporation

In the current year, S company owed P Company MK4,000 which was included in the payable. At the year end, S company paid MK2,000 to settle the liability which was not received by P Company until 3rd January 2010. The financial statements of the group are drawn up to December each year.

Prepare the consolidated accounts as at 31st December 2009

Solution

Since the investment in P and ordinary share capital in S cancels as they are like items, the consolidated statement will be prepared as follows:

P and S consolidated financial Position

		MK
Net Assets 30-4 +20 *		46,000
Cash in transit		2,000
		48,000
Ordinary Share capital		20,000
Reserves		15,000
Payable	10+5-2**	13,000
		48,000

*the MK4,000 reduced in the Net assets is the inter-company balance which is in P Company and should be eliminated.

**the MK2,000 is the remaining balance of the intra Company balances in the S company not yet paid to P company.

Situations where there is a non -controlling interest.

The share of net assets in the subsidiary is controlled by the parent but the ownership is shared with other partner (Non-controlling Interest)

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	MK	MK'000
	P	S
Investment in S 80%	8,000	
Net Assets	22,000	20,000
Total Assets	30,000	20,000
Ordinary Share Capital	20,000	10,000
Reserves	10,000	10,000
	30,000	20,000

P Company acquired the shares in S company since incorporation.

Prepare consolidated financial statement for the group.

Solution

Like cancels like. Investment MK8,000 cancels with share capital of S company MK8,000 which leaves MK2,000 of share capital of S company.

P Company acquired 80% of share capital of S Company. Therefore only 80% of profit of S Company belong to P Company i.e. MK8, 000 profit and MK2,000 profit to Non Controlling interest.

Thus Group Profit will be

Parent	MK10,000
Subsidiary	MK 8,000
Total	MK18,000

Non-controlling Interest will be

Ordinary Share capital	MK2,000
Profit from Subsidiary	MK2,000
Total	MK4,000

Thus consolidated financial position of P and S companies

		MK
Net Assets	MK22+MK20	42,000
Total		42,000
Ordinary Share Capital		20,000
Profit Reserves		18,000
Non Controlling Interests		4,000
		42,000

b) Goodwill

Goodwill is the excess consideration over the fair value of net assets of the subsidiary acquired. The subsidiary net assets are represented by the share capital and reserves. IFRS 3 Business Combinations says goodwill be calculated using fair value method or proportionate share of the assets.

The calculation of goodwill is as follows:

Consideration transferred by the Parent	X
Non-controlling Interest % Share of B	X
Total	A
Net assets acquired	
Ordinary share capital	X
Reserves	X
Total	B
Goodwill	A-B

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Example

	MK P	MK S
Investment in S 80% of shares	20,000	
Net Assets	22,000	20,000
Total Assets	42,000	20,000
Ordinary Share Capital	30,000	10,000
Reserves	12,000	10,000
	42,000	20,000

P Company acquired 80% S Company when the reserve in the subsidiary was K4,000

Prepare consolidated financial position

Solution

Goodwill	
Consideration Transferred	MK20,000
Non-Controlling Interest 20%*14,000	MK 2,800
	MK22,800
Net assets acquired	
Ordinary Shares	MK10,000
Reserves at the date of share acquisition	MK 4,000
Total	MK14,000
Goodwill	MK 8,800

Non-Controlling Interest are valued basing on their share of net assets of the subsidiary as at the year end. Basing on information above, minority interest will be computed as follows;

Ordinary Share capital	MK10.000
Profit Reserves	MK10.000
Total	MK20,000.
20% Non-controlling Interest	MK 4,000

Consolidation reserves		
Parent reserves	MK12,000	
Subsidiary – only post acquisition (80% *6,000)	MK 4,800	
Total		MK16,800

P and S statement of Financial Position	MK'000
Goodwill	MK 8,800
Net Assets 22+20	MK42,000
Total assets	MK50,800

Ordinary Share Capital	MK30,000
Reserves	MK16,800
Non Controlling Interest	MK 4,000
	MK50,800

17.5 FAIR VALUE ADJUSTMENTS

IFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

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Fair value adjustment calculation

As we have been calculating goodwill as the difference between the cost of investment and the book value of net assets acquired by the group. If this calculation is to comply with the IFRS 13 definition reproduced above then the net assets must ensure that they include fair value adjustments.

There are two ways to include such fair value in consolidated books:

i. The subsidiary might include the fair value in its books of accounts. In this case, the assets will have included the fair value and then consolidate the assets already including fair value
ii. The subsidiary may not have included the fair value in its books of accounts. In this situation, include the fair value in the consolidated accounts.

Example fair value

P acquired its holding in the subsidiary S co. when the reserves of the subsidiary were as follows MK15,000. The subsidiary's net assets were the same as the accounts except the Plant which had the fair value of MK6,000 more than the book value. The plant had 4 years to go. The financial position of the two companies were as follows:

	P	S
	MK	MK
Investment: 7,500 share in s	26,000	
Non-current assets	42,000	50,000
Current Assets	34,000	18,000
	102,000	68,000
Financed by		
Ordinary Shares MK1 each	40,000	10,000
Reserves	62,000	58,000
	102,000	68,000

Prepare consolidation if P co acquired S co. 2 years ago.

Solution

Consolidated accounts

Non-current assets		
Property plant and equipment (42,000 +50,000 + 3000)		95,000
Goodwill		2,750
Current assets	(34,000 + 18,000)	52,000
Total assets		149,750

Capital	40,000
Consolidated reserves	92,000
Total	132,000
Non- controlling interest	17,750
Total	149,750

Workings

W1. Goodwill

Consideration transferred by P		26,000
NCI. (25% * 31,000)		7,750
Total		33,750
Net Assets acquired		
Ord. Share Cap	10,000	
Pre acquisition reserve	15,000	
Fair Value	6,000	31,000
Goodwill		2,750

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W2. Reserves	P	s
Per question	62,000	58,000
Less: Pre acquisition		(15,000)
Post acquisition		43,000
Extra depreciation *		(3,000)
		40,000
75% parents	30,000	
Total Reserve	92,000	

Extra depreciation arise on the fair value adjustment of K6,000. It is depreciated over 4 years and currently two year have passed after acquisition so the depreciation is 6,000/4years x 2 years.

W3 Non controlling interest	
Share of net assets at at the year-end (68,000 x 25%)	17,000
Adjustment for the fair value adjustment (3,000 x 25%)	750
Total	17,750

17.6 CONCLUSION

The chapter has looked at introduction to consolidated accounts. The syllabus only covers consolidated statement of financial position. It is important to note that though the syllabus is only looking at subsidiary, there are various investment categories and the accounting method differs.

When consolidating the results of the subsidiary, always remember to treat the subsidiary as an extension to the operations of the parent as such consolidation will involve adding of assets and liabilities of the parent and the subsidiary.

The chapter also looked at non- controlling interest (minority interest). These are other investors in the subsidiary and are recognized as almost as long term liability in consolidated accounts.

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END OF CHAPTER QUESTIONS

1. Tutorial questions

a) Define the following

i. Parent undertaking

ii. Subsidiary undertaking

iii. Group accounts

iv. Control

b) List four major types of investments in other business

c) When do unrealized profit arise in group accounting?

d) What is fair value?

2. Exam style question

The draft statement of financial position for Oak plc and its subsidiary Chestnut ltd at 30th September 2013 are as follows;

	Oak Plc	**Chestnut Ltd**
	MK'000	MK'000
Non-current assets		
Land and building	225	270
Plant	202.5	157.5
Shares in Chestnut Ltd	562.5	0 .0
	990.0	427.5
Current assets		
Inventory	255.0	180.0
Receivables	375.0	90.0
Bank	112.5	22.5

Current assets	742.5	292.5
Total Assets	**1,732.5**	**720.0**
Capital and reserves		
Ordinary shares (K1 each)	1,125.0	450.0
Profit reserves	450.0	202.5
	1,575.0	652.5
Current liabilities		
Payables	157.5	67.5
Total	**1,732.5**	**720.0**

The following information is also available;

i) Oak plc purchased 350,000 shares in Chestnut Ltd some years ago when that company had a credit balance of K105,000 in the reserves. The goodwill was fully impaired through the statement profit or loss by 30th September 2013.

ii) For the purpose of the takeover, land for Chestnut Ltd was revalued at K120,000 in excess of its book value. This was not reflected in the accounts of Chestnut Ltd. Land is not depreciated.

iii) At 30th September 2013 Chestnut Ltd owed Oak plc K15, 000 for goods purchased.

iv) The inventories of Chestnut included goods purchased from Oak plc at a price which includes a profit to Oak plc of K10, 500.

v) Non-controlling interest is held at fair value and the value of non-controlling interest at the time of acquisition was K145, 000

Required;

Prepare the consolidated statement of financial position for Oak group as at 30th September 2013. **20 MARKS**

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SOLUTIONS TO END OF CHAPTER QUESTIONS EXAM STYLE QUESTIONS

CHAPTER 1

a) Five users of financial information and their requirements

i) Shareholders
They are the owners of the business and would like to know how the value of the business so as to assess their net worth but also in addition how much return they should expect from the business.

They rely on both the statement of profit or loss and statement of financial position to make these assessments.

ii) Employees
The employees would like to assess the performance of the business in assessing their job security. In addition, the employees use financial information in negotiation for remuneration increases.

They rely on both the statement of profit or loss

iii) Suppliers
The suppliers would like to assess the credit worthiness of the business before committing any credit facility to the business.
Their primary statement of account is the statement of financial position.

iv) Government
Government does collect various forms of tax from the business. These include corporation tax, value added tax and PAYE which the business collects from employees on behalf of the government.

The primary statement used in making these assessments is the statement of profit or loss account.

v) Financial institutions
Financial institutions do provide credit facilities to the business and they need financial information to assess the financial viability and stability of the business.

Their primary statement of account is the statement of financial position.

vi) Management

Management are supposed to manage and control the business operations. Financial information act as a yard stick in assessing the how the business is performing.

They rely on both the statement of profit or loss and statement of financial position

vii) Customers

Very influential customers like Government would not want to engage with a supplier which has poor financial standing for fear of frustrating them in future due to failure to honor contracts.

The primary statement used in this aspect is the statement of financial position.

b) Qualitative characteristic of financial information

i) Reliability
ii) Relevance
iii) Cost /benefit
iv) Timeliness
v) Accuracy

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CHAPTER 2

The Small Enterprise Income Statement for the year ended 31 December 2008

	K	K
Sales		480,000
Opening stocks	161,000	
Purchases	320,000	
	481,000	
Less: Closing stocks	166,400	
Cost of goods sold		314,600
Gross profit		165,400
Less: expenses		
Insurance (5,600-3,200)	2,400	
Rent	17,600	
Wages (52,000 + 8,000)	60,000	
Advertising	27,800	
Depreciation (57,000 – 37,000)	20,000	127,800
Net profit		37,600

CHAPTER 3

(b)

Debtors' Control Account

1 Jan bal b/f	60,000.00	31/11/10	Bal c/d	108,000.00
Sales	675,525.00		Cash banked	627,525.00
	735,525.00			735,525,00

Creditors' Control Account

31/11/10 bal c/d	29,190.00	11/01/10	Bal b/f	23,100.00
Cash payment	392,385.00		Purchases	398,475.00
	421,575.00			421,575,00

Cash book

1 Jan bal b/f	10,800.00	Suppliers	392,385.00
Debtors	627,525.00	Cash Expenses	129,750.00
	638,325.00	Purchase non-current asset	14,400.00
		Salaries	72,300.00
		Drawings	5,000.00
		Burnt documentation	12,040.00
		31/11/10 Bal c/d	12,450.00
Balance b/d	12,450.00		638,325,00

CHAPTER 4

(a) Realisation A/C

Land & buildings		600,000	Chimombo	Land & buildings	700,000
Motor vehicles		800,000		Motor vehicles	800,000
Fixtures and fittings		180,000	Discount on payables (1% x 100000)		1,000
Inventories		80,000	Inventories – cash		72,000
Accounts receivables		60,000	Accounts receivables		60,000
Dissolution costs		12,500	Chimombo (2/5 x 99500)		39,800
			Chapola (3/5 x 99500)		59,700
		1,732,500			1,732,500

(b) (i) Capital Accounts

	Chimombo	Chapola		Chimombo	Chapola
			Balance b/f	1,000,000	500,000
Current account		60,000	Current account	200,000	
Land & buildings	700,000				
Motor vehicle	800,000				
Realization a/c	39,800	59,700			
Bank a/c		380,300		339,800	
	1,539,800	500,000		1,539,800	500,000

(ii) Bank A/C

Balance b/f	20,000	Accounts payables (99%x100000)	99,000
Inventories	72,000		
Accounts receivables	60,000	Capital A/C - Chapola	380,300
Chimombo	339,800	Realization – dissolution costs	12,500
	491,800		491,800

(c) Disadvantages of partnership over sole trader

(i) The profits have to be shared among all the partners.

(ii) You do not have as much control over the business as there are a number of owners. All of the partners will want to have a say in important decisions and this may lead to you being overruled.

(iii) Deeds of partnership have to be written if a partner leaves or dies, which can take a lot of time and cost money.

(iv) There can be disagreements between the partners. This can cause major difficulties as partners are bound by any commitments made by a single partner, even if they did not agree to it.

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CHAPTER 5

(a) (i)

Cash book

Bal b/f		12,000.00	Tourism tickets	160,000.00
Subscription fees	2010	50,000.00	Coach hiring	79,000.00
	2009	81,000.00	Sundry expenses	10,000.00
	2008	6,000.00	Printing & stationery & telephone	5,000.00
Interest received		4,000.00	Cash c/d	108,500.00
Tourism tickets		137,500.00		
Coach hiring		62,000.00		
Donations		10,000.00		
		362,500.00		362,500,00

(ii) Tinyama club's Income and Expenditure Statement for the year ended 31 December 2010

		K
Income		
Subscription fee		50,000.00
Interest received		4,000.00
Tourism tickets		137,500.00
Coach hiring		62,000.00
Expenditure		253,500.00
Tourism tickets		
Coach hiring	(79,000 – 4,000)	160,000.00
Sundry expenses		75,000.00
Subscription written off		10,000.00
Printing & stationery & telephone		4,500.00
		5,000.00
		254,500.00
Deficit		-1,000.00

(iii) Tinyama club's Statement of financial position as at 31December 2010

		K
Current assets		
Cash at bank		108,500.00
Accumulated fund	(91,500 + 12,000 + 10,000 – 4,000)	109,500.00
		(1,000.00)
Deficit		108,500.00

(b) Weighted Average Cost

Receipts				Issues				Closing stocks			
Date	Qty	Unit price	Amount	Date	Qty	Unit price	Amount	Date	Qty	Unit price	Amount
1/6/10	25	20,000.00	500,000.00					1/6/10	25.00	20,000.00	500,000.00
25/6/10	30	16,000.00	480,000.00					25/6/10	30.00	16,000.00	480,000.00
								25/6/10	55.00	17,818.18	980,000.00
					13.00	17,818.18	231,636.36		-13.00	17,818.18	-231,636.36
								30/7/10	42.00	17,818.18	748,363.64

Workings

Issues (0.5 x(30th-5th)+1)

0.5(25+1)

13 tons

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CHAPTER 6

(a) Information in the fixed asset register

- Date of purchase of the asset
- Type of the asset
- Depreciation rate
- Location of the asset
- Fixed asset code
- Allocation of asset etc

(b) Non-current asset schedule

(i)

	Land & buildings	Plant & Machinery	Motor vehicles	Total
Cost 31/12/2008	10,600,000	5,250,000	6,200,000	22,050,000
Additions	1,100,000			1,100,000
Disposal		750,000		750,000
Cost 31/12/2009	11,700,000	4,500,000	6,200,000	22,400,000
Accum depn 31/12/2008	2,600,000	960,000	2,800,000	6,360,000
Charge for the year	280,000	450,000	1,550,000	2,280,000
Disposal		150,000		150,000
Accm depn 31/12/2009	2,880,000	1,260,000	4,350,000	8,490,000
Net book value 31/12/08	8,000,000	4,290,000	3,400,000	15,690,000
Net book value 31/12/09	8,820,000	3,240,000	1,850,000	13,910,000

Workings

Charge for year		
Buildings	(11,700,000 – 5,000,000 – 1,100,000) x 5%	280,000
Plant & machinery	(4,500,000 x 10%)	450,000
Motor vehicles	(6,200,000 x 25%)	1,550,000
Disposal depreciation		
Plant & machinery	(750,000 x 10% x 2)	(150,000)

(ii)

	Dr	Cr
Buildings	1,100,000	
Bank/supplier		1,100,000
Depreciation buildings – P&L	280,000	
Accumulated depreciation – buildings		280,000
Depreciation plant and machinery – P&L	450,000	
Accumulated depreciation – plant and machinery		450,000
Disposals	750,000	
Plant & machinery		750,000

Bank a/c	550,000	
Disposals		550,000
Accumulated depreciation – plant & machinery	150,000	
Disposals		150,000
Loss on disposal (550,000 – (750,000 – 150,000)	50,000	
Disposal		50,000
Depreciation motor vehicles – P&L	1,550,000	
Accumulated depreciation – motor vehicles		1,550,000
	4,880,000	4,880,000

CHAPTER 7

a) Capitalization of development expenditure

Development expenditure should be capitalized if;

- Research costs are costs in search of new ideas and with no direct business value.
- Research costs are supposed to be charged as expense to profit or loss
- Development costs are capitalized only after technical and commercial feasibility of the product for sale or use have been established.
- The technical and commercial feasibility is met when:
- An entity intends to use the asset and will be able to complete the project
- An entity be able to demonstrate how the asset will generate future economic benefits.

b) Annual amortization for the patent

December 2011	900,000 10 years	K90
December 2011	900,000 10 years	K90, 000
December 2013	960,000 15 years	K64, 000

c) Revaluation surplus or deficit

New value on 1 January 2013			K960, 000
Net book value (900,000-90,000-90,000)			K720, 000
			K240, 000
Dr	Patent	240,000	
Cr	Revaluation surplus		240,000

d) The Balance Sheet extract

	2011	2012	2013
Patents	810,000	720,000	896,000

e) Accounting for Goodwill;

- Only the purchased goodwill should be recognized in the Financial Statement
- Goodwill should be recognized as the difference between the cost of investment and the fair value of identifiable net assets.
- Goodwill created should be amortised for a period not more than 20 years
- Goodwill should be reviewed for impairment at the end of 1 year of recognition
- Goodwill should never be reviewed upwards

CHAPTER 8

a) Impairment losses

Manufacturing lathe	800,000 * 30%	K240, 000
Bottling Equipment	650,000 * 30%	K195, 000
Labelling Machine	500,000 * 20%	K100, 000
Other Office Equipment	700,000 * 20%	K140, 000

New carrying value

Manufacturing lathe	(800-240)	K560,000
Bottling Equipment	(650-195)	K455,000
Labelling Machine	(500-100)	K400,000
Other Office Equipment	(700-140)	K560,000
		K 1,975,000

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b) Revised depreciation charges for the year to 31st December 2012

	New carrying value	Useful life	Net book value
Manufacturing lathe	K560,000	20	28,000
Bottling Equipment	K455,000	10	45,500
Labelling Machine	K400,000	10	45,500
Other Office Equipment	K560,000	5	112,000
	K 1,975,000		**231,000**

c) Revaluation of Bottling equipment

New value for the equipment after valuation	594,000
Carrying value as at 1st January 2013 (K455,000 – 45,500)	409,500
Revaluation surplus	184,500

There is need to determine what would have been the carrying value if there was no impairment on 1st January 2012;

Old carrying value	K650,000
Depreciation	65,000
Net book value	K585,000

Reversal of impairment is recognized to statement of profit or loss up to what would have been the carrying value if there was no reversal and the excess is credited to revaluation reserve.

New value	594,000	
	⇒	K9,000
What would have been the carrying value	585,000	
	⇒	K175,500
Current carrying value	409,500	

Accounting entries

Dr.	Bottling equipment	K184,500	
Cr.	Profit or loss (reversal of impairment)		K175,500
Cr.	Revaluation reserves		9,000

Being a revaluation surplus following an impairment loss in the prior year.

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CHAPTER 9

a) **Three** advantages of using first in first out valuation method for inventories

i) It is practical and represents what actually happens in practice whereby the first items to be purchased will be the first to be sold.
ii) It is easy to compute and understand
iii) Closing inventories are valued are relatively present cost
iv) It is recommended by the accounting standard

b) Valuation of closing inventories for Dziko Ltd for the month of October 2010

Date	Purchases	Sales	Balance
1/10			70 @ K700 = 49,000
2/10		10 @ K1,200 = 12,000	60 @ K700 = 42,000
5/10		40 @ K1,200 = 48,000	20 @ K700 = 14,000
10/10	50 @ K750 = 37,500		20 @ K700 = 14,000
			50 @ K750 = 37,500
15/10	30 @ K820 = 24,600		20 @ K700 = 14,000
			50 @ K750 = 37,500
			30 @ K820 = 24,600
20/10		90 @ K1,200 = 108,000	10 @ K820 = 8,200
25/10	40 @ K800 = 32,000		10 @ K820 = 8,200
			40 @ K800 = 32,000
30/10		20 @ K1,200 = 24,000	30 @ K800 = 24,000

c) Trading profit account for Dziko Ltd for October 2010

Sales (160 x 1,200)		192,000
Cost of sales		
Opening inventories	49,000	
Purchases (37,500 + 24,600 + 32,000)	94,100	
Closing inventories	(24,000)	111,000
Gross profit		81,000

d) Two categories of inventories

i) Finished goods
ii) Work in progress
iii) Raw materials

CHAPTER 10

(i) Lease payment schedule

Period	Cost of Asset	Annual Instalment	Annual interest 18%	Capital Repayment	Closing Balance
Year 1	6,070,000.00	1,941,055.50	1,092,600.00	848,451.50	5,221,548.50
Year 2	5,221,548.50	1,941,055.50	939,878.73	1,001,172.77	4,220,375.73
Year 3	4,220,375.73	1,941,055.50	759,667.63	1,181,382.87	3,038,991.86
Year 4	3,038,991.86	1,941,055.50	547,018.54	1,394,032.96	1,644,958.90
Year 5	1,644,958.90	1,941,055.50	296,092.60	1,644,958.90	-
	¼ Each 1	¼ Each 1¼	½ Each 2½	¼ Each 1¼	

6¼ Marks

(ii) Creditor's Account : Finance lease

Y1	Bank a/c	1,941,051.50	Y1	P&M	6,070,000.00
	bal c/d	5,221,548.50		finance charges	1,092,600.00
		7,162,600.00			7,162,600.00
Y2	Bank a/c	1,941,051.50	Y2	Bal b/f	5,221,548.50
	bal c/d	4,220,375.73		finance charges	939,878.73
		6,161,427.23			6,161,427.23
Y3	Bank a/c	1,941,051.50	Y3	Bal b/f	4,220,375.73
	bal c/d	3,038,991.86		finance charges	759,667.63
		4,980,043.36			4,980,043.36
Y4	Bank a/c	1,941,051.50	Y2	Bal b/f	3,038,991.86
	bal c/d	1,644,958.90		finance charges	547,018.54
		3,586,010.40			3,586,010.40
Y5	Bank a/c	1,941,051.50	Y3	Bal b/f	1,644,958.90
	bal c/d			finance charges	296,092.60
		1,941,051.50			1,941,051.50

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CHAPTER 11

a) Entries to statement of profit or loss

Sales for milk	K20,300,000
Price movement in animals	
Matured	K43,000,000
Immature	K92,000,000

Workings

- Milk sales

Milk opening balance	5,000 litres		
Milk produced	820,000 litres		
	825,000 litres		
Milk sold	812,000 litres	@ K25	K20,300,000
Closing balance	13,000 litres	@ K25	K325,000

- Fair value movement in animals

		January 2013	December 2013	Movement
1yrs	(1,000)	40,000,000	72,000,000	32,000,000
2 yrs	(500)	30,000,000	41,000,000	11,000,000
3 yrs	(4,000)	300,000,000	392,000,000	92,000,000
Total		370,000,000	505,000,000	135,000,000

b) Extracts for the statement of financial position

Non-current assets

Biological assets

Matured	392,000,000
Immature	113,000,000

Current assets

Agriculture produce (closing inventory milk)	325,000

Disclosure on movement in animals

a) Physical growth

At the beginning		At the end of the year	Difference Value	
1 year	K40,000	2yrs now	K60,000	20,000 x 1,000 = K20,000,000
2 year	K60,000	3yrs now	K75,000	15,000 x 500 = K7,500,000
3 years	K75,000	4yrs now	K90,000	15,000 x 4,000 = K60,000,000

b) Fair value less cost to sale

Fair value adjustment

	Movement in Fair values		**Total MK**
2 yrs	(72,000 – 60,000) x 1,000	=	12,000,000
3yrs	(82,000 – 75,000) x 500	=	3,500,000
4yrs	(98,000 – 90,000) x 4,000	=	32,000,000
			47,500,000

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CHAPTER 12

(a)

(i) Share Applicant Account

Bank a/c	6,000	Bank a/c (60%x1x510,000)	306,000
Ordinary share capital (500000x0.60)	300,000		
	306,000		306,000

(ii) Bank Account

Balance b/f	1,234,000		
Applicant a/c	306,000	Applicant a/c (60%x1x10,000)	6,000
Share allotment	4,700,000	Balance c/d	6,234,000

	6,240,000		6,240,000
Balance b/d	6,234,000		

(iii) Share Allotment Account

Ordinary share capital (500000xK0.4)	200,000	500000 shares at (K10-0.6) 9.40	4,700,000
Share premium a/c (500000 x K9)	4,500,000		
	4,700,000		4,700,000

(iv) Ordinary Share Capital a/c

		Balance b/f (250,000 x 1)	250,000
Balance c/d	750,000	Share applicants	300,000
		Share allotment a/c	200,000
	750,000		750,000
		Balance b/d	750,0003

(v) Share premium a/c

		Balance b/f (250,000 x(7.50-1) = 6.50)	1,625,000
Balance c/d	6,125,000	Share allotment a/c	4,500,000
	6,125,000		6,125,000
		Balance b/d	6,125 ,000

(b) Authorized and paid up capital (500000+250000) 750,000

(c) Extract of statement of financial position after issue

750,000 K1 ordinary share capital	750,000 ½
Share premium	6,125,000 ½
Profit and loss	2,345,673
	9,220,673
Current assets	
Cash and bank	6,234,000

(d) Types of registers

- Shareholder register
- Directors register
- Debenture register etc

CHAPTER 13

a) Corporate tax account

Corporation tax Account 2009

Tax paid	180,000	profit or loss charge	180,000
Balance c/d	0		
	180,000		180,000

Corporate tax account 2010

Tax paid	216,000	Balance b/f		0
		Proft charge	216,000	
		Prior year adjust.	(60,000)	156,000
		Balance C/d		60,000
	216,000			216,000

Corporate tax Account 2011

Balance b/f	60,000	Profit loss charge	243,000	
Bank	216,000	Prior year adjust.	24,000	267,000
		Balance c/d		9,000
	276,000			276,000

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Corporate tax account 2012

Balance b/f	9,000	Profit and loss charge	255,000	
Bank	255,000	Prior year adjust.	42,000	297,000
Balance c/d	33,000			
	297,000			297,000

Corporate tax account 2013

Bank	261,000	Balance c/d		33,000
		Profit & loss	261,000	
		Prior year adjust.	(39,000)	222,000
		Balance c/d		6,000
	261,000			261,000

b) Statement of profit or loss entry

	2009	2010	2011	2012	2013
	K'000	K'000	K'000	K'000	K'000
Tax charge	180	256	267	297	222

c) Statement of financial position

	2009	**2010**	**2011**	**2012**	**2013**

Current assets

Tax receivable	0	60,000	9,000	0	6,000

Current liabilities

Tax payable	0	0	0	33,000	0

CHAPTER 14

(a) (i) Income statement for Chitukuko Ltd for the year ended 31 December 2010

	K	K
Sales		4,484,000
Returns inwards		(129,342)
		4,354,658
Opening inventories	323,000	
Purchases	2,360,750	
Returns outwards	(117,372)	
Warehouse wages	384,028	
	2,950,406	
Less: closing inventories	392,018	
Cost of goods sold		2,558,388
Gross profit		1,796,270
Less: Expenses		
Administration Expenses		
Wages & salaries	228,000	
General expenses	140,277	
Depreciation-plant & machinery (20% x 608,000) x 60%	72,960	
Audit fees	51,841	
Motor hire expenses	78,612	
	571,690	
Distribution Expenses		
Carriage outwards	40,641	
Salesmen's salaries	289,750	
General expenses	120,873	
Depreciation – plant & machinery (20% x 608,000) x 40%	48,640	

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	499,904	
Total Expenses		1,071,594
Profit before tax		724,676
Taxation		181,659
Profit after tax		543,017
Dividends (25%x950,000)		237,500
Retained profit for the year		305,517
Retained profit b/f		145,550
Retained profit c/f		451,067

(ii) Statement of financial position for Chitukuko Ltd as at 31December 2010

	K
Non-current Assets	
Plant and machinery	608,000
(accumulated depreciation)	328,976
	279,024
Current Assets	
Inventories	392,018
Accounts receivables	1,539,000
Cash at bank	171,238
	2,102,256
Less: Current Liabilities	
Accounts payables	343,491
Audit fees	51,841
Taxation	181,659
Dividends	237,500
	814,491
Working capital	
	1,287,765
Net assets	
	1,566,789
Ordinary share capital	
Share premium	950,000
Retained profit	165,722
	451,067
	1,566,789

(a) Drawings are monies or goods withdrawn from business for proprietor's personal use while dividends are payments made by a company to its shareholders out of profits. The main difference is that drawings could be money or goods and are not regulated while dividends are mainly in monetary form though could be in shares form but they are regulated payments.

CHAPTER 15

Statement of cash flows for the year ended 31 December 2010

		K	K
Profit before taxation		275,000	
Add depreciation	(215000-(200000-(75000-50000))	40,000	
Loss on disposal		4,000	
Interest		5,000	
		324,000	
Increase in inventories	(250000-300000)	(50,000)	
Increase in accounts receivables	(200000-235000)	(35,000)	
Decrease in accounts payables	(125000-135000)	(10,000)	
Cash generated from operations		229,000	
Interest paid		(5,000)	
Income taxes paid (45000+50000-40000)		(55,000)	
Dividends (50000+110000-60000)		(100,000)	
Net cash flows from operating activities			69,000
Cash flows for investing activities			
Acquisition of machinery (650000-(600,000-75000)		(125,000)	
Proceeds disposal of machinery (50000-4000)		46,000	
Net cash flows from investing activities			(79,000)
Cash flows from financing activities			
Proceeds from issue of shares (340000-325000)+(360000-(250000+115000))		10,000	
Debenture repayments (15000-10000)		(5,000)	5,000
Net cash flows from financing activities			(5,000)
Net decrease in cash and cash equivalents			
Cash and cash equivalent at beginning of period			20,000
Cash and cash equivalent at end of period			15,000

(TOTAL : 20 MARKS)

CHAPTER 16

(a)	Gross margin	gross profit/sales	(22,400,000 – 15,920,000)/22,400,000	28.9%
	Return on capital employed	- profit before interest and taxation/Equity and liabilities	(970,000 + 120,000 + 10,000)/7,200,000	15.3%
	Current ratio – total current assets/total current liabilities		3,900,000/1,910,000	2.04
	Asset turnover – turnover/total asset		22,400,000/7,200,000	3.11
	Inventory turnover – cost of sales/average inventory		15,920,000/1,260,000	12.63
	Gearing ratio – total long term liabilities/total funds		1,200,000/5,290,000	22.7%

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(b) The company's gross profit margin is 28.9% as against the industry 30% - therefore performing below the industry average.

The company's current ratio is 2.04 against the industry's 2 – therefore performing slightly better than the industry.

The company's gearing ratio is 22.7% against the industry's 25% - therefore performing better than the industry.

(c) Differences in accounting methods between companies

- Differences in financial and business risk profile of companies being compared
- Differences in management.

CHAPTER 17

Consolidated Statement of Financial position for Oak Plc

Non-current assets				**MK**
Land and buildings	(225 + 270+ **120)**			615,000
Plant	(202.5 + 157.5)			360,000
				975,000
Current assets				
Inventories	(255 + 180 – 10.5)	(working 2)	424,500	
Receivables	(375 + 90 – 15)	(working 3)	450,000	
Bank	(112.5 + 22.5)		135,000	1,009,500
				1,984,500
Capital and liabilities				
Ordinary share capital				1,125,000
Reserves (Working 4)				494,000
				1,619,000
Non-controlling interest (working 5)				140,500
Non-current liabilities				
Payables	(157.5 + 67.5)			225,000
				1,984,500

Workings

1. Goodwill computation

Cost of investment		562,500
Non-controlling interest		145,000
Share capital	150,000	
Reserves	105,000	
Fair value adjustment	120,000	(675,000)
Goodwill		32,500
To Group	32,500 x 80%	22,500
To non-controlling interest	(balancing figure)	10,000

2. Intercompany adjustments – receivables

Dr.	Receivables – Oak	15,000	
Cr.	Payables – Chestnut		15,000

Being adjustment for intercompany balances

3. Intercompany adjustment – Unrealized profit

Dr.	Consolidated profit reserves	10,500	
Cr.	Inventories		10,500

Being adjustment for unrealized profit on closing inventories

4. Consolidated profit reserves

Parent reserves	450,000
Share of post acquisition for subsidiary (202.5 – 105) x 80%	78,000
Goodwill written off	(23,500)
Unrealized profit on intercompany transaction	(10,500)
	494,000

NOT FOR SALE

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ACCOUNTING 2 (TC6)

TECHNICIAN DIPLOMA IN ACCOUNTING

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