# Kampala International University Uganda

**BACHELOR OF COMMERCE (ACCOUNTING)**

**MODULE**

# ADVANCED ACCOUNTING

**By**

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# INTRODUCTION

## Unit 1
## Accounting Theory and Regulatory Framework
### 1.1 Introduction

**The scope of Accounting**

Accounting as a profession has evolved overtime and keeps changing from time to time depending on the demands put on it by users of accounting information. It is not what it was ten years ago and it will not be what it is now ten years from now.

Traditionally, accounting involved the following functions;

**Record keeping**; this involved recording transactions about an entity in monetary terms as they arose.

**Preparation of budgets**; expected operating results and financial positions of business entities

**Financial statement preparation and presentation;** to be used by interested groups in determining the financial operations and results of a business entity. These statements include; the balance sheet, income statement, cashflow statement, statement of changes in equity and explanatory notes and accounting policies.

The present scope of accounting is, however, wider. It is taking on social importance, social welfare and the environment. In particular, public interest in protecting the natural environment has grown significantly during the last ten years. The other areas which are important for decision making include the following;

- Human resource accounting
- Forecast reporting
- Social reporting
- Environmental accounting

### 1.2 Difficulties facing an accountant

- Traditional accounting areas are being invaded by different skills for example systems analysis, computerized accounting systems etc.

- Different accountants may produce different statements from the same set of data. This confuses readers of financial statements who expect accountants to produce correct data.

**International Accounting Standards and International Financial Reporting Standards.**

The foreword to accounting standards defines accounting standards as authoritative statements of how particular types of transaction and other events should be reflected in financial statements. Accounting standards are developed to achieve comparability of financial information between and among different organizations. International Accounting Standards (IAS's) and International Financial Reporting Standards (IFRS) are meant to apply to most organizations in the world. IAS's and IFRS's are produced by the International Accounting Standards Board (IASB) whose objectives are:

(a) To formulate and publish in the public interest accounting standards to be observed in the presentation of financial statements and to promote their worldwide acceptance; and
(b) To work generally for the improvement and harmonization of regulations, accounting standards and procedures relating to the presentation of financial statements.

## 1.3 International Accounting Standards

### (a) Historical Development

The International Standards Committee (IASC), established in 1973, was an independent private sector body and had no formal authority. It therefore had to rely on persuasion and the professionalism of others to encourage adoption of the International Accounting Standards (IASs) that it issued. The IASC operated under the umbrella of the International Federation of Accountants (IFAC), which is the worldwide organization of accountancy bodies and is independent of any country's government. All members of IFAC were originally members of IASC. One of the problems facing the IASC was that it quite often had to issue standards that accommodated two or more alternative acceptable accounting treatments. This situation arose because these alternative treatments were being practiced in countries that were members of the IASC.

In 1995 the IASC entered into an agreement with the International Organisation of Securities Commission (IOSCO) (the body representing stock exchanges throughout the world) to produce a core set of accounting standards. These standards were to be endorsed by IOSCO as an appropriate reporting regime for business entities in the global marketplace for the raising of finance. This deal was to give IASC its much needed

authority. However, to gain IOSCO's backing the IASC had to agree to a restructuring which occurred in 2000. The core standards were completed in 2000 and adopted by IOSCO in May 2000.

The European Union, besides issuing directives on company law (Fourth and Seventh Directives), has also adopted the IASB standards for the preparation of financial statements.

**(b) International Accounting Standards Board (IASB)**
The IASC became known as the IASB under the required restructuring in 2000. It is governed by a group of 19 individual trustees, known as the IASC Foundation, with diverse geographical and functional backgrounds. The current Chair of the trustees is Paul A. Volcker, the former chair of the US Federal Reserve Board. The trustees are responsible for the governance, fundraising and public awareness of the IASB. Currently the IASB has developed about 40 International Accounting Standards (IASs). Examples include:

**IAS 1 Presentation of Financial Statements** (FRS 3 UK similar, but not identical)
The standard sets out overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content. It specifies that a complete set of financial statements comprises:

- a balance sheet
- an income statement (profit and loss statement) – a statement of changes in equity
- a cash flow statement
- notes and specified disclosure requirements

**IAS 2 Inventories** (SSAP 9 UK similar, but not identical)
The primary issue in the accounting for inventories is the amount of cost to be recognized as an asset and carried forward until the related revenues are recognized. Inventories are assets;

- held for sale
- in the process of production for such sale
- in the form of materials or supplies to be consumed in the production process or the rendering of services.

The standard does not cover construction contracts. These are dealt with under IAS 11

**IAS 7 Cash Flow Statements** (FRS 1 revised UK similar, but not identical)
The standard deals with the preparation of one of the primary financial statements as specified by IAS 1. It deals with cash flows during the period

rather the matching of revenue and expenses and, therefore, provides further information to users in terms of performance and liquidity in addition to information provided in the income statement.

**IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors** (FRS 18 UK similar, but not identical)
The objective of the standard is to prescribe the criteria for selecting and changing accounting policies used in the preparation of financial statements. Its use should enhance the relevance and reliability of the financial statements produced.

**IAS 10 Events After the Balance Sheet Date** (FRS 21 UK)
The standard deals with events that occur after the balance sheet date and whether these affect the financial statements prepared and/or whether information on these events should be provided in the notes to the accounts.

**IAS 11 Construction Contracts** (SSAP 9 UK similar, but not identical)
The primary issue in dealing with construction contracts that cover more than one accounting period is the allocation of contract revenue and contract costs to the appropriate accounting period.

**IAS 12 Income Taxes** (FRS 16 and 19 UK similar, but not identical)
Income taxes are all domestic and foreign taxes which are based on taxable profits. The standard deals with the accounting of both current taxes and deferred taxes.

**IAS 16 Property, Plant and Equipment** (FRS 15 UK similar, but not identical)
The principal issues in accounting for property, plant and equipment (tangible fixed assets) are the recognition of the assets, the determination of their carrying amounts and the depreciation charges and impairment losses to be recognized in relation to them.

**IAS 17 Leases** (SSAP 21 UK similar, but not identical)
Businesses do not always purchase the fixed assets they require but, rather; quite often lease them from another party. These leased assets in substance can be used by the business as if they had purchased them and, therefore, the standard details the recognition and accounting for such leased assets. This is an example of accounting for substance over form.

**IAS 18 Revenue** (FRS 5 UK similar, but not identical)
Income as defined in the framework for the preparation and presentation of financial statements is increases in economic benefits during the accounting period. It further states that income encompasses both revenues and gains.

So what is revenue? This standard answers that question and explains how it should be measured.

**IAS 19 Employee Benefits** (FRS 17 UK similar, but not identical)
Many businesses, in addition to wages/salaries, provide further benefits to their employees. Such benefits include:

- retirement plans
- insurance plans such as hospital, dental, life and disability insurance
- stock options
- profit sharing plans
- recreational programmes
- vacation schemes, etc.

This standard deals with the accounting for all employee benefits except those dealt with under a specific standard. The standard requires the recognition of a liability when an employee has provided service in exchange for employee benefits to be paid in the future and the recognition of an expense when the entity consumes the economic benefit arising from service by an employee in exchange for employee benefit.

**IAS 20 Accounting for Government Grants and Disclosure of Government Assistance** (SSAP 4 UK similar, but not identical)
Government grants should be recognized in the income statement so as to match the expenditure to which they relate. Capital grants relating to capital expenditure should be credited to revenue over the expected useful economic life of the asset.

**IAS 21 The Effects of Changes in Foreign Exchange Rates** (SSAP 20 UK similar, but not identical)
A business may carry on foreign activities in two ways – it may have transactions in foreign currencies or it may have foreign operations. The objective of this standard is to prescribe how to deal with such activities in the financial statements.

**IAS 23 Borrowing Costs** (no UK equivalent)
Businesses often borrow and acquire loans, to purchase assets. Normally the interest costs on such assets should be expensed to the income statement in accordance with the matching principle. However, it is possible to put forward an alternative argument that such borrowing costs, the interest, should be capitalized as part of the cost of the asset. This standard deals with the accounting for borrowing costs and whether the alternative treatment can be permitted.

**IAS 24 Related Party Disclosures** (FRS 8 UK similar, but not identical)

The objective of this standard is to ensure that a business's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties. This disclosure is necessary because quite often such transactions would not be entered into with unrelated parties.

**IAS 26 Accounting and Reporting by Retirement Benefit Plans** (FRS 17 UK, similar but not identical)
This standard deals with the preparation of financial statements by retirement benefit plan (pension schemes) entities.

**IAS 27 Consolidated and Separate Financial Statements** (FRS 2 UK similar, but not identical)
This forms the basis of study units 11 and 12 where we deal with the preparation of financial statements for holding and subsidiary businesses.

**IAS 28 Investments in Associates** (FRS 9 UK similar, but not identical)

**IAS 29 Financial Reporting in Hyperinflationary Economies** (FRS 24 UK)
In a hyperinflationary economy, financial statements are only useful if they are expressed in terms of the measuring unit current at the balance sheet date. Thus, the standard requires restatement of financial statements of businesses operating in a hyperinflationary economy.

**IAS 31 Interests in Joint Ventures** (FRS 9 UK similar, but not identical)

**IAS 32 Financial Instruments: Presentation** (FRS 25 UK)

**IAS 33 Earnings per Share** (FRS 22UK)
This statement specifies the determination and presentation of the earnings per share figure/s in the financial statements.

**IAS 34 Interim Financial Reporting** (ASB statement interim reports)

**IAS 36 Impairment of Assets** (FRS 11 UK similar, but not identical)
The objective of this standard is to prescribe the procedures that a business applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying value exceeds the amount to be recovered through the use or sale of the asset. If this is the case, the asset is described as impaired and the standard requires the business to recognize an impairment loss.

**IAS 37 Provisions, Contingent Liabilities and Contingent Assets** (FRS 12 UK, similar but not identical)
The standard deals with the appropriate recognition and measurement of provisions and contingencies. It defines a provision as a liability of uncertain timing or amount.

**IAS 38 Intangible Assets** (FRS 10 UK similar, but not identical)
The standard only permits the recognition of intangible assets if certain criteria are met. An intangible asset is defined as an identifiable non-monetary asset without physical substance, such as research and development costs, broadcasting licenses, airline route authority, patents, copyrights, etc.

**IAS 39 Financial Instruments: Recognition and Measurement** (FRS 26 UK)

**IAS 40 Investment Property** (SSAP 19 UK similar, but not identical)
An investment property is property held by a business to earn rentals or for capital appreciation or both, rather than for use in the production or supply of goods or services. The standard deals with the accounting treatment of such investment properties.

**IAS 41 Agriculture**

**Reasons why Accountants should observe International Accounting Standards:**

a) Use of IASs adds credibility to the financial statements as they can be compared with others globally.
b) Facilitates communication within an enterprise that has foreign branches or subsidiaries due to harmonized reporting by the separate entities in the group.
c) Adds value to the financial statements in case an entity is sourcing for foreign capital.
d) In case an entity wishes to be quoted on the Stock Exchange Market more so for companies.

## (c) Accounting Concepts Bases and Policies

### Concepts/conventions/principles
Accounting Concepts are broad basic assumptions that underlie the periodic financial accounts of business enterprises. Examples of concepts include:

i) **The going concern concept:**

This implies that the business will continue in operational existence for the foreseeable future, and that there is no intention to put the company into liquidation or to make drastic cutbacks to the scale of operations. Financial statements should be prepared under the going concern basis unless the entity is being (or is going to be) liquidated or if it has ceased (or is about to cease) trading. The directors of a company must also disclose any significant doubts about the company's future if and when they arise. The main significance of the going concern concept is that the assets of the business should not be valued at their 'break-up' value, which is the amount that they would sell for it they were sold off piecemeal and the business were thus broken up. Also it is through this concept that forecasting and budgeting are based on. However, the short coming of the concept is that the business operates in an environment and sometimes it leaves an organisation with no choice but to wind up as we have seen many organisations doing so e.g. GTV.

ii) **The accruals concept**

States that revenue and costs must be recognized as they are earned or incurred, not as money is received or paid. They must be matched with one another so far as their relationship can be established or justifiably assumed, and dealt with in the profit and loss account of the period to which they relate. This means that income is recorded when it is earned and expense is recorded when incurred i.e. the organization has obtained the benefit from it.

iii) **The Prudence Concept:**

The prudence concept states that accountants should not only anticipate for profits alone, but should also provide for losses as well. Where alternative procedures, or alternative valuations, are possible, the one selected should be the one that gives the most cautious presentation of the business's financial position or results. Therefore, revenue and profits are not anticipated but are recognized by inclusion in the profit and loss account only when realized in the form of either cash or of other assets the ultimate cash realization of which can be assessed with reasonable certainty: provision is made for all liabilities (expenses and losses) whether the amount of these is known with certainty or is best estimate in the light of the information available. Assets and profits should not be overstated, but a balance must be achieved to prevent the material overstatement of liabilities or losses.

The other aspect of the prudence concept is that where a loss is foreseen, it should be anticipated and taken into account immediately. If a business purchases stock for £1,200 but because of a sudden slump in the market only £900 is likely to be realized when the stock is sold the prudence

concept dictates that the stock should be valued at £900. It is not enough to wait until the stock is sold, and then recognize the £300 loss; it must be recognized as soon as it is foreseen. A profit can be considered to be a realized profit when it is in the form of:

a) Cash
b) Another asset that has a reasonably certain cash value. This includes amounts owing from debtors, provided that there is a reasonable certainty that the debtors will eventually pay up what they owe.

A company begins trading on 1 January 20X2 and sells goods worth £100,000 during the year to 31 December. At 31 December there are debts outstanding of £15,000. Of these, the company is now doubtful whether £6,000 will ever be paid. The company should make a provision for doubtful debts of £6,000. Sales for 20x5 will be shown in the profit and loss account at their full value of £100,000, but the provision for doubtful debts would be a charge of £6,000. Because there is some uncertainty that the sales will be realized in the form of cash, the prudence concept dictates that the £6,000 should not be included in the profit for the year.

iv) **The consistency concept:**

The consistency concept states that in preparing accounts consistency should be observed in two respects.

a) Similar items within a single set of accounts should be given similar accounting treatment.
b) The same treatment should be applied from one period to another in accounting for similar items. This enables valid comparisons to be made from one period to the next.

v) **The entity concept:**

The concept is that accountants regard a business as a separate entity, distinct from its owners or managers. The concept applies whether the business is a limited company (and so recognized in law as a separate entity) or a sole proprietorship or partnership (in which case the business is not separately recognized by the law.

vi) **The money measurement concept:**

The money measurement concept states that accounts will only deal with those items to which a monetary value can be attributed. For example, in the balance sheet of a business, monetary values can be attributed to such assets as machinery (e.g. the original cost of the machinery; or the amount it would cost to replace the machinery) and stocks of goods (e.g. the original cost of goods, or, theoretically, the price at which the goods are likely to be sold).

The monetary measurement concept introduces limitations to the subject matter of accounts. A business may have intangible assets such as the flair of a good manager or the loyalty of its workforce. These may be important enough to give it a clear superiority over an otherwise identical business, but because they cannot be evaluated in monetary terms they do not appear anywhere in the accounts.

vii) **The materiality concept:**

An item is considered material if it's omission or misstatement will affect the decision making process of the users. Materiality depends on the nature and size of the item. Only items material in amount or in their nature will affect the true and fair view given by a set of accounts.

An error that is too trivial to affect anyone's understanding of the accounts is referred to as immaterial. In preparing accounts it is important to assess what is material and what is not, so that time and money are not wasted in the pursuit of excessive detail.

Determining whether or not an item is material is a very subjective exercise. There is no absolute measure of materiality. It is common to apply a convenient rule of thumb (for example to define material items as those with a value greater than 5% of the net profit disclosed by the accounts). But some items disclosed in accounts are regarded as particularly sensitive and even a very small misstatement of such an item would be regarded as a material error. An example in the accounts of a limited company might be the amount of remuneration paid to directors of the company.

The assessment of an item as material or immaterial may affect its treatment in the accounts. For example, the profit and loss account of a business will show the expenses incurred by he business grouped under suitable captions (heating and lighting expenses, rent and rates expenses etc); but in the case of very small expenses it may be appropriate to lump them together under a caption such as 'sundry expenses', because a more detailed breakdown would be inappropriate for such immaterial amounts.

**Example:**

a) If a balance sheet shows fixed assets of £2 million and stocks of £30,000; an error of £20,000 in the depreciation calculations might not be regarded as material, whereas an error of £20,000 in the stock valuation probably would be. In other words, the total of which the erroneous item forms part must be considered.
b) If a business has a bank loan of £50,000 balance and a £55,000 balance on bank deposit account, it might well be regarded as a material misstatement if these two amounts were displayed on the balance sheet

as 'cash at bank £5,000'. In other words, incorrect presentation may amount to material misstatement even if there is no monetary error.

viii) **The historical cost convention:**

This concept requires accountants to record assets and or liabilities at their original cost of acquisition. A basic principle of accounting (some writers include it in the list of fundamental accounting concepts) is that resources are normally stated in accounts at historical cost, i.e. at the amount that the business paid to acquire them. An important advantage of this procedure is that the objectivity of accounts is maximized: there is usually objective, documentary evidence to prove the amount paid to purchase an asset or pay an expense. Historical cost means transactions are recorded at the cost when they occurred.

In general, accountants prefer to deal with costs, rather than with 'values'. This is because valuations tend to be subjective and to vary according to what the valuation is for. For example, suppose that a company acquires a machine to manufacture its products. The machine has an expected useful life of four years. At the end of two years the company is preparing a balance sheet and has decided what monetary amount to attribute to the asset. The limitation of the concept is that it does not consider the effect of changes in value since some assets appreciate e.g. land where as others depreciate.

ix) **Objectivity (neutrality):**

An accountant must show objectivity in his work. This means he should try to strip his answers of any personal opinion or prejudice and should be as precise and as detailed as the situation warrants. The result of this should be that any number of accountants will give the same answer independently of each other. Objectivity means that accountants must be free from bias. They must adopt a neutral stance when analysing accounting data. In practice objectivity is difficult. Two accountants faced with the same accounting data may come to different conclusions as to the correct treatment. It was to combat subjectivity that accounting standards were developed.

x) **The realization concept:**

Revenue and profits are recognized when realized. The concept states that revenue and profits are not anticipated but are recognized by inclusion in the income statement only when realized in the form of either cash or of other assets the ultimate cash realization of which can be assessed with reasonable certainty.

xi) **Duality:**

For every debit entry, there must be a corresponding credit entry. Every transaction has two-fold effect in the accounts and is the basis of double entry bookkeeping.

xii) **Substance over form**:

The principle that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form e.g. a non current asset on Hire purchase although is not legally owned by the enterprise until it is fully paid for, it is reflected in the accounts as an asset and depreciation provided for in the normal accounting way.

I) **Bases**

Bases are the methods that have been developed for expressing or applying fundamental accounting concepts to financial transactions and items. Examples include:

- Depreciation of Non current Assets (e.g. by straight line or reducing balance method)
- Treatment and amortization of intangible assets (patents and trade marks)
- Stocks and work in progress (FIFO, LIFO and AVCO)

II) **Policies**

Accounting policies are the specific accounting bases judged by business enterprises to be the most appropriate to their circumstances and adopted by them for the purpose of preparing their financial accounts.

NB: The distinction between concepts, bases and policies is often unclear in some people minds. The following table should facilitate a clear understanding.

| **Concept** | **Base** | **Policy** |
|---|---|---|
| Prudence | Provision against bad debts | 1% or 5% etc of total debtors plus specific provisions against certain debtors. |
| Going concern | Carrying forward research and development expenditure | Only carried forward expenditure relating to commercially viable projects |
| Consistency | Stock valuation or Depreciation. | Using Straight-line or reducing balance) LIFO or FIFO being followed |

| | | from one year to the other. |
|---|---|---|

## 1.4 Qualities of Useful Financial Information

The four principal qualities of useful financial information are understand ability, relevance, reliability and comparability.

**Understandability:**
An essential quality of the information provided in the financial statements is that it is readily understandable by users. For these reason users are assumed to have a reasonable knowledge of business and economic activities and accounting.

**Relevance:**
Information has the quality of being relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming or correcting their past evaluations. The relevance of information is affected by its nature and materiality.

**Reliability:**
Information is useful when it is free from material error and bias and can be depended upon by users to represent faithfully that which it purports to represent or could reasonably be expected to represent. To be reliable then the information should:

a) Be represented faithfully,
b) Be accounted for and presented in accordance with their substance and economic reality and not merely their legal form,
c) Be neutral i.e. free from bias,
d) Include some degree of caution especially where uncertainties surround some events and transactions (prudence),
e) Be complete i.e. must be within the bounds of materiality and cost. An omission can cause information to be false.

**Comparability:**
Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different accounting policies, changes in the various policies and the effect of these changes in the accounts. Compliance with accounting standards also helps achieve this comparability.

## Review Questions

1.

## Unit 2
## International Accounting Standard 1: Preparation and Presentation of Financial Statements.
### 2.1 Introduction

The idea of publishing financial statements, at least to members is a consequence of the development of the concept of limited liability and the spread world wide of the company with share capital as the main form of organization for larger companies. The purpose of IAS 1 is to prescribe the basis for the presentation of general purpose financial statements, in order to ensure comparability.

IAS 1 deals with six accounting concepts and sets out standard formats for the income statement and balance sheet as well as several supporting statements. The accounting concepts dealt with here most include; Going concern, Historical cost, Business entity, Accruals, Prudence concept and duality concept. Management should select and apply appropriate accounting policies so that the financial statements comply with all international standards and interpretations as well as local regulations. If there is a specific standard for a particular item, then management should choose policies that are relevant and reliable.

**Requirements of IAS 1**

**Identification of Financial statements**

a) Financial statements should be clearly identified and distinguished from other information in the same published document.
b) Each component of the financial statements should be clearly identified. In addition, the following information should be prominently displayed, and repeated if necessary for the proper understanding of the information presented as follows:
    - The name of the reporting enterprise or other means of identification
    - Whether the financial statements cover an individual enterprise or a group of enterprises
    - The balance sheet date or date covered by the financial statements, whichever is appropriate to the related component of the financial statements.
    - The reporting currency

- The level of precision used in the presentation of figures in the financial statements(e.g. '000, '000000)

**Components of Financial statements**

A complete set of financial statements includes the following five components:

- Balance Sheet
- Income Statement
- Statement of changes in Equity
- Cash flow Statement
- Accounting Policies and Explanatory Notes.

## 2.2 Statement of Changes in Equity

- The statement of changes in equity shows the movement in the shareholders equity (capital and reserves) during the year.
- We can say that it replaces profit and loss appropriation account of partnership business.

**FORMAT OF STATEMENT OF CHANGES IN EQUITY**

| **Name of the Company** | | | | | |
|---|---|---|---|---|---|
| **Statement of Changes in Equity for Year Ended June 30,** | | | | | |
| | Share Capital | Share Premium Account | Reserves | Profit & Loss A/c | Total |
| Balance On Jun 30, 2000 | X | X | X | X | X |
| Movements During the Year | | | | X | X |
| Balance On Jun 30, 2001 | X | X | X | X | X |
| Movements During the Year | | | | X | X |
| Balance On June 30, 2002 | X | X | X | X | X |

**Procedure for preparing statement of change in equity**

- All the opening balances of share holders' equity are listed down first.
- Movement during the year in share holders' equity is recorded.
- After adding/reducing the share holders' equity, closing balances are calculated.
- All information regarding share holders' equity is collected from balance sheet of the company.

- According to International Accounting Standards, fixed assets revaluation reserve is included in the statement of changes in equity. But The Companies Ordinance does not allow revaluation reserve to become a part of statement of changes in equity. As Companies Ordinance prevails over International Accounting Standards, so we do not show Revaluation reserve in the statement of changes in equity.

**Example One**

The following is a trial balance is extracted from the books of RCL as on 31st December 2005

| | Dr | Cr |
|---|---|---|
| | **$** | **$** |
| 10% preference share capital | | 20,000 |
| Ordinary share capital | | 70,000 |
| 10% Debentures (repayable 2009) | | 30,000 |
| Goodwill at cost | 15,500 | |
| Buildings at Cost | 95,000 | |
| Equipment at cost | 8,000 | |
| Motor vehicles at cost | 17,200 | |
| Provision for depreciation: Equipment 1.1.2005 | | 2,400 |
| Provision for depreciation: Motors 1.1.2005 | | 5,160 |
| Stock 1.1.2005 | 22,690 | |
| Sales | | 98,200 |
| Purchases | 53,910 | |
| Carriage inwards | 1,620 | |
| Salaries and wages | 9,240 | |
| Director's remuneration | 6,300 | |
| Motor expenses | 8,120 | |
| Rates and insurance | 2,930 | |
| General expenses | 560 | |
| Debenture interest | 1,500 | |
| Debtors | 18,610 | |
| Creditors | | 11,370 |
| Bank | 8,390 | |
| General reserve | | 5,000 |
| Share premium | | 14,000 |
| Interim ordinary dividend paid | 3,500 | |
| Profit and loss account 31.12.2004 | | 16,940 |

| | | |
|---|---|---|
| | **273,070** | **273,070** |

*The following adjustments are needed:*

I. Stock at 31.12.2005 was $27,220
II. Depreciate motors $3,000, equipment $1,200
III. Accrue debenture interest $1,500
IV. Provide for preference dividend $2,000 and final ordinary dividend of 10%
V. Transfer $2,000 to general reserve
VI. Write off goodwill $3,000
VII. Authorized share capital is $20,000 in preference shares and $100,000 in ordinary shares
VIII. Provide for corporation tax $5,000.

***Required;***

Using IAS 1, prepare the company's Income Statement for the year ended 31.12.2005 and the Balance sheet as at 31.12.2005. ***Notes to accounts are required.***

**RCL**

**Income statement for the year ended 31.12.2005**

| | **Notes** | **$** | **$** |
|---|---|---|---|
| Sales | | | 98,200 |
| Less: Cost of Sales | | | |
| Opening Stock | | 22,690 | |
| Add Purchases | | 53,910 | |
| Add Carriage inwards | | 1,620 | |
| Cost of Goods available for sale | | 78,220 | |
| Less Closing Stock | | (27,220) | |
| Cost of Sales | | | (51,000) |
| Gross Profit | | | 47,200 |
| Less Operating Expenses | | | |
| Salaries and Wages | | 9,240 | |
| Motor expenses | | 8,120 | |
| Rates and insurance | | 2,930 | |
| General Expenses | | 560 | |
| Director's remuneration | (A) | 6,300 | |
| Debenture Interest | (B) | 3,000 | |
| Depreciation: Motors | | 3,000 | |
| Equipment | | 1,200 | (34,350) |
| Profit before tax | | | 12,850 |

| | | | |
|---|---|---|---|
| Corporation tax | | | (5,000) |
| Profit after tax | | | 7,850 |
| Add Retained earnings | | | 16,940 |
| | | | 24,790 |
| Less Appropriations: | | | |
| Transfer to General reserve | | 2,000 | |
| Goodwill written off | | 3,000 | |
| Preference share dividend | | 2,000 | |
| Ordinary share dividends: Interim | | 3,500 | |
| Final | (c) | 7,000 | (17,500) |
| Retained Profits Carried foreword | | | **7,290** |

**RCL**
**Balance sheet as at 31.12.2005**

| **NON-CURRENT ASSETS** | **COST** | **ACC.DEP** | **NBV** |
|---|---|---|---|
| | **$** | **$** | **$** |
| Buildings | 95,000 | - | 95,000 |
| Equipment | 8,000 | 3,600 | 4,400 |
| Motors | 17,200 | 8,160 | 9,040 |
| Goodwill | 15,500 | 3,000 | 12,500 |
| | 135,700 | 14,760 | 120,940 |
| **CURRENT ASSETS** | | | |
| Stock | | 27,220 | |
| Debtors | | 18,610 | |
| Bank | | 8,390 | 54,220 |
| **TOTAL ASSETS** | | | **175,160** |
| FINANCED BY: | | | |
| Share Capital: | | | |
| **Authorized** | | | |
| Ordinary Shares | | | 100,000 |
| Preference shares | | | 20,000 |
| | | | 120,000 |
| **Issued and Fully Paid** | | | |
| Ordinary Shares | | | 70,000 |

| | | |
|---|---|---|
| Preference shares | | 20,000 |
| **Reserves** | | |
| Share premium | | 14,000 |
| General reserve | | 7,000 |
| Retained Earnings | | 7,290 |
| | | 118,290 |
| **Liabilities** | | |
| 10% Debentures | | 30,000 |
| **Current Liabilities** | | |
| Creditors | 11,370 | |
| Dividends owing | 9,000 | |
| Debenture interest owing | 1,500 | |
| Tax payable | 5,000 | 26870 |
| **TOTAL EQUITY&LIABILITIES** | | **175,160** |

**Notes to Accounts**

A: Directors remuneration is an expense and thus charged in the income statement

B: Debenture interest is to be adjusted and charged in the Income statement

C: The final dividend of 10% is charged on the issued capital of 70,000

**Example Two**

A.A.Aheebwa plc are wholesalers. The following is their trial balance as at 31 December 2006.

| | £ *Dr* | £ *Cr* |
|---|---|---|
| Ordinary Share Capital: £l shares | | 150,00 |
| Share Premium | | 10,000 |
| General Reserve | | 8,000 |
| Retained Profits as at 31/12 / 2005 | | 27,300 |
| Stock: 31/12/2005 | 33,235 | |
| Sales | | 481,37 |
| Purchases | 250,270 | |

| | | |
|---|---|---|
| Returns Outwards | | 12,460 |
| Returns Inwards | 13,810 | |
| Carriage Inwards | 570 | |
| Carriage Outwards | 4,260 | |
| Warehouse Wages | 50,380 | |
| Salesmen's Salaries | 32,145 | |
| Administrative Wages and Salaries | 29,900 | |
| Plant and Machinery | 62,500 | |
| Hire of Motor Vehicles | 9,600 | |
| Provision for Depreciation – Plant and | | 24,500 |
| Goodwill | 47,300 | |
| General Distribution Expenses | 2,840 | |
| General Administrative Expenses | 4,890 | |
| Directors' Remuneration | 14,800 | |
| Rents Receivable | | 3,600 |
| Trade receivables | 164,150 | |
| Cash at Bank | 30,870 | |
| Trade payables | | 34,290 |
| | 751,520 | 751,52 |

You are given the following information:

(1) Closing stock at 31/12/06 has been valued at £45,890.
(2) Plant and machinery is to be depreciated at 20% straight line. 60% relates to distributive expenses, 40% relates to administrative expenses.
(3) Motor vehicle hire is to be split £6,200 to distribution and £3,400 to administrative expenses.
(4) Audit fees of £600 need to be accrued for the year ending 31/12 / 06.
(5) A Corporation Tax provision of £29,100 is needed.
(6) A final dividend of 36p per share approved by the directors has not yet been accounted for.
(7) An impairment review is undertaken in respect of the goodwill and its value is found to have been impaired by £5,000.

***Required;***
Income Statement for the year ended 31 December 2006 and a Balance Sheet as at 31 December 2006. ***Notes are required.***

**A.A. Aheebwa plc**

## Income statement for the year ended 31.12. 2006

| | £ | £ |
|---|---|---|
| Sales | | 481,37 |
| Returns Inwards | | (13,810 |
| | | 467,56 |
| Cost of Sales | | |
| Opening Stock | 33,235 | |
| Add: Purchases | 250,27 | |
| Less: Purchases Returns | (12,46 | |
| Carriage Inwards | 570 * | |
| | 271,61 | |
| Less: Closing Stock | (45,89 | |
| | | (225,72 |
| Gross Profit | | 241,83 5 |
| Other Income – Rent Received | | 3,600 |
| | | 245,43 |
| Distribution Expenses | | |
| Carriage Outwards | 4,260 | |
| Warehouse Wages | 50,380 | |
| Salesmen's Salaries | 32,145 | |
| Plant and Machinery Depreciation | 7,500 | |
| Motor Vehicle Hire | 6,200 | |
| General Expenses | 2,840 | |
| | 103,32 5 | |
| Administrative Expenses | | |
| Wages and Salaries | 29,900 | |
| Motor Vehicle Hire | 3,400 | |
| General Expenses | 4,890 | |
| Directors' Remuneration | 14,800 | |
| Plant and Machinery Depreciation | 5,000 | |
| Audit Fee | 600 | |
| | 58,590 | (161,91 |
| | | 83,520 |
| *Goodwill impairment* | | (5,000) |
| | | 78,520 |
| Less: Taxation | | (29,100 |
| | | 49,420 |
| Less: Ordinary Dividend | | (54,000 |
| Retained Profit for the Year | | (£4,580 |

**A.A. Aheebwa plc**
**Balance Sheet as at 31.12.2006**

| **Non Current Assets** | £ | £ |
|---|---|---|
| Tangible | | 25,500 |
| Intangible | | 42,300 |
| | | |
| **Current Assets** | | |
| Stock | 45,890 | |
| Trade | 164,150 | |
| Cash at Bank | 30,870 | 240,910 |
| **Total Assets** | | **308,710** |
| | | |
| **Financed By Capital and Reserves** | | |
| Paid Up Share Capital | | |
| 150000 £1 Ordinary Shares | | 150,000 |
| **Reserves** | | |
| Share Premium Account | | 10,000 |
| General Reserve | | 8,000 |
| Retained Profits | | 22,720 |
| **Liabilities due with in 1 Year** | | |
| Trade payables | 34,290 | |
| Dividends | 54,000 | |
| Tax | 29,100 | |
| Audit fee | 600 | 117,990 |
| **Total Equity and Liabilities** | | **308,710** |

**Review Question**

The following trial balance has been extracted from the books of Aloin Plc as at 31st March 1997.

| | **$** | **$** |
|---|---|---|
| Administrative expenses | 95,000 | |
| Called Up share capital(all ordinary | | 200,000 |

| | | |
|---|---|---|
| shares $1 each) | | |
| Cash at Bank | 25,000 | |
| Debtors | 230,000 | |
| Deferred taxation( 1st April 1996) | | 60,000 |
| Distribution costs | 500,000 | |
| Fixed asset investments | 280,000 | |
| Income from fixed asset investments | | 12,000 |
| Interim dividend paid | 21,000 | |
| Overprovision of last year's corporation tax | | 5,000 |
| Land and buildings at cost | 200,000 | |
| Accumulated Depreciation-Land and Buildings 1.4. 1996 | | 30,000 |
| Plant and machinery at cost | 400,000 | |
| Accumulated Depreciation-Plant and machinery 1.4. 1996 | | 170,000 |
| Profit & loss A/c (1.4.1996) | | 229,000 |
| Profit on exceptional item | | 50,000 |
| Purchases | 1,210,000 | |
| Sales | | 2,215,000 |
| Inventory at 1.4.1996 | 140,000 | |
| Creditors | | 130,000 |
| | 3,101,000 | 3,101,000 |

**Additional information**

I. inventory at 31st March 1997 was valued at $150,000
II. depreciation for the year to 31st March 1997 is to be charged against administrative expenses as follows: Land and Buildings $5,000; Plant and machinery $40,000
III. Assume that the basic rate of income tax is 30%
IV. Corporation tax of $180,000 is to be charged against the profits on ordinary activities for the year to 31st march 1997
V. $4,000 is to be transferred to the deferred taxation account
VI. The company proposes to pay a dividend of $0.3 per share

**Required**

Prepare Aloin Plc's income Statement for the year ended 31st March 1997 and the Balance Sheet as at that date. ***NB: Notes to accounts are required.***

## PREPARATION OF CASH FLOW STATEMENT IAS7

### *Statement of cash flows*

Cash flow information provides users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows. IAS 7 sets out requirements for the presentation and disclosure of cash flow information.

Structure

The notes shall:

(a) Present information about the basis of preparation of the financial statements and the specific accounting policies

(b) Disclose the information required by IFRSs that is not presented elsewhere in the financial statements; and

(c) Provide information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them.

An entity shall, as far as practicable, present notes in a systematic manner. An entity shall cross reference each item in the statements of financial position and of comprehensive income, in the separate statement of comprehensive income (if presented), and in the statements of changes in equity and of cash flows to any related information in the notes.

### *Fundamental Principle in IAS 7*

All entities that prepare financial statements in conformity with IFRSs are required to present a statement of cash flows.

The statement of cash flows analyses changes in cash and cash equivalents during a period. Cash and cash equivalents comprise cash in hand and demand deposits, together with short-term, highly liquid investments that are readily convertible to a known amount of cash.

Guidance notes indicate that an investment normally meets the definition of a cash equivalent when it has a maturity of three months or less from the date of acquisition.

**The following terms are used in this Standard with the meanings specified:**

***Cash*** **comprises cash on hand and demand deposits.**

***Cash equivalents:*** are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

*Cash flows* are inflows and outflows of cash and cash equivalents.

***Operating activities:*** are the principal revenue-producing activities of the entity and other 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 contributed equity and borrowings of the entity.

### *III.4 Presentation of the Statement of Cash Flows*

Cash flows must be analyzed between operating, investing and financing activities.

Key principles specified by IAS 7 for the preparation of a statement of cash flows are as follows:

- **Operating activities** are the main revenue-producing activities of the entity that are not investing or financing activities, so operating cash flows include cash received from customers and cash paid to suppliers and employees.

- **Investing activities** are the acquisition and disposal of long-term assets and other investments that are not considered to be cash equivalents.

- **Financing activities** are activities that alter the equity capital and borrowing structure of the entity. The interest and dividends received and paid may be classified as operating, investing, or financing cash flows, provided that they are classified consistently from period to period.

The **method** shows each major class of gross cash receipts and gross cash payments. The operating cash flows section of the statement of cash flows under the direct method would appear something like this:

**Statement of Cash Flows**

| **Cash flows from operating activities** | |
|---|---|
| Profit for the period | XX |
| *Adjustments for income and expenses not involving cash flows:* | |
| Depreciation of property, plant and equipment (a) | XX |
| Profit from discontinued operations (b) | (XX) |
| *Changes in assets and liabilities:* | |
| Increase in inventories (c) | XX |
| Increase in trade payables (d) | (XX) |
| ***Net cash generated from continuing operating activities*** | XX |
| ***Net cash used by discontinued operations*** | (XX) |
| ***Net cash inflow from operating activities*** | **XX** |
| **Cash flows from investing activities** | |
| Acquisition of property, plant and equipment | (XX) |
| ***Net cash used in continuing investing activities*** | (XX) |
| ***Net cash generated from investing activities – discontinued operations*** | XX |
| ***Net cash outflow from investing activities*** | **(XX)** |
| **Cash flows from financing activities** | |
| ***Net cash generated from/(used in) financing activities*** | XX- |
| ***Net cash generated from/(used in) financing discontinued operations*** | XX- |

| ***Net cash flow financing activities*** | **XX-** |
|---|---|
| **Decrease in cash and cash equivalents in 20X3** | **(XX)** |
| Opening cash and cash equivalents (1 January 20X3) | XX |
| **Closing cash and cash equivalents (31 December 20X3)** | **XX** |

EXECRCISE

| **ASSET: Current Assets** | **2018** | **2017** |
|---|---|---|
| Cash | 46,000 | 15,000 |
| Accounts Receivable | 47,000 | 55,000 |
| Inventory | 144,000 | 110,000 |
| Prepaid Expenses | 1000 | 5,000 |
| **Total Current Assets** | **238,000** | **185,000** |
| Investments | 115, 000 | 127,000 |
| **Plant Assets** | | |
| Plant Assets | 715,000 | 505,000 |
| Accumulated Depreciation | 103,000 | 68,000 |
| Total Plant Asset | 612,000 | 437,000 |
| **Total Assets** | **965,000** | **749,000** |
| **LIABILITIES** | | |
| **Current Liabilities** | | |
| Account Payable | 50,000 | 43,000 |
| Accrued Liabilities | 12,000 | 9,000 |
| Income Taxes Payable | 3,000 | 5,000 |
| **Total Current Liabilities** | **65,000** | **57,000** |
| **Long Term Liabilities** | | |
| Bonds Payable | 295,000 | 245,000 |
| Total Liabilities | 360,000 | 302,000 |
| **STOCKHOLDERS' EQUITY** | | |
| Common Stock | 276,000 | 200,000 |
| Paid In Capital In Excess of Par Value | 189,000 | 115,000 |
| Retained Earning | 140,000 | 132,000 |
| Total Stockholder Equity | 605,000 | 447,000 |
| Total Liability And Stakeholders Equity | **965,000** | **749,000** |

Income Statement and other Information on Non-Current Accounts for X Company for the year Ended 31st December 2018.

| Sales | | Shs. 698,000 |
|---|---|---|
| Cost of Goods Sold | | 520,000 |
| Gross Margin from Sales | | **178,000** |
| Operating Expenses (Including Depreciation Expenses-**37,000**) | | 147,000 |
| Operating Income Profit | | 31,000 |
| **Other Expenses** | | |
| - Interest Income Expense | (23,000) | |
| - Interest Expense | 6,000 | |
| - Gain on Sale of Investment | 12,000 | |
| - Loss on Sale of Investment | (3,000) | 8000 |
| Income Before Taxes | | 23,000 |
| Income Taxes | | 7,000 |
| Net Income | | 16,000 |

Other transactions affecting non-current accounts during 2018 include:

a) Purchased investment in the amount of shs. 78,000.
b) Sold investment for shs. 102,000, which earlier cost 90,000.
c) Purchased plant assets in the amount of shs. 120,000.
d) Sold plant assets that cost 10,000 with accumulated depreciation of shs. 2,000 for shs, 5,000.
e) Issued 100,000 bonds at face value in a non-cash exchange for plant assets.
f) Repaid shs. 50,000 of bonds at face value at maturity.
g) Issued 15,200 shares of shs.5 par value common stock for shs. 150,000.
h) Paid cash dividends in the amount 8,000

You are required to PREPARE THE STATEMEN OF CASHFLOWS

| **ASSET: Current Assets** | **2015** | **2014** | **Change** | **Increase/Decrease** |
|---|---|---|---|---|
| Cash | 46,000 | 15,000 | 31,000 | Increase |
| Accounts Receivable | 47,000 | 55,000 | 8,000 | Decrease |
| Inventory | 144,000 | 110,000 | 34,000 | Increase |
| Prepaid Expenses | 1000 | 5,000 | 4,000 | Decrease |
| **Total Current Assets** | 238,000 | 185,000 | 53,000 | |
| **Investments** | **115, 000** | **127,000** | **12,000** | |
| **Plant Assets** | | | | |
| Plant Assets | 715,000 | 505,000 | 210,000 | Increase |

| | | | | |
|---|---|---|---|---|
| Accumulated Depreciation | 103,000 | 68,000 | 35,000 | Increase |
| Total Plant Asset | 612,000 | 437,000 | 175,000 | |
| **Total Assets** | **965,000** | **749,000** | **216,000** | |
| **LIABILITIES** | | | | |
| **Current Liabilities** | | | | |
| Account Payable | 50,000 | 43,000 | 7,000 | Increase |
| Accrued Liabilities | 12,000 | 9,000 | 3,000 | Increase |
| Income Taxes Payable | 3,000 | 5,000 | 2,000 | Decrease |
| **Total Current Liabilities** | **65,000** | **57,000** | **8,000** | |
| **Long Term Liabilities** | | | | |
| Bonds Payable | 295,000 | 245,000 | 50,000 | Increase |
| Total Liabilities | 360,000 | 302,000 | 58,000 | |
| **STOCKHOLDERS' EQUITY** | | | | |
| Common Stock | 276,000 | 200,000 | 76,000 | Increase |
| Paid In Capital In Excess Of Par Value | 189,000 | 115,000 | 74,000 | Increase |
| Retained Earning | 140,000 | 132,000 | 8,000 | Increase |
| Total Stockholder Equity | 605,000 | 447,000 | 158,000 | |
| **Total Liability And Stakeholders Equity** | **965,000** | **749,000** | **216,000** | |

*There are key adjustments which are supposed to be done before resuming accounting for cash flow from operating activities.*

| | **Add** | **Subtract** |
|---|---|---|
| **Current assets** | Decrease | Increase |
| e.g., Accounts receivable, inventory, prepaid expenses | | |
| **Current liabilities** | Increase | Decrease |
| e.g., Accounts payable, accrued expenses, accrued liabilities, income taxes payable | | |

| **1. Determining Cash Flows from Operating Activities**<br>**Cash Receipts from:** | | |
|---|---|---|
| Sales | 706,000*[1] | |

*[1] 698,000+8,000=**706,000**

| | | |
|---|---|---|
| Interest Received | 6,000 | 712,000 |
| **Cash Payments from**: | | |
| Purchase | 547,000**[2] | |
| Operating expense | 103,000***[3] | |
| Interest payments | 23,000 | |
| Income taxes | 9000****[4] | 682,000 |
| **Net Cash Flows from Operating Activities** | | **30,000** |
| **Cash Flows from Investing Activities** | | |
| **Inflow of cash from:** | | |
| Sale of Investment | 102,000 | |
| Sale of Plant Assets | 5,000 | |
| purchase of investment | (78,000) | |
| Purchase of Plant Assets | (120,000) | **(91,000)** |
| **Cash Flow from Financing Activities** | | |
| Issue of Common Stock | 150,000 | |
| Repayment of Bonds | (50,000) | |
| Dividend Paid | (8,000) | **92,000** |
| Net Increase/Decrease Is Cash | | **31,000** |

**[2] 520,000 + (34000-7000) = **547,000**

***[3] 147,000-(37,000+4000+3000)=**103,000**

****[4] 7000+2000=**9000**

| | |
|---|---|
| Cash at the Beginning of the Year | 15,000 |
| Cash at the End of the Year | **46,000** |
| Issue of Bonds Payable for Plant Assets | **100,000** |

**Using Indirect Method for Calculating Cash Flow from Operating Activities**

| | | |
|---|---|---|
| Net Income | | 16,000 |
| Adjustments to Reconcile Net Income to Net Cash Flows from Operating Activities | | |
| Depreciation | 37,000 | |
| Gains from Sale of Investments | (12,000) | |
| Loss on Sale of Plant | 3,000 | |
| Decrease in Accounts Receivable | 8,000 | |
| Increase in Inventory | (34,000) | |
| Decrease in Prepaid Expenses | 4,000 | |
| Increase in Accounts Payable | 7,000 | |
| Increase in Accrued Liability | 3,000 | |
| Decrease in Income Taxes Payable | (2,000) | 14,000 |
| **Net Cash Flows from Operating Activities** | | **30,000** |

**Student Exercises**

Sawa citi ltd presents the following information as at december31, 2012:

- Foreign exchange loss is UGX 747 0000 000

- Interest expense : UGX 288 000 000
- Foreign exchange gain : UGX 533 000 000
- Interest income : UGX 149 000 000
- Salary and wages : UGX 4 149 000 000
- Contribution to employees assurance scheme : UGX 121 980 0000
- Contribution to NSSF : UGX 499 000 000
- Other staff costs :   UGX 1 690 000
- Current income tax UGX 5 932 269 000
- Due to some adjustments that affected net income for previous accounting period, the income tax was over charged of UGX 98 259 000
- Profit before income tax is UGX 24 861 000 000
- Amount paid to suppliers : UGX 7 450 000 000

**Required:** prepare cash flow statement as per IAS7

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**Review Questions**

1.

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## Unit Three

## International Accounting Standard 27: Consolidated and Separate Financial Statements

### 3.1 Introduction

Most businesses would wish to expand and grow, in many cases growth is achieved by such things as:

- Developing new products on the market
- Purchasing new non-current assets
- Recruiting new staff etc

All the above processes can be quite time consuming and it may be easier and more appropriate to buy assets from, or shares in, an existing business. Various possibilities exist some of which have already been dealt with i.e amalgamation and re-organisation. Under group accounts we are particularly concerned with the situation where expansion is achieved by the purchase of the controlling interest in another business which continues in existence and is not wound up. Where this situation arises, a special parent/subsidiary relationship arises.

Many companies have more than one type of business activity and trade in different geographical locations. In these circumstances there are often advantages in establishing separate companies to undertake separate activities or to trade in other countries. The shares in the individual companies, the subsidiaries, are usually owned by a holding company which may or may not be quoted on the stock market. Each, has to prepare its own individual published accounts. In the holding company's accounts the investments in the subsidiary companies will be carried at cost and the only income recognised in its accounts concerning the subsidiaries will be dividends receivable.

Over the years the subsidiaries will hopefully earn profits and, if these are not all paid in the form of dividends, will accumulate assets. Hence the holding company's accounts will not reflect the true value of the investment nor its earnings. The solution adopted to this problem was for the holding company to prepare an additional set of consolidated or group accounts which would reflect the "economic substance over the legal form" of the group. The consolidated accounts would show the assets and liabilities of the group as if they were owned directly by the holding company.

Over the years the various definitions concerning group companies have evolved along with the criteria for preparing group accounts. The rules dealing with the preparation of group accounts are now contained in:

- IFRS 3: Business combinations
- IAS 27: Consolidated and separate financial statements
- IAS 28: Investments in associates

IAS 27 broadly defines a subsidiary undertaking as an entity, including an unincorporated entity such as a partnership, that is controlled by another entity.

**So what is control?**
Control is defined in the standard as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. It elaborates further on this definition by telling us that:

- Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than half of the voting power of an entity unless it can be clearly demonstrated that such ownership does not constitute control.
- Control also exists even where the parent owns half or less than half of the voting power when it has power over more than half the voting power by virtue of an agreement with other investors
- Control is apparent if the entity has power to govern the financial and operating policies of the entity under a statute or agreement
- The power to appoint or remove the majority of the members of the board of directors or equivalent governing body also indicates control
- The power to cast the majority of votes at meetings of the board of directors or equivalent governing body also indicates control.

Clearly note, therefore, that a business may own less than 50% of the equity shares in another, but if it has control as defined above then the other entity will constitute a subsidiary.
Consider the following examples to test your understanding of this concept of control.

**Example 1**
A owns 100% of the equity of C, who in turn owns 20% of the equity of B. A also owns 33% of the equity of B. Voting rights in A, B and C are in relation to equity ownership. Is B a subsidiary of A? the answer is YES. As a controls C totally, then it also controls 20% of B. If we add this to A's own holding, then we have a total of 53% which is more than the half required to give control.

**Example 2**
A owns 42% of the voting rights of B and also has the power to appoint or remove five of the nine members of its board of directors. Is B a subsidiary of A? The answer is also YES. A clearly controls the board of directors. If A

only had the power to remove 4 members of the board, then B would not be a subsidiary as control would not have been established.

**Example 3**

A owns 49% of the voting rights of B. Is B a subsidiary of A? The answer is NO. A does not control over half of B. Minority interest is that portion of the profit or loss and net assets of a subsidiary attributable to equity interests that are not owned, directly or indirectly through subsidiaries, by the parent.

**Accounting Requirements of IAS 27**

IAS 27 identifies the consolidation procedures as follows.

The consolidation procedures are:

- Eliminate the carrying amount of the parent's investment and the parent's share of equity in each subsidiary
- Allocate the profit or loss for the period on the face of the income statement between the parent and the minority interest
- Identify minority interest in consolidated subsidiaries' net assets and present them within equity on the balance sheet, but separately from parent equity
- Eliminate intergroup balances and transactions in full
- Prepare the consolidated statements using uniform accounting policies
- Include the subsidiaries income and expenses only from the date of acquisition to date when control ceases
- Make adjustments where reporting dates between parent and subsidiary are longer than three months.

## 3.2 The Consolidated Balance Sheet

**Basic Consolidation Procedures**

We will generally use the double-entry method and open a memorandum ledger to record the consolidating entries; no adjustments are made in the books of the individual companies.

Such accounts will be opened for:

- Every element of shareholders' funds
- Cost of control (i.e. goodwill) for each subsidiary (often referred to as "adjustment account")
- Minority interests
- Assets containing inter-company transactions and profits (e.g. stock)
- Assets revalued by the group at the date of balance sheet, if no adjustment has been made in the individual companies' books.

After writing up these accounts, the closing balance will be transferred to the consolidated balance sheet and the assets and liabilities on the individual balance sheet, to which no alteration has been made, will be added together and shown on the consolidated balance sheet (CBS).

### 3.3 Process of Consolidation for the Consolidated Balance Sheet

The preparation of a consolidated balance sheet in its simplest form consist of the following:

- Assets of the parent company and subsidiaries are added together as though the group was a single entity. The liabilities are added up in a similar way.
- Before making the above additions, items should be cancelled as assets of one company if they appear as corresponding liabilities of another company in the group. These are also known as inter-company transactions
- The share capital in the consolidated balance sheet relates to that of the parent company.
- The minority interests are made up of share capital of outside shareholders at the year end together with their share of total year end profits and reserves. Minority interest is regarded as a source of finance and should be reflected in the consolidated balance sheet.
- The consolidated profits and reserves consist of those for the parent company together with those of the subsidiary after acquisition.
- **The cost of control**; this is worked out by crediting against the cost of shares in the subsidiaries. The fraction of share capital acquired in all subsidiaries together with the appropriate fraction of profits and reserves at the end of the acquisition.

**Example One**

From the following balance sheets of Company X and Company Y, prepare the Consolidate Balance Sheet. All the shares in X were acquired by Y at the date of the balance sheets.

***Balance Sheets at 31 December***

| | X | Y |
|---|---|---|
| | *£000* | *£000* |
| Premises | 35 | 24 |
| Plant | 19 | 10 |
| Shares in subsidiary | – | 60 |
| Inventories | 13 | 18 |
| Trade receivables | 9 | 16 |
| Cash | 1 | 2 |
| Trade payables | (12) | (19) |
| Overdraft | (5) | (11) |
| Net assets | 60 | 100 |
| Share capital | 60 | 80 |
| Undistributed profits | – | 20 |
| | 60 | 100 |

Apply the rules:

(a) Combine the assets:

| | £000 |
|---|---|
| Premises (35 + 24) | 59 |
| Plant (19 + 10) | 29 |
| Inventory (13 + 18) | 31 |
| Trade receivables (9 + 16) | 25 |
| Cash (1 + 2) | 3 |
| | 147 |

(b) Combine the liabilities:

| | £000 |
|---|---|
| Trade payables (12 + 19) | 31 |
| Overdraft (5 + 11) | 16 |
| | 47 |

Cancel out "Shares in subsidiary" in Y's balance sheet against share capital of X.

**Consolidated Balance Sheet of Y and its Subsidiary X at 31 December**

| **Non Current Assets** | £'000' | £'000' |
|---|---|---|
| Premises | | 59 |
| Plant | | 29 |
| **Current Assets** | | |
| Inventory | 31 | |
| Trade receivables | 25 | |
| Cash | 3 | 59 |
| **Total Assets** | | **147** |
| **Financed By** | | |
| **Capital and Reserves** | | |
| Called-up share capital | | 80 |
| Retained profits | | 20 |
| **Current Liabilities** | | |

| | | |
|---|---|---|
| Bank overdraft | 16 | |
| Trade payables | 31 | 47 |
| **Total Equity and Liabilities** | | **147** |

Note that the only share capital shown in the CBS is that of the holding company. This is always the case, no matter how involved the affairs of the group. We will now work through a simple consolidation example which will lay the foundations for your future studies of group accounts. Make sure you fully understand the example before proceeding to the next stage.

### 3.4 Cost of Control (Goodwill)

In our earlier example, the item "Shares in subsidiary" in the holding company's balance sheet was replaced in the CBS by the actual assets and liabilities represented by this investment. This was so since the net value of assets acquired was equal to the price paid for the shares. However, if the price paid for the shares exceeds the book value of the net assets of the subsidiary, the excess represents a premium, called the cost of control or goodwill on acquisition of the subsidiary.

Since the value of the net assets of a subsidiary is represented in its balance sheet by the amount of its paid-up capital plus reserves, the cost of control is the difference between the cost of the investment to the holding company and the total of the nominal value of shares issued and paid up, and all undistributed profits and reserves at the date of acquisition.

**Example**

From the balance sheets of Company A and Company B immediately after A had acquired all the shares in B, which were as follows, prepare the CBS. (Note this example assumes that B is a wholly-owned subsidiary, i.e. there is no minority interest.)

|  | A | B |
| --- | --- | --- |
|  | *£000* | *£000* |
| Non-current assets | 22 | 14 |
| Current assets | 12 | 8 |
| 10,000 shares in B | 20 | – |
|  | 54 | 22 |
| *less* Current liabilities | 8 | 6 |
| Net assets | 46 | 16 |
| Share capital (£1 shares) | 24 | 10 |
| Reserves | 10 | 4 |
| Undistributed profits | 12 | 2 |
|  | 46 | 16 |

***NB: All assets and liabilities are stated at fair values.***

### 3.5 Consolidation Workings

Open memorandum ledger accounts for the share capital, reserves and undistributed profits of the subsidiary and then apply the following double-entry procedure to ascertain the amount of goodwill:

(a) For the nominal value of 100% of shares acquired
Dr: Share capital
Cr: Cost of control

(b) For the balances existing on date of acquisition
Dr: Reserves
Dr: Undistributed profits
Cr: Cost of control

(c) For the cost of shares acquired
Dr: Cost of control
Cr: A – investment in B

***The memorandum accounts are as follows:***

B – Share Capital

| | £000 | | £000 |
|---|---|---|---|
| Cost of control | 10 | Balance b/d | 10 |

B – Reserves

| | £000 | | £000 |
|---|---|---|---|
| Cost of control | 4 | Balance b/d | 4 |

B – Undistributed Profits

| | £000 | | £000 |
|---|---|---|---|
| Cost of control | 2 | Balance b/d | 2 |

A – Investment in B

| | £000 | | £000 |
|---|---|---|---|
| Balance b/d | 20 | Cost of control | 20 |

| Cost of Control | | | |
|---|---|---|---|
| | £000 | | £000 |
| Cost of 10,000 shares in B (A – Investment in B) | 20 | Share capital – B | 10 |
| | | Reserves – B | 4 |
| | | Undistributed profits – B | 2 |
| | | Balance = Goodwill | 4 |
| | 20 | | 20 |

Note carefully that the balances on B reserves and undistributed profits are all transferred to the cost of control account because they reflect pre-acquisition profits and reserves.

***Consolidated Balance Sheet of A and its Subsidiary B as at ....***

| | £000 | £000 |
|---|---|---|
| Non-current assets | | |
| Intangible asset: goodwill | | 4 |
| Tangible assets (22 + 14) | | 36 |
| Current assets (12 + 8) | 20 | |
| Creditors: Amounts falling due within one year (8 + 6) | 14 | |
| Net current assets | | 6 |
| Total assets less current liabilities | | 46 |
| Called-up share capital (A only) | | 24 |
| Reserves (see footnote) | | 10 |
| Retained profits | | 12 |
| | | 46 |

None of the reserves of B appear because they all relate to pre-acquisition profits. Goodwill is tested for impairment annually and impairment losses taken to the income statement.

Note that it is quite possible for the cost of shares in a subsidiary to be less than the net value of assets acquired. In this case goodwill will be negative, i.e. a credit balance. Negative goodwill will then appear credited to the income statement.

**Partly-owned Subsidiaries**

Where the holding company does not own the whole of the share capital of the subsidiary, it is clear that if the total value of net assets of the subsidiary is included in the CBS, some part of those assets is owned by an outside body, and this part should be shown as a liability in the CBS under "Minority interests".

**Example**

Use the information given in the previous example for company A and B, but suppose that A's holding in B consists of only 8,000 shares at a cost of £20,000. Since A only owns 4/5ths of the shares of B, only 4/5ths of the reserves and undistributed profits are attributable to the group.

B – Share Capital

| | £000 | | £000 |
|---|---|---|---|
| Cost of control (4/5) | 8 | Balance b/d | 10 |
| Minority interest (1/5) | 2 | | |
| | 10 | | 10 |

B – Reserves

| | £000 | | £000 |
|---|---|---|---|
| Cost of control (4/5) | 3.2 | Balance b/d | 4.0 |
| Minority interest (1/5) | 0.8 | | |
| | 4.0 | | 4.0 |

B – Undistributed Profits

| | £000 | | £000 |
|---|---|---|---|
| Cost of control (4/5) | 1.6 | Balance b/d | 2.0 |
| Minority interest (1/5) | 0.4 | | |
| | 2.0 | | 2.0 |

A – Investment in B

| | £000 | | £000 |
|---|---|---|---|
| Balance b/d | 20 | Cost of control | 20 |

| Cost of Control | | | |
|---|---|---|---|
| | £000 | | £000 |
| Cost of 8,000 shares in B | 20.0 | B – Share capital (4/5) | 8.0 |
| | | Reserves (4/5) | 3.2 |
| | | Undistributed profits (4/5) | 1.6 |
| | | Balance, being goodwill | 7.2 |
| | 20.0 | | 20.0 |

| Minority Interest | | | |
|---|---|---|---|
| | £000 | | £000 |
| Balance c/d | 3.2 | B – Share capital (1/5) | 2.0 |
| | | Reserves (1/5) | 0.8 |
| | | Undistributed profits (1/5) | 0.4 |
| | 3.2 | | 3.2 |

***Consolidated Balance Sheet of A and its Subsidiary B as at ....***

| | £000 | £000 |
|---|---|---|
| Non-current assets | | |
| Intangible assets: goodwill | | 7.2 |
| Tangible assets (22 + 14) | | 36.0 |
| Current assets (12 + 8) | 20.0 | |
| Creditors: Amounts falling due within one year (8 + 6) | 14.0 | |
| Net current assets | | 6.0 |
| Total assets less current liabilities | | 49.2 |
| Called-up share capital (A only) | | 24.0 |
| Reserves | | 10.0 |
| Retained profits | | 12.0 |
| | | 46.0 |
| Minority interest | | 3.2 |
| | | 49.2 |

## Questions for Practice

1. H plc acquired 80% of S Ltd's ordinary share capital on 1 January Year 4 for £700,000. S Ltd's reserves were £600,000 on that date and the fair value of some land owned by S Ltd on that date was £200,000 in excess of book value. S Ltd has not subsequently revalued the land.

   The balance sheets of the two companies as at 31 December Year 9 were as follows:

| | H plc | S Ltd |
|---|---|---|
| | *£000* | *£000* |
| Tangible non-current assets | 1,000 | 1,400 |
| Investments | 700 | – |
| Net current assets | 500 | 400 |
| | 2,200 | 1,800 |
| Represented by: | | |
| £1 Ordinary shares | 100 | 100 |
| 10% Preference shares (issued 1 June Year 1) | – | 50 |
| Retained profits | 2,100 | 1,650 |
| | 2,200 | 1,800 |

Prepare the consolidated balance sheet of H plc at 31 December Year 9.

2. H plc acquired 75% of S Ltd's ordinary share capital on 18 July Year 8 when S Ltd's reserves were £300,000. The balance sheets of the two companies as at 31 December Year 9 were:

| | H plc | S Ltd |
|---|---|---|
| | *£000* | *£000* |
| Tangible non-current assets | 800 | 900 |
| Investment in S Ltd | 420 | |
| Inter-company a/cs | 120 | (100) |
| Other current assets | 520 | 360 |
| | 1,860 | 1,160 |
| Represented by: | | |
| £1 Ordinary shares | 100 | 200 |
| Retained profits | 1,760 | 960 |
| | 1,860 | 1,160 |

   There was cash in transit from S Ltd to H plc amounting to £20,000 at the year-end.

   Goodwill has been impaired by £2,250 as at 31 December Year 9.

There was cash in transit from S Ltd to H plc amounting to £20,000 at the year-end. Goodwill has been impaired by £2,250 as at 31 December Year 9. Prepare H plc's consolidated balance sheet as at 31 December Year 9.

**Question3**

The Balance Sheets of Dad Ltd and its subsidiary Company Son Ltd as at 31st December, 2004 are shown below:

| | Dad Ltd | Son Ltd |
|---|---|---|
| **Non Current Assets:** | **US $ '000'** | **US $ '000'** |
| Land and Buildings | 3,000 | 1,000 |
| Plant and Equipment | 2,000 | 500 |
| **Investments:** | | |
| 800,000 Shares in Son Ltd | 1,200 | - |
| Debentures in Son Ltd | 200 | - |
| Other Investments | 200 | 100 |
| **Current Assets:** | | |
| Inventory | 500 | 300 |
| Debtors - Son Ltd | 100 | - |
| - Others | 600 | 300 |
| Cash | 200 | 250 |
| **Total Assets** | **8,000** | **2,450** |
| | | |
| **Financed by:** | | |
| Ordinary Share Capital ($ 1 Share fully paid) | 5,000 | 1,000 |
| Share Premium | 500 | 100 |
| General Reserves | 1,000 | 400 |
| Profit & Loss A/c | 600 | 100 |
| | 7,100 | 1,600 |
| **Current Liabilities:** | | |
| Creditors - Dad Ltd | - | 50 |
| - Others | 300 | 400 |
| Debentures | 600 | 400 |
| **Total Equity & Liabilities** | **8,000** | **2,450** |

**Additional Information:**

1) Dad Ltd acquired the share capital of Son Ltd when reserves of Son Ltd were as follows:

Share Premium $ 100,000; General Reserves $ 200,000; Profit & Loss A/c $ 50,000

2) On 31st December, 2004 Son Ltd sent a cheque to Dad Ltd for $ 50,000. This was received by Dad Ltd on 3rd January, 2005.

**Required:**

Prepare a Consolidated Balance Sheet as at 31st December, 2004.

## 3.6 The Consolidated Income Statement

The object of a consolidated income statement (CIS) is to present information obtained from the separate income statements of the companies in the group in such a way as to show the amount of undistributed group profit at the end of the period. The actual layout of a CIS is similar to an individual business income statement. In addition, though, we need to add a line in the statement to show the profit allocated to the minority interest.

### Principles of Consolidation

You will appreciate that the principles involved here are the same as we met in preparing a CBS. The following matters in particular must not be overlooked:

- Pre-acquisition profits or losses of subsidiary companies
- Minority interests, both as regards current preference dividends paid and undistributed profits of subsidiary companies
- Inter-company dividends
- Inter-company profits or losses
- Impairment of goodwill now charged to the CIS.

With these in mind, we will consider the steps to be taken in preparing our CIS. You are usually given the separate income statements of the holding company and the various subsidiary companies. Additional information is given and you are then required to draw up the CIS.

### Example

W plc acquired 80% of the £1 ordinary share capital of S Ltd some years ago when the retained profits of S Ltd was £20,000. The following draft income statements for the two companies for the year to 31 December have been prepared:

| | W plc | S Ltd |
|---|---|---|
| | *£000* | *£000* |
| Sales | 1,000 | 400 |
| Cost of sales | (600) | (200) |
| Gross profit | 400 | 200 |
| Distribution costs | (80) | (30) |
| Administration expenses | (70) | (50) |
| Operating profit pre-tax | 250 | 120 |
| Tax | (80) | (40) |
| Profit after tax | 170 | 80 |
| Dividend proposed | (100) | (50) |
| Retained profit of year | 70 | 30 |
| Retained profit b/f | 260 | 100 |
| Retained profit c/f | 330 | 130 |

(a) W plc sold goods £100,000 to S charging cost + 25%. There were £10,000 of these goods in the inventory of S Ltd at 31 December.
(b) W plc has not yet taken the dividend from S Ltd into its records.
(c) There was no goodwill at acquisition.

**Required;**
Prepare a consolidated Income Statement for the period.

## Consolidated Income Statement

| Note | | £000 | £000 |
|---|---|---|---|
| (1) | Revenue (1,000 + 400 – 100) | | 1,300 |
| (2) | Cost of sales (600 + 200 – 100 + 2) | | (702) |
| | Gross profit | | 598 |
| | Distribution costs (80 + 30) | | (110) |
| | Administrative expenses (70 + 50) | | (120) |
| | Profit on ordinary activities before taxation | | 368 |
| | Taxation on profit on ordinary activities (80 + 40) | | (120) |
| | Profit on ordinary activities after taxation | | 248 |
| (3) | Minority interest: (20% × £80,000 (after tax profits of S Ltd)) | | (16) |
| | | | 232 |
| | Dividend proposed (W only) | | (100) |
| | Retained profit for year | | 132 |
| | Retained profit b/f: | £000 | |
| | W plc | 260 | |
| | Group share of S Ltd i.e. 80% of post-acquisition retained profit b/f = 80% × (100 – 20) | 64 | 324 |
| | Retained profit c/f | | 456 |

W plc had not accounted for dividends received from S Ltd, no adjustment was necessary to eliminate these prior to the preparation of the CIS for the group. Remember, the pre-acquisition profits of S Ltd are effectively frozen by being taken to cost of control account and are excluded from the retained profit brought forward figures.

**Notes**

(1) The £100,000 sales from W to S are eliminated as inter-company trading.

(2) The purchase price of goods to S from W is the same adjustment £100,000. In addition cost of sales is increased by the unrealized profit included in the inventory, thus reducing group profits.

(3) The dividends attributable to the minority interest in S Ltd will eventually appear as a current liability in the consolidated balance sheet. The profit for the year attributable to the minority interest is split between the proposed dividend and the net addition to the minority interest figure in the consolidated balance sheet, i.e.:

| | £000 |
|---|---|
| Profit attributable to minority interest | 16 |
| Proposed dividend payable to minority interest (£50,000 × 20%) | 10 |
| Minority interest share of S Ltd retained profit for year (£30,000 × 20%) | 6 |
| | 16 |

**Review Questions**

1.

## Unit 4
## Reorganization/Reconstruction
### 4.1 Introduction

It is not unusual for companies to be liquidated, the principal reasons for this being that:

- The company does not have enough cash to pay its liabilities and its creditors apply to the court for it to be wound up – this may happen even if the company is profitable.
- A company may not be profitable enough to continue in business (or it may be acquired by another company).

However, a company may be able to prevent liquidation if it can devise a capital reconstruction scheme attracting new capital and/or persuade its creditors to "change" their loan to the business into company securities, thus allowing the business to continue trading. The business must be able to show that its problems are only temporary and that the scheme will allow it to become profitable and/or improve its cash flow situation. Negotiating such schemes is often difficult, but a failure to do so may lead to the business being liquidated.

We should distinguish between the term reconstruction, which is used to refer to major changes to capital as a prelude to a merger, and capital restructuring. Capital restructuring (or reorganization) is the term usually used when there is only one company concerned and the rights of its members, and sometimes of its creditors, are varied by an alteration of its capital structure but with the existing company continuing in business.

**Reasons for Capital Reconstruction**

There are a number of reasons why a restructuring may be necessary:

- The company may have become too highly geared and a solution may be to issue equity in place of debt capital.
- The existing capital structure may have become over-complicated with perhaps too many classes of shareholder with different rights to each class. They can be consolidated into one or two classes, but care must be taken to ensure that the relative voting strength remains in the same proportion.

- Capital with prior rights may carry a high fixed dividend which then gives a misleading impression of the company, or preference shareholders may have control of the company. In such cases the structure should be reorganized into a more convenient nature.
- The company may decide to replace preference shares with debentures in order to reduce the corporation tax on the company's shares.

## 4.2 Principles of Capital Reconstruction

There are a number of points of principle in the design of a scheme of reconstruction.

(a) Firstly, if the company is having problems it is likely to require more finance which may come from either existing shareholders or a bank, generally in the form of equity finance, although some may be in the form of loan stock. This new equity may replace existing share capital, or may have a different nominal value to it. Those providing such finance will require profit and cash flow forecasts to show how the business can be turned round and provide a good return for their additional money. In such cases it is wise to maintain the income position of a particular class under the scheme as far as it is possible. Often more income will be offered as an incentive to the holders of a particular security to agree to the capital restructuring.

(b) In addition, a reconstruction scheme must treat all parties fairly, and not favour one group over others. The outcome of the scheme should be more beneficial to creditors than if the company went into liquidation, or they may press for the winding-up of the company. Often this is avoided by including in the scheme provision for paying off the company's debts in full. The increased benefits to creditors (and investors) from the reconstruction scheme can be shown by comparing the liquidation value of the firm with the estimated future results arising from the reconstruction scheme.

(c) The company must also take account of fixed charges (e.g. a mortgage on a factory) on assets of the business used as security for loans. These charges mean that the creditor is "secured" and thus entitled to first claim in the process of liquidation (if there are insufficient funds the creditor becomes unsecured for the balance of the loan unpaid). The charges mean that such

creditors may have less incentive to keep the business afloat. Second charges are when the lender has the prior claim on the surplus from the sale of a secured asset after the prior claim has been met.

(d) In addition, the company may have to consider the existence of floating charges over the assets (generally the current assets of the business which are continually turned over during trading) that crystallize on liquidation thus providing the charge owner with prior call on the funds realized from these assets. Similarly to above, such creditors may have less incentive to keep a business afloat, unless it can be shown that it would be financially beneficial to them to do so. You may also find in practice that certain creditors can have a fixed charge on an asset, with a floating charge over a group of assets for the balance of their loan – this is known as a fixed and floater.

The capital structure may be reorganized when after some time of operating the company has made substantial profits or losses such that the capital structure is grossly out of line with the assets its financing. The value of assets as reflected in the financial statements may not be showing the true earning capacity. When this happens the company can reorganize its capital, either by issuing bonus shares out of the excess reserves by carrying out capital reduction to eliminate the accumulated losses. Normally the share structure is substantially altered to write off that is not represented by the available assets.

The process of re-organization and reconstruction is governed by sec 207 to 210 of the Uganda's company's Act Cap 110. Basically in order to effect any alteration or transfer of the company, it must have the necessary authority in its articles of association. A special resolution by the shareholders is required. There must be an application made to the court so that an order sanctioning the alteration or transfer can be granted.

## 4.3 Reconstruction Scheme

Accounting entries for capital reduction/ re-organization includes the following;

- A capital reduction occurs where a company wishes to extinguish or reduce a liability in respect of share capital which is lost or un represented by available assets or payoff any paid up share capital which is in excess of the company's requirements. During the reduction, the following principles must be followed;

a) Set up a capital reduction fund by
   Dr. The various share capital A/cs
      Cr. Capital redemption A/cs
   (By amounts by which capital is to be reduced)

b) Apply the capital reduction fund to eliminate the debit balances (if any) on the P&L A/c and for writing off or writing down assets.
   Dr. Capital Reduction A/c
     Cr. Asset A/c

In summary the entries to be made are as follows:

| | **Activity** | **Dr** | **Cr** |
|---|---|---|---|
| 1 (a) | Suppose some assets have been written off on revaluation | Capital Reduction A/c | Individual Asset A/c |
| (b) | Assets whose values have appreciated | Individual Asset A/c | Capital Reduction A/c |
| 2 | Debit balances on reserve A/cs i.e. P&L | Capital reduction A/c | Individual reserve A/c |
| 3 | Amounts written off called up share capital | Individual capital A/c | Capital Reduction A/c |

| 4 | Settlement of liabilities by issuance of shares | Individual liability A/c | Respective Share capital A/c |
|---|---|---|---|
| 5 | Waiver of preference share dividend arrears by issue of shares or debentures | Capital reduction A/c | Share capital or Debenture A/c |
| 6 | Replacement of one class of shares by shares of a different class | i)share capital replaced<br>ii)Capital reduction(new issue) | i)capital reduction A/c<br>ii) Share capital (New issue) |
| 7 | i)Capitalization of surplus on capital reduction A/c | Capital reduction A/c | Capital Reserve A/c |
| | ii)Capitalization of deficit | Capital reserve A/c | Capital reduction A/c |

**Example**

The following is a summarized balance sheet of Yakin Enterprises Ltd as at 31st December 2006.

| **Equity & Liabilities** | $ | **Assets** | $ |
|---|---|---|---|
| **Authorized, Issued & Called-up Share Capital** | | Land & Buildings | 88,000 |
| 200,000 $ 1 Ordinary Shares | 200,000 | Plant & Machinery | 86,000 |
| 100,000 $ 1 6% Preference Shares | 100,000 | Goodwill | 25,000 |

| | | | |
|---|---|---|---|
| 5% Debenture Stock | 50,000 | Patents | 35,000 |
| Directors Loans | 23,000 | Investments (Shares in S Ltd) | 30,000 |
| Profit & Loss | (85,000) | | **264,000** |
| **Current Liabilities** | | **Current Assets** | |
| Creditors | 85,000 | Inventory | 73,000 |
| Bank Overdraft | 60,000 | Debtors | 98,500 |
| Debenture interest payable | 2,500 | | |
| | **435,500** | | **435,500** |

The following information is also relevant.

a. Preference share dividends are three years in arrears
b. A capital reduction scheme dully approved settled the following items:
    - The preference shares to be reduced to 80 cents each and Ordinary Shares to 25 cents respectively and consolidated into $ 1 each.
    - The authorized share capital to be restored to $ 100,000 6% Preference Cumulative shares and 200,000 Ordinary Shares.
    - There is a contingent liability for damages amounting to $. 10,000.
    - The preference Shareholders waived 2/3 of the dividend arrears and received Ordinary shares for the Balance.
    - All intangible Assets to be eliminated and bad debts of $7,500 and obsolete inventory of $ 10,000 to be written off.
    - The shares in S Ltd are sold for $ 60,000
    - The debenture holders agreed to take over one of the company’s buildings (whose Book Value is $ 18,000) at a price of $ 25,000 in part satisfaction of the debenture and to provide further cash of $ 15,000 on a floating charge. The arrears of interest are paid.
    - The contingent liability materialized but the company recovered $ 5,000 of these damages in an action against one of its Directors. This was debited to his loan account of $ 8,000, the balance of which was paid in cash on his resignation.
    - The remaining directors agreed to take Ordinary shares in satisfaction of their loans.

**Required;**

a) Post to the appropriate accounts to effect re-organisation

b) Prepare the balance sheet immediately after re-organisation.

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**Review Questions**

1.

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**Unit Five**

**Mergers and Acquisitions/Amalgamation**

## 5.1 Introduction

When a firm is considering expanding whether internally (by expansion, integration or diversification) or externally (via a merger or acquisition) it must ensure that growth is economically justified, carefully planned and structured. Management must consider the impact on the company, its (and if appropriate the target's) shareholders and employees, the environment it operates in, and the Stock Market's views. In addition, the current regulatory framework should be borne in mind and it is very important that the firm allows for a period of transition for success to be achieved.

The converse of mergers and acquisitions is where a firm may decide to disinvest part of itself. Reasons for disinvestment include removing a part of the business which does not fit correctly into a group's portfolio or its core business, selling an unprofitable subsidiary, or selling a profitable subsidiary to finance expansion elsewhere. There may also be a desire by the owners of a private concern to arrange their affairs to the best advantage to their heirs in the light of favourable political or tax regimes. Disinvestment includes demergers, management buy-outs, management buy-ins, spin-offs and sell-offs.

There are several internal and external stakeholders in an organization, and the majority of them will be concerned with its stability and long-term viability. In order to help them assess this several models of corporate failure have been developed using financial and other ratios, often based on past empirical evidence. Although these models can provide some useful guidance, as yet there is no one method that is capable of predicting corporate failure in advance. Acquisitions and mergers are a fairly frequent occurrence, and you should read the financial press for details of any currently taking place – providing up-to-date examples is always useful to your arguments.

5.2 Company Growth

**Strategies for Growth**

The three main strategies a firm may adopt for growth are expansion, integration and diversification.

(a**) Expansion**

This is the growth of existing, or development of new, markets or products, which can be in response to changes in technology, customer taste or simply to exploit an opportunity in the market.

(b) **Integration**

Integration, of which there are two forms – horizontal and vertical – is a form of expansion. Horizontal integration is when a firm adds either new markets for its existing products, or introduces new products to its current markets. It may be done so the firm can benefit from economies of scale, although this may cause difficulties for the firm if there are problems with the markets or the products.

Vertical integration is expansion of the firm along the supply chain and can be either backward (supply of components or raw materials) or forward (being one-step closer to the end customer). It allows a firm to have greater control over the industry including quality, quantity, price and share of the profits, although it becomes more prone to falls in demand within the industry as a whole.

(c**) Diversification**

This policy is also a form of expansion – indeed, integration is sometimes referred to as related diversification. The diversification we are now going to consider is referred to as unrelated diversification and comprises concentric and conglomerate diversification.

- Concentric diversification is the development of products which are synergetic with current products.
- Conglomerate diversification is the development of products with no marketing, technology or product synergy with the business's current products. The firm, however, expects to obtain management synergies from the conglomeration. There are several other potential advantages of conglomerate diversification. Can you think what they might be?

**Advantages include the following points:**

- The firm can move quickly into high profit areas by acquiring a firm in that market.
- The resultant larger firm may have better access to funds.
- A larger firm may have greater influence in the market and in the political environment.
- A spreading of risk may occur from operating in different markets.
- Profitability may improve as a result of the diversification.
- The new firm may be more flexible, and the acquisition of new firms may allow withdrawal from existing markets.
- There may be synergies to be obtained from the merger utilising a surplus in one firm to satisfy a deficit in another (e.g. cash).
- Unlike the takeover of a similar firm which may lead to a referral to the Competition Commission, conglomerate (and concentric) diversification is unlikely to be regulated by the state.

**Problems associated with conglomerate diversification.**

- Profits in one part of the business may be used to help others making losses, which may lead to the failure of the whole organisation.
- Empirical evidence has shown that EPS (Earnings per share) are diluted when companies with high P/E (Price Earnings) ratios are acquired and that risk may be increased rather than reduced.
- Empirical evidence has also shown that management synergies are often not obtained in practice.

## 5.2 Economic Justification for Growth via Acquisition

Internal growth is one method of growth and here there is a balance to be struck between distributing available profits to shareholders as dividends and retaining profits to fund internal growth. An alternative method of growth is by acquiring or merging with another company (known as external growth):

- The purchase of a controlling interest by one company in another is known as an acquisition or takeover – this is the acquisition by one company of the share capital of another company in exchange for cash, ordinary shares, loan stock or some combination of these.
- A merger or amalgamation is the combination of two separate companies into one single entity. It is a pooling of interests of two

companies into a new business requiring an agreement by both sets of shareholders.

It is often difficult to determine in practice whether a takeover or merger has occurred, especially when there is a difference in size between the organizations. Whilst many such joinings are called mergers, and the two terms are often used interchangeably, in reality there are very few true mergers, and those tend to occur in industries with histories of poor growth and returns.

**Common reasons for acquisitions and mergers are:**

- To reduce competition, although this may have to be controlled by relevant authorities
- To purchase a new product range or move into a new market.
- To obtain tax advantages.
- To spread risk by diversification into new markets and/or products, which should lead to more secure earnings.
- To obtain assets that are undervalued or can be sold off ("asset stripping"), cash (if the victim company is very liquid) and/or access to finance, expert staff, management expertise, technology, suppliers or production facilities. Whilst they might all be acquired internally they can be acquired a lot quicker by a takeover.
- To achieve economies of scale in production, purchasing or marketing and other areas of the business.
- To act as a defence against being acquired itself, either by purchasing the predator company or by making itself bigger and thus harder to be taken over.
- Growth can be achieved via a share exchange rather than having to acquire the cash that an internal policy of growth would require. The policy may also be less expensive than internal growth if a premium has to be paid to attract assets and staff.

**There are also major problems with acquisitions and mergers:**

- Economies of scale, especially in head office functions, often do not materialise, or indeed become diseconomies of scale. There can also be transportation problems when the acquired sites are geographically separate from existing sites.

- There can be problems integrating the different work forces and there may be large-scale redundancies. Similarly problems in integrating new products, markets, customers, suppliers, management and systems can lead to management overload. It is sometimes known as "indigestion".
- There may be public relations problems with customers and the general public boycotting the firm because they disagree with the takeover. Directors of the victim company may also do their best to impede the takeover.
- There may be regulatory intervention.
- The cost of the acquisition may be too high.
- Shareholders of the target company may adopt defensive tactics to oppose the bid, and there may be problems in unifying dividend, reporting and other policies affecting the shareholders of both companies.

## 5.3 Amalgamation

Under amalgamation there are 3 main accounts which have to be opened in effecting a merger.

- **Realization Account**; this is where all the assets and all liabilities that are taken over are closed to.
- **Purchasing Company's Account.** this is where total purchase consideration is later passed to the realization account.
- **Sundry Members/Shareholders Account;** this where all equity accounts are transferred and amount due to the shareholders computed.

**The full accounting procedures are outlined as follows:**

a) Assets**:** Balance represents the assets taken-over together with any relevant provision such as depreciation or bad and doubtful debts are transferred to the Realization Account.
b) Those that are paid off are credited to the Realization Account

c) Capital and other Equity accounts i.e. capital reserves are credited to Sundry Members Accounts
d) Purchase Consideration: this may be executed in one of the following ways:
   1. Payment of cash
   2. Issue of shares
   3. Issue of debentures
   4. Any combination of the above.
      - Cash received is debited to the Sundry Members Accounts and credited to the Purchase Accounts.
      - The shares issued by the purchases are debited to Sundry Members Accounts and credited to Purchase Accounts.
      - The balance of the Purchase Accounts represent Purchase Consideration which is to be transferred to the Realization Account

The accounting procedures for the company being wound up will be as follows

| | **Activity** | **Dr** | **Cr** |
|---|---|---|---|
| **1** | Assets taken over(Book values) | Realization A/c | Individual Asset A/c |
| **2** | In case Liabilities are paid (realization Expenses | Realization A/c | Bank/Cash A/c |
| **3** | Liabilities taken over | Individual Liability A/c | Realization A/c |
| **4** | Purchase Consideration (a) Agreed | a) New Company A/c | Realization A/c<br>New Company A/c |

|  | (b) When action has been taken | b) Sundry Members A/c |  |
|---|---|---|---|
| **5** | a) Profit on realization<br>b) Loss on realization | a) Realization A/c<br>b) Sundry members | Sundry members A/c<br>Realization A/c |
| **6** | Equity Accounts | Individual equity A/c | Sundry members A/c |

**In the books of the Purchasing Company**

|  | **Activity** | **Dr** | **Cr** |
|---|---|---|---|
| **1** | Assets taken over(Current Value) | Individual Asset Accounts | Business Acquisition A/c |
| **2** | Liabilities taken over (Current Value) | Business Acquisition A/c | Individual liability a/c |
| **3** | Purchase consideration agreed | Business Acquisition a/c | Liquidators a/c |
| **4** | Payment of purchase consideration | Liquidators of the company | Bank/Share Capital/Debentures |

**Example**

Barclays ltd and Nile Ltd decided to amalgamate on 1st August 2006 by selling their business to Standard ltd, a new company formed for the purpose with an authorized capital of **Shs** 320,000,000 in Ordinary shares of Shs 1 each.

The following are the summarized balance sheets of the respective business as at 31st July 2005.

| **Non Current Assets** | **Barclays Ltd Shs'000'** | **Nile Ltd Shs'000'** |
|---|---|---|
| Land & Buildings | - | 115,200 |

| | | |
|---|---|---|
| Plant & Furniture | 99,696 | 38,912 |
| **Current Assets** | | |
| Inventory | 42,784 | 44,496 |
| Debtors | 110,000 | 32,112 |
| Bank Balance | 77,120 | 86,192 |
| **TOTAL ASSETS** | **329,600** | **316,912** |
| **Financed By:** | | |
| Capital | 200,144 | 91,952 |
| Loans | - | 80,000 |
| **Liabilities** | | |
| Interest accrued on loan | - | 2,400 |
| Sundry other Creditors | 129,456 | 142,560 |
| **TOTALEQUIT AND LIABILITIES** | **329,600** | **316,912** |

**Additional Information:**

It was agreed that:

a) The new Company should takeover the assets and assume the liabilities of the 2 businesses **except Bank balances, the loan and interest accrued thereon.** The loan and accrued interest was settled by Nile ltd who introduced necessary additional cash for the purpose into the business.

b) The sale values should be the book accounts after adjusting for:

- An agreed value of Shs 144,000,000 for Land Buildings.
- Obsolete inventory of Barclays ltd included at Shs 5,760,000 (obsolete inventory has zero value)
- A debt of Shs 2,800,000 owed to Nile Ltd but agreed to be irrecoverable.
- An error of Shs 3,520,000 in the accounts of Nile ltd being the omission of an invoice for goods supplied to him. Nile Ltd's inventory figure is correct.

c) The company should take over the liability of formation costs of Shs 1,920,000 incurred by Barclays Ltd (for which no provision had been made in the accounts).
d) The company should issue 128,000,000 Ordinary shares at Par to Barclays and 120,000,000 Ordinary shares to Nile ltd in consideration for;
   i. The amounts due to them respectively for the net assets acquired as above.
   ii. The cash payment from each vendor for the balance.

**Required**

Assuming all the above transactions were completed by the company as agreed, **Prepare:**

1) A statement showing the amount of cash to be paid by Barclays Ltd and Nile Ltd in respect of the shares allotted to them.
2) The Balance Sheet of Standard Ltd as it would appear immediately after the completion of the acquisition (assume that there were no other transactions and ignore taxation and any further costs).
3) By way of Ledger accounts, the closing books of Nile ltd.

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**Review Questions**

1.

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## Unit 6
## Assessing Financial Performance
## 6.1 Introduction

### Interpretation of Accounts

Interpretation – or comprehension, assessment or criticism – of accounts usually means the interpretation of balance sheets and income statements (often referred to as "final accounts" or "financial statements") or their equivalent. Such accounts may be either:

- Published accounts, i.e. those prepared for the information of shareholders, etc; or
- Internal accounts, i.e. those prepared for the information of the directors and management.

The second type, being the accounts upon which the policy of the concern is based, is usually in much greater detail than the first. In either case, greater reliance can be placed on accounts which have been audited by a professional firm of standing; in particular accounts drawn up by a trader himself are always open to question.

The primary object of interpretation of accounts is the provision of information. Interpretation which does not serve this purpose is useless. The type of information to be provided depends on the nature and circumstances of the business and the terms of reference. By the latter we mean the specific instructions given by the person wanting the enquiry to the person making it. Of course, if the person making the enquiry is also the person who will make use of the information thus obtained, he will be aware of the particular points for which he is looking.

The position of the ultimate recipient of the information must be especially noted. Thus, suppose that you are asked by a debenture holder to comment on the balance sheet of an enterprise in which he/she is interested. It would be a waste of time to report at length on any legal defects revealed in the balance sheet. You would naturally pay attention to such points as particularly concerned the debenture holder – for example, the security of his loan to the enterprise and the extent to which his interest on the debentures is "covered" by the annual profits. This does not mean that legal defects should be ignored. It is very important that they should be mentioned (although briefly), for failure to comply with legal requirements

may be indicative of more serious shortcomings, possibly detrimental to the security of the debenture holder.

**Matters of Interest**

The interpreter must consider and form conclusions on the following matters:

(a) **Profitability;** how does the profit in relation to capital employed compare with other and alternative uses of the capital?

(b) **Solvency;**

- Can the business pay its creditors, should they demand immediate payment?
- Does the enterprise have sufficient working capital?
- Is it under- or over-trading?

(c) **Financial Strength;**

- What is the credit position of the enterprise?
- Has it reached the limit of its borrowing powers?
- Is it good policy to retain some profits in the business?
- Assessing Financial Performance

(d) **Trends;**

- Are profits rising or falling?
- What are the future profit prospects, based on recent planning and investment?

(e) **Gearing and Cover;**

- What is the gearing (see later) of the enterprise?
- What does this imply for the future dividend prospects of shareholders?

## 6.2 The Perspective

So vital is this matter of approach to the task of interpretation that we shall now consider certain special matters in which various persons will be particularly interested. For the sake of illustration, we will deal with their positions in relation to the accounts of a Ugandan limited company.

(a) **Debenture Holder**

Debentures may be secured on non-current assets and/or current assets; they may cover uncalled and unissued capital as well. Much depends on the terms of the issue. As a secured creditor, therefore, the debenture holder is primarily concerned with the realizable value of the assets which form the security. He will therefore pay attention to the following:

i. Bases of valuation of assets; whether depreciation has been provided out of profits and, if so, whether it is adequate.
ii. Whether any provision, such as a sinking fund, has been made for repayment of debentures (if not irredeemable) or for replacement of non-current assets.
iii. Adequacy of working capital (for if no cash resources exist, the interest cannot be paid).
iv. Profits earned; although debenture interest is a charge against profits, its payment in the long run depends on the earning of profits.

He will be interested in (iii) and (iv) from the point of view of annual interest. Point (iv) particularly concerns a debenture holder whose security takes the form of a floating charge over all of the assets, for the assets (his security) are augmented or depleted by profits and losses.

(b) **Trade Creditor**

As a general rule, a trade creditor will rely on trade references or personal knowledge when forming an opinion on the advisability of granting or extending credit to a company. He is not often concerned with the accounts, which he rarely sees, but if he does examine the accounts he will be as much concerned with existing liabilities as with assets. In particular, he will note the following:

i. The existence of secured debts.
ii. The net balance available for unsecured creditors.
iii. The existence of uncalled capital and undistributed profits.
iv. The adequacy of working capital.

Profits are of minor importance in this connection, but a series of losses would provide a warning.

(c) **Banker**

In deciding whether to grant overdraft facilities to a company, a banker will study with great care all the points mentioned in (a) and (b) above. He will also wish to be assured that the company can pay off the overdraft within a reasonable time. This may necessitate an estimate as to future profits, dividends, capital commitments, other commitments, e.g. loan repayments, leasing obligations, and whether any assets can be pledged as security.

(d) **Shareholder**

The average shareholder is interested in the future dividends he will receive. Future profits are of secondary importance, so long as they are adequate to provide the dividend. Past dividends provide the basis on which future dividends may be estimated, just as past profits afford a similar indication as to future profits. Estimates may, however, be upset because of radical changes in the nature of trade, production methods, general economic conditions, etc.

It is usually recognized that the single most influential factor in determining a company's share price is the amount of dividend paid. Any shareholder will want to ensure that the level of dividend paid is sustainable, i.e. that much is not just being distributed in order falsely to support the market price of the shares. The "cover" is a useful way of comparing or appraising a company's dividend policy. This ratio is obtained by dividing the after-tax profits by the amount of the dividend.

Financial statement analysis is a judgmental process. One of the primary objectives is identification of major changes in trends, and relationships and the investigation of the reasons underlying those changes. The judgment process can be improved by experience and the use of analytical tools. Probably the most widely used financial analysis technique is ratio analysis, the analysis of relationships between two or more line items on the financial statement. Financial ratios are usually expressed in percentage or times. Generally, financial ratios are calculated for the purpose of evaluating aspects of a company's operations and fall into the following categories:

- *Liquidity ratios* measure a firm's ability to meet its current obligations.
- *Profitability ratios* measure management's ability to control expenses and to earn a return on the resources committed to the business.
- *Leverage ratios* measure the degree of protection of suppliers of long-term funds and can also aid in judging a firm's ability to raise additional debt and its capacity to pay its liabilities on time.

- *Efficiency, activity or turnover ratios* provide information about management's ability to control expenses and to earn a return on the resources committed to the business.

A ratio can be computed from any pair of numbers. Given the large quantity of variables included in financial statements, a very long list of meaningful ratios can be derived. A standard list of ratios or standard computation of them does not exist. The following ratio presentation includes ratios that are most often used when evaluating the credit worthiness of a customer. Ratio analysis becomes a very personal or company driven procedure. Analysts are drawn to and use the ones they are comfortable with and understand.

## (A) Liquidity Ratios

### *Working Capital*

Working capital compares current assets to current liabilities, and serves as the liquid reserve available to satisfy contingencies and uncertainties. A high working capital balance is mandated if the entity is unable to borrow on short notice. The ratio indicates the short-term solvency of a business and in determining if a firm can pay its current liabilities when due.

Formula;
Current Assets - Current Liabilities

### *Acid Test or Quick Ratio*

A measurement of the liquidity position of the business. The quick ratio compares the cash plus cash equivalents and accounts receivable to the current liabilities. The primary difference between the current ratio and the quick ratio is the quick ratio does not include inventory and prepaid expenses in the calculation. Consequently, a business's quick ratio will be lower than its current ratio. It is a stringent test of liquidity.

Formula;

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

### *Current Ratio*

Provides an indication of the liquidity of the business by comparing the amount of current assets to current liabilities. A business's current assets generally consist of cash, marketable securities, accounts receivable, and inventories. Current liabilities include accounts payable, current maturities of long-term debt, accrued income taxes, and other accrued expenses that are

due within one year. In general, businesses prefer to have at least one dollar of current assets for every dollar of current liabilities. However, the normal current ratio fluctuates from industry to industry. A current ratio significantly higher than the industry average could indicate the existence of redundant assets. Conversely, a current ratio significantly lower than the industry average could indicate a lack of liquidity.

Formula;
Current Assets
Current Liabilities

***Cash Ratio***
Indicates a conservative view of liquidity such as when a company has pledged its receivables and its inventory, or the analyst suspects severe liquidity problems with inventory and receivables.

Formula;
Cash Equivalents + Marketable Securities
Current Liabilities

**(B) Profitability Ratios**

***Net Profit Margin (Return on Sales)***
A measure of net income dollars generated by each dollar of sales.

Formula;
Net Income *
Net Sales

* Refinements to the net income figure can make it more accurate than this ratio computation. They could include removal of equity earnings from investments, "other income" and "other expense" items as well as minority share of earnings and nonrecurring items.

***Return on Assets***
Measures the company's ability to utilize its assets to create profits.

Formula;
Net Income *
(Beginning + Ending Total Assets) / 2

***Operating Income Margin***

A measure of the operating income generated by each dollar of sales.

Formula;

$$\frac{\text{Operating Income}}{\text{Net Sales}}$$

***Return on Investment***

Measures the income earned on the invested capital.

Formula;

$$\frac{\text{Net Income *}}{\text{Long-term Liabilities + Equity}}$$

***Return on Equity***

Measures the income earned on the shareholder's investment in the business.

Formula;

$$\frac{\text{Net Income *}}{\text{Equity}}$$

***Return on Assets***

A combination of financial ratios in a series to evaluate investment return. The benefit of the method is that it provides an understanding of how the company generates its return.

Formula;

$$\frac{\text{Net Income *}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Equity}}$$

***Gross Profit Margin***

Indicates the relationship between net sales revenue and the cost of goods sold. This ratio should be compared with industry data as it may indicate insufficient volume and excessive purchasing or labor costs.

Formula;

$$\frac{\text{Gross Profit}}{\text{Net Sales}}$$

**(C) Financial Leverage Ratio**

***Total Debts to Assets***

Provides information about the company's ability to absorb asset reductions arising from losses without jeopardizing the interest of creditors.

Formula;
Total Liabilities
Total Assets

***Capitalization Ratio***
Indicates long-term debt usage.

Formula;
Long-Term Debt
Long-Term Debt + Owners' Equity

***Debt to Equity***
Indicates how well creditors are protected in case of the company's insolvency.

Formula;
Total Debt
Total Equity

***Interest Coverage Ratio (Times Interest Earned)***
Indicates a company's capacity to meet interest payments. Uses EBIT (Earnings Before Interest and Taxes)

Formula;
EBIT
Interest Expense

***Long-term Debt to Net Working Capital***
Provides insight into the ability to pay long term debt from current assets after paying current liabilities.

Formula;
Long-term Debt
Current Assets - Current Liabilities

**(D) Efficiency Ratios**
***Cash Turnover***
Measures how effective a company is utilizing its cash.

Formula;
Net Sales
Cash

***Sales to Working Capital (Net Working Capital Turnover)***
Indicates the turnover in working capital per year. A low ratio indicates inefficiency, while a high level implies that the company's working capital is working too hard.

Formula;
Net Sales
Average Working Capital

***Total Asset Turnover***
Measures the activity of the assets and the ability of the business to generate sales through the use of the assets.

Formula
Net Sales
Average Total Assets

***Fixed Asset Turnover***
Measures the capacity utilization and the quality of fixed assets.

Formula
Net Sales
Net Fixed Assets

***Days' Sales in Receivables***
Indicates the average time in days, that receivables are outstanding (DSO). It helps determine if a change in receivables is due to a change in sales, or to another factor such as a change in selling terms. An analyst might compare the days' sales in receivables with the company's credit terms as an indication of how efficiently the company manages its receivables.

Formula
Gross Receivables
Annual Net Sales / 365

## 6.3 Accounts Receivable Turnover

Indicates the liquidity of the company's receivables.

Formula;
Net Sales
Average Gross Receivables

***Accounts Receivable Turnover in Days***

Indicates the liquidity of the company's receivables in days.

Formula
Average Gross Receivables
Annual Net Sales / 365

***Days' Sales in Inventory***
Indicates the length of time that it will take to use up the inventory through sales.

Formula
Ending Inventory
Cost of Goods Sold / 365

***Inventory Turnover***
Indicates the liquidity of the inventory.

Formula
Cost of Goods Sold
Average Inventory

***Inventory Turnover in Days***
Indicates the liquidity of the inventory in days.

Formula
Average Inventory
Cost of Goods Sold / 365

***Operating Cycle***
Indicates the time between the acquisition of inventory and the realization of cash from sales of inventory. For most companies the operating cycle is less than one year, but in some industries it is longer.

Formula;
Accounts Receivable Turnover in Days + Inventory Turnover in Day

***Days' Payables Outstanding***
Indicates how the firm handles obligations of its suppliers.

Formula;
Ending Accounts Payable
Purchases / 365

***Payables Turnover***
Indicates the liquidity of the firm's payables.

Formula;

$$\frac{\text{Purchases}}{\text{Average Accounts Payable}}$$

***Payables Turnover in Days***
Indicates the liquidity of the firm's payables in days.

Formula;

$$\frac{\text{Average Accounts Payable}}{\text{Purchases / 365}}$$

**Example**
Study the financial statements below for two similar types of Supermarkets A and B, and answer the questions that follow:

**Trading, Profit and Loss Accounts:**

| | **Mtn** | | **Warid** | |
|---|---|---|---|---|
| | **Shs** | **Shs** | **Shs** | **Shs** |
| Net Sales | | 80,000 | | 120,000 |
| Less Cost of Goods Sold | | | | |
| Opening Stock | 25,000 | | 22,500 | |
| Add Purchases | 50,000 | | 91,000 | |
| | 75,000 | | 113,500 | |
| Less Closing Stock | 15,000 | 60,000 | 17,500 | 96,000 |
| Gross Profit | | 20,000 | | 24,000 |
| Less Depreciation | 1,000 | | 3,000 | |
| Other Expenses | 9,000 | 10,000 | 6,000 | 9,000 |
| Net Profit | | **10,000** | | **15,000** |

**Balance Sheets:**

| | **Mtn** | | **Warid** | |
|---|---|---|---|---|
| **Non Current Assets** | **Shs** | **Shs** | **Shs** | **Shs** |
| Equipment at Cost | | 10,000 | | 20,000 |
| Depreciation | | (8,000) | | (6,000) |
| | | 2,000 | | 14,000 |

| | | |
|---|---|---|
| **Current Assets** | | |
| Inventory | 15,000 | 17,500 |
| Debtors | 25,000 | 20,000 |
| Bank | 5,000 | 2,500 |
| **Total Assets** | **47,000** | **54,000** |
| | | |
| Financed By: | | |
| Capital | 38,000 | 36,000 |
| Net Profit | 10,000 | 15,000 |
| | 48,000 | 51,000 |
| Drawings | (6,000) | (7,000) |
| | 42,000 | 44,000 |
| Current Liabilities | 5,000 | 10,000 |
| **Total Equity & Liabilities** | **47,000** | **54,000** |

**Required:**

a) Compute the following ratios

i) Gross profit Margin **(2 marks)**

ii) Net profit Margin **(2 marks)**

iii) Current ratio **(2 marks)**

iv) Acid Test ratio **(2 marks)**

v) Debtors ratio **(2 marks)**

vi) Creditors ratio **(2 marks)**

vii) Stock turn-over **(2 marks)**

b) Using your accounting knowledge, comment upon the differences and similarities of the accounting ratios for Mtn and Warid, and the general performance of the two Supermarkets. **(11 marks)**

## Review Questions

1. **Question 1**

Roundsby Ltd is a construction firm and Squaresby Ltd is a property company which specializes in letting property to professional firms. The following information is relevant:

| | Roundsby Ltd | Squaresby Ltd |
|---|---|---|
| | £ | £ |
| £1 ordinary shares | 600,000 | 150,000 |
| £1 preference shares (10%) | 15,000 | 450,000 |
| Retained profits | 600,000 | 75,000 |
| 8% debentures | 75,000 | 450,000 |
| Operating profit for the year | 300,000 | 300,000 |
| Current market price per ordinary share | £3.65 | £10.20 |

The rate of corporation tax is 25%.

***Tasks;***

(a) (i) What do you understand by the term gearing?

(ii) Calculate the gearing ratios for both Roundsby Ltd and Squaresby Ltd.

(b) Prepare a schedule for each company in which you indicate the profit remaining after allowing for debenture interest, taxation and the preference dividend.

(c) Calculate the earnings per share for each company.

(d) Calculate the price earnings ratio for each company.

**Question 2**

The following are extracts from the final accounts of a trading company over the last two years:

**Profit & Loss Data**

| | Year 1<br>£ | Year 2<br>£ |
|---|---|---|
| Purchases (all on credit) | 216,000 | 285,000 |
| Sales (all on credit) | 675,000 | 834,000 |
| Cost of sales | 210,000 | 272,000 |
| Gross profit | 465,000 | 562,000 |
| Net profit before tax | 130,000 | 200,000 |

| | £ | £ | £ | £ |
|---|---|---|---|---|
| **Non-current Assets** | | 620,000 | | 800,000 |
| **Current Assets** | | | | |
| Inventories | 11,000 | | 24,000 | |
| Debtors | 95,000 | | 106,000 | |
| | 106,000 | | 130,000 | |
| **Current Liabilities** | | | | |
| Trade creditors | (28,000) | | (39,000) | |
| Bank Overdraft | (39,000) | | (77,000) | |
| Taxation | (10,000) | | (20,000) | |
| Proposed Dividends | (25,000) | | (30,000) | |
| | (102,000) | 4,000 | (166,000 | (36,000) |
| | | 624,000 | | 764,000 |
| **Long-term Liabilities** | | | | |
| Mortgage | | (100,000) | | (90,000) |
| | | 524,000 | | 674,000 |

| **Capital and Reserves** | | |
|---|---|---|
| £1 ordinary shares | 300,000 | 300,000 |
| Retained profits | 224,000 | 374,000 |
| | 524,000 | 674,000 |

**Tasks:**

(a) Calculate two profitability ratios for both years.

(b) Calculate two liquidity ratios for both years.

(c) Calculate two efficiency ratios for both years.

(d) Briefly comment on the financial performance of the company over the two years.

(e) Briefly discuss the options available to the company to eliminate the negative working capital.

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**READING MATERIALS**