Financial ACCOUNTING

LAWYER C. OBARA (JP)
JUDE C. EDEH

About the Authors

Lawyer C. Obara holds a Bachelor of Science Degree in Accountancy and a Master of Business Administration Degree (MBA) from the Rivers State University of Science and Technology, Nkpolu, Port Harcourt.

He has been a lecturer in the Department of Accountancy, Faculty of Management Sciences, Rivers State University of Science and Technology, Port Harcourt since 1990.

He has authored/co-authored several books as well as contributed to several articles in academic journals and books of readings in Accountancy and Finance.

He is also the Chief Consultant of Global Konsult, Port Harcourt.

Jude C. Edeh holds a Bachelor of Science (B.Sc) degree, and a Master of Business Administration (MBA) degree, all in Accountancy from the Rivers State University of Science and Technology, Port Harcourt.

He is also the Senior Research Officer of Global Konsult, Port Harcourt.

Published in Nigeria by Springfield Publishers Ltd.

ISBN: 978-978-8405-01-6

Springfield Publishers Ltd.
Plots P 9 & 11, Housing Area A
New Owerri (Behind Federal Secretariat)
e-mail: springpub@hotmail.com; springfieldpublishers@yahoo.com;
08037160590; 08053040277; 0803-256-8871 ; 083-303759; 083302590
visit us at www.springfieldpublishers.com

DEDICATION

Staff Members, Global Konsult—
The Capacity Builders

PREFACE

This text is an attempt to present integrated and contemporary view of Financial Accounting. The concepts and technicalities involved in financial accounting practice are conceptually presented and comprehensively illustrated to enhance the understanding of the subject.

Sincerely this book will be found useful to all grades of students, both in the polytechnics and universities, who are offering causes in financial accounting. The materials has been arranged to allow flexibility of usage by both students and instructors. The end-of-chapter revision questions are meant to stimulate the student further in their effort to consolidate their understanding of the subject.

Suggestions and comments from the users of this book will be appreciated.

L. C. Obara (JP)
Rivers State University of
Science and Technology
Port Harcourt

and

Jude Edeh
Senior Research Officer
Global Konsult
Port Harcourt

ACKNOWLEDGEMENT

We are particularly grateful to all our lecturers throughout our university education. The cooperation of our family members were very encouraging. We will always remain grateful to them.

Above all, we thank God Almighty; the source of all knowledge, for making this feat possible.

TABLE OFCONTENT

SECTION ONE

PARTNERSHIP ACCOUNTS

CHAPTER ONE

GENERAL PRINCIPLES AND DIVISION OF PROFITS

A partnership is an association of two or more persons intended to carry on as co-owners of a business for profit. The special advantage of a partnership includes the ease of formation, complete control by the partners, and the fact that no income taxes are paid by the business itself. Its major disadvantage is the unlimited liability associated with it.

Unlike the limited liability company, the partnership is not a separate entity from a legal and tax viewpoint, thus the partnership's profit is not taxable. However, individual partners pay personal income taxes on their individual earnings.

Partnerships are usually found in medical practices, professional accounting practices, surveying, legal and architectural practices, wholesale trade, etc.

PARTNERSHIP AGREEMENT

A partnership agreement is a formal agreement drawn up to regulate the conduct of a partnership business. It is otherwise known as the partnership deed. It covers the following points;

- The amount of capital to be contributed by each partner.
- Whether the capital accounts are to be fixed, drawings and profits being adjusted on current accounts; or whether the capital accounts are to be fluctuating, drawings and profits being adjusted on capital accounts.
- The ratio in which profits/losses are to be shared among the partners.

- The rate at which interest is to be allowed on partners' capital
- The rate at which interest is to be charged on partners' drawings.
- The amount of salary receivable by partners.
- The rate of interest to be allowed on partners' loan
- Whether current accounts, if any, are to bear interest and, if so, at what rate.
- The method of calculating goodwill in the event of death, retirement or admission of partner(s).
- The method of treating the premiums on life assurance policies, if any, and how the proceeds of the policies are to be shared among the partners.

It should be noted that a written partnership agreement is important for the orderly conduct of operations, and for healthy financial relations. Without a carefully conceived and drawn-up agreement, a partnership which is usually based on a relationship cultivated over a long time period may be inadvertently destroyed.

The amount of capital to be contributed by the partners

It is most important to agree on these amounts otherwise disputes may take place in the future. Not all partners are able to contribute the same proportion of capital and this is usually reflected in the division of profits. There are exceptions to this. For example, where two people enter into a partnership, one has considerable business acumen, the other has considerable wealth. Neither can successfully run a business on his own, but by combining one can supply the 'brains' and the other the 'money'. Each contributes in his own way and therefore, may share profits equally. Generally, the capital originally contributed is fixed and is credited to each partners' capital account. Profits are usually credited to a partners' current account against which he makes his drawings.

Restrictions on Drawings

Unlike a sole trader, the capital of a partner is fixed in the partnership deed, but as profits are not known until the end of the year, and drawings are made during the year, a partner could place his current account in debit. The effect of this is that he had withdrawn part of his original capital. To attempt to overcome this situation, the maximum amount of drawings allowed to each partner is stipulated in the deed. It is also advisable to list the dates on which drawings can take place, e.g. monthly or quarterly, etc.

The Payment of Salaries

Strictly speaking partners cannot be paid salaries as they are owners of the firm, and share in the total profits. A partners' salary is a means of sharing out the profits at the year end; it is a charge against the net profit and is credited to his current account. The question of whether any salaries should be credited to partners depends to a large extent on their work within the partnership. If some partners are more actively engaged in business affairs whilst others are non-active and regard the partnership as an investment, it may seem appropriate that the former receive a salary credit whilst the latter do not.

A junior partner may only receive a small proportion of the firm's profits and is usually credited with a salary to compensate for his work within the partnership.

Interest on Capital and Current Account

If all partners contribute the same amount of capital, their stake in the firm is uniform and there may be no need to credit them with interest. When the capital contributions are different, the partner with the highest amount has the greater risk of losing more than the other partners. To compensate for the various amounts at risk, a charge against the net profits can be made in the form of interest on capital, these amounts being credited to the partners' current accounts. In the same way, a partner who does not withdraw all he is entitled to from his current account is benefiting the firm as it can make use of the funds available. To reward the partners for balances not withdrawn, interest can be credited to their current accounts.

Interest on Drawings

This adjustment has the same effect as the preceding one. The object is to reduce the amount of drawings taken from the firm. The entry is to debit the partners' current accounts with interest, and add these amounts to the net profit. The longer balances are left in the firm the more benefit can be obtained so that the interest is calculated on each amount of drawings. For example, a partner withdraws N400 each quarter, ie. 31st March, 30th June, 30th September, and 31st December. Interest is chargeable on drawings at 5% per annum. Calculate the interest to be debited to his current account.

Quarterly	Amount (₦)	Rate %	Period	Fraction	Interest (₦)
31st March	400	5	9 months	9/12ths	15
30th June	400	5	6 months	6/12ths	10
30th Sept.	400	5	3 months	3/12ths	5
31st December	400	5	0 months	-	-

Balance of Profits

The remaining balance of profits after all or any of the above adjustments have been dealt with is divided among the partners in a pre-determined ratio. This ratio is incorporated in the partnership deed and will depend to some extent on the amounts already agreed upon in respect of interest or salaries. In many instances this balance is divided equally as the previous adjustments should cover the different contributions made by the partners towards the business interests. If the balance is to be distributed in unequal proportions, a clause is sometimes inserted into the deed that a particular partner will receive a minimum amount. In this case, the amount that may be required to make up this sum will be borne by the other partners in a proportion laid down in the deed.

The partnership Act of 1890

Although every endeavour may have been made to ensure that all eventualities have been covered in the partnership agreement, certain matters may be overlooked. Where omissions have occurred, the provisions of the partnership Act of 1890 will apply.

This act covers most disputes that might arise between partners, but will only apply in the absence of any partnership agreement or clauses within the deed.

Exceptions to the application of the Act are where the partners' conduct over a number of years implies that certain agreements have been made although not supported by written evidence. For example, if a partner had been credited with an annual salary since the inception of the partnership, it would be understood that it formed part of the original agreement.

The rules applying to the accounts are contained in section 24 of the Act and are as follows:

- The capital should be subscribed equally by the partners.
- Profits and losses should be shared equally among the partners
- No interest is allowed on capital or current accounts.
- No interest is to be charged on drawings.
- No partner is entitled to receive a salary
- Any partner who lends the firm money in excess of the capital he has agreed to subscribe is entitled to interest at the rate of 5% per annum.
- Every partner is entitled to inspect and copy any of the accounting records which must be kept at the place of business.

PARTNERSHIP FINAL ACCOUNTS; DIVISION OF PARTNERSHIP PROFITS AND THE APPROPRIATION ACCOUNT

The Final accounts of a partnership are, to a large extent, similar to those of a sole trader except for the following differences; in the case of a partnership, an account known as the appropriation account is drawn up after the net profit/loss has been ascertained on the profit and loss account. The appropriation account shows the details of how the net profit/loss of the partnership is distributed to the partners. Below is a summary of items debited as well as those credited to the appropriation account.

Debits

(i) Interest on capital
(ii) Salary of partners
(iii) Partners share of profit

Credits

(i) Interest on drawings
(ii) Partners' share of loss

A different approach is equally adopted in the presentation of owners' equity in the case of a partnership. In a partnership, all items (such as drawings, interest on drawings, interest on capital, interest on partners' loans, partners salaries and share of profit) affecting the stake of partners are posted to partners' capital or current accounts after which the balance on these accounts are carried to the balance sheet.

Illustration I

Two professional men, Ama and Bile, formed a partnership on January 1, 1999. The partnership agreement stipulates the following;

(a) The partners' fixed capital are: Ama: ₦60,000
Bile: ₦48,000
(b) Mr. Bile is entitled to a salary of ₦3,600 annually
(c) Interest is to be charged on drawing at the rate of 4%, and interest on capital is to be calculated at 10% per annum.
(d) Profits are to be shared between Ama and Bile in the ratio 3:2 respectively.

The following balances were on the accounts of the partnership as at the year end 31st December, 1999:

Drawings:

Ama ₦ 4,500
Bile ₦ 3,500

Net profit N27,000

Required:

(i) show the profit and loss appropriation account for the year ended 31/12/99

(ii) prepare the partners' current account and the balance sheet extract as at December 31, 1999

Note: Assume that the partners maintain fixed capital accounts.

Suggested solution:

(i) Ama and Bile

Profit and Loss Appropriation Account

for the year ended 31st December, 1999

	₦	₦		₦	₦
Salary: Bile		3,600	Net profit		27,000
Interest on capital:			Interest on drawings:		
A (10% x 60,000)	6,000		A (4% x 4,500)	180	
B (10% x 48,000)	4,800	10,800	B (4% x 3,500)	140	320
Share of Profits:					
A (3/5 x12,920)	7,752				
B (2/5 x12,920)	5,168	12,920			
		27,320			27,320

(iii) Partners' Current Accounts

PARTICULARS	AMA	BILE	PARTICULARS	AMA	BILE
	₦	₦		₦	₦
Drawings	4,500	3,500	salary – Bile	-	3,600
Interest on drawings	180	140	interest on capital	6,000	4,800
Bal c/d	9,072	9,928	Share of profits	7,752	5,168
	13,752	13,568		13,752	13,568
			Bal b/d	9,072	9,928

Ama and Bile
Balance Sheet (extract) as at 31st December, 1999

	₦	₦	₦
Financed by:	AMA	BILE	Total
Capital Accounts	60,000	48,000	108,000
Current Accounts	9,072	9,928	19,000
	69,072	57,928	127,000

Example II:

Peter, James and john are in partnership.
The deed of the partnership provides the following:

1. James shall receive a salary of N1000 and John shall receive a salary of N2,000
2. Interest is allowable at 5% on their fixed capitals.
3. Interest is allowable at 5% on their current account balances at the beginning of the year
4. Interest is chargeable on drawing at the rate of 6% per annum.
5. Balance of profits is to be shared among the partners as follows:

Peter	50%
James	30%
John	20%

The net profit for the year ended 31st December, 19 x 6 amounted to ₦6,730. You are given the following additional information.

	Peter	James	John
	₦	₦	₦
Capital Acct: 1/1/19 x 6	6,000	5,000	4,000
Current Acct: 1/1/19 x 6	1,000CR	500CR	200CR
Drawings:			
31/3/19x6	400	400	400
30/6/19x6	400	300	500
30/9/19x6	400	400	200
31/12/19x6	400	300	100

Required: Prepare the appropriation account at 31st December, 2000, and the partners' current accounts.

Suggested solution

Appropriation Account

	₦	₦		₦	₦
Salaries:					
James	1000		Net profit b/d		6,730
John	2000	3000	Interest on drawings:		
Interest on Capital:			Peter	36	
Peter	300		James	33	
James	250		John	36	105
John	200	750			
Interest on Current A/c:					
Peter	50				
James	25				
John	10	85			
Share of Profits:					
Peter (50%)	1500				
James (30%)	900				
John (20%)	600	3,000			
		₦6,835			₦6,835

Partners' Current Account

Details	Peter	James	John	Details	Peter	James	John
	₦	₦	₦		₦	₦	₦
Drawings	1600	1400	1200	Bal b/d	1000	500	200
Int. on drawings	36	33	36	Salaries	-	1000	2000
Bal. c/d	1214	1242	1774	int. on capital	300	250	200
				Int. on C/A's	50	25	10
				Share of profits	1500	900	600
					2850	2675	3010
	2850	2675	3010	Bal b/d	1214	1242	1774

EXERCISES

1. Explain the partnership form of organization and itemize how it differs from the limited liability company.

2. The differences between partnership and sole proprietorship relate more to form than substance. Discuss the bases on your agreement or disagreement with this statement.

3. On 6th January, 1990, Bisi, Biola and Betty set up a partnership with the objective of importing and exporting fashion items. Bisi invested cash of N3,500; Biola N6,000 and Betty N4,000. Biola withdrew N1,500 cash on 2nd May, 1990, while Bisi withdrew N900 on the 5th August, 1990. For the year ending 31 December 1990, the profit earned from the business was N18,900. Their partnership agreement provided for the following salaries to partners: Biola, N150 per month and Betty, N120 per month. The remaining profits are divided in the ratio of average capital during the year.
   Required:
   (i) Present the journal entries to record the initial investment by partners
   (ii) Compute the profit allocated to each partner and make entries to record the profit distribution.
   (iii) Make entries necessary to close the books at the end of the year

4. Elekwachi, Ekwem and Emere were in partnership. The partnership deed contains the following:
   (i) The partners' fixed capitals were:
   Elekwachi N24,000, Ekwem N20,000 and Emere N16,000
   (ii) Ekwem and Emere were to receive salaries of N1,500 and N1,000 respectively.
   (iii) Interest on capital is to be calculated at 5% per annum.
   (iv) Elekwachi, Ekwem and Emere are to share profits and losses in the ratio 3:2:1. You are given the following particulars

	Elekwachi	Ekwem	Emere
	₦	₦	₦
Current account balances (all credit) at 1st Jan. 19x7	1000	750	500
Drawings for year 31st December, 19x7	4000	3500	2700

The profit for the year ended 31st December, 19x7 amounted to N8,500.
You are required to prepare the appropriation account and the partners' current accounts.

5. Fish, fowl and bird were in partnership. The partnership deed provided that:

a. Interest is credited on the partners' capital accounts at 5% per annum.
b. Interest is charged on partners drawings at 5% per annum.
c. Bird is to receive a salary of N1000
d. Profits are to be shared in the ratio 2:2:1

During the year ended 30th June, 19x4, the net profit of the firm was N4,800. Drawings were: Fish N2,400, Fowl n2,000, Bird N1,600, in each case in two equal installments on 31st December, 19x3 and 30th June, 19x4

The partners' balances on 1st July 19x3 were;

	Fish	Fowl	Bird
	₦	₦	₦
Capital Account	10,000	9,000	5,000
Current Account (all credits)	800	600	200

On 1st January, 19x4, it was agreed that Fish should withdraw N1,000 of his capital and that Fowl should increase his capital by N1,000

You are required to prepare the firm's profit and loss appropriation account for the year ended 30th June, 19x4, and to show the entries in the partners' capital and current accounts.

6. Aham, Wechie and Sokari are trading in partnership. Each is to receive interest at 5% on their capital accounts. Sokari is to receive a further 10% of the net profit after charging interest on the capital accounts in lieu of a salary. The balance of profits is shared in the ratio 3:2:1

The capital accounts at 1st January 19x7 were Aham N9,600, Wechie N4,600 and Sokari N2,300. The net profit for the year ended 31st December, 19x7 was N2,165

You are required to prepare the profit and loss appropriation account and the partners' current accounts.

7. Nyeso, Ola and Obisike have been in partnership since 1st January, 19x0. They have shared profits in the ratio 3:2:1 respectively. On the 31st December, 19x2, it was unanimously agreed that interest at the rate of 5% per annum should have been allowed on partners' capital accounts. The following details apply to the three years.

8.

		19x0	19x1	19x2
		₦	₦	₦
Fixed capitals:	Nyeso	10,000	10,000	10,000
	Ola	8,000	8,000	8,000
	Obisike	6,000	6,000	6,000
Drawings:	Nyeso	2,500	1,000	1,000
	Ola	2,000	1,500	1,000
	Obisike	1,000	1,500	1,000
Profits		6,000	8,400	-
Loss		-	-	1,200

You are required to show the partners' current account showing the original division of profits for 19x0 and 19x1, the adjustment necessary to effect the interest on capital, and the division of the loss for 19x2

9. Sobereko and Madiki are in partnership as foodstuff dealers. There is no partnership deed. On 31st March, 19x7, the balance in their books were:

Capital Account:		Freehold Property	52,000
Sobereko	34,000	Shop fittings	2,000
Madiki	26,000	Prov for depreciation	
Current account:		- Fittings	800
Sobereko (CR)	6,000	Debtors	35,120
Madiki (CR)	4,000	Creditors	39,500
Drawings:		Stock (1/4/19x6)	28,940
Sobereko (CR)	4,000	Sales	198,000
Madiki (CR)	5,600	Prov. For d/debts	640
Purchases	143,600	Lighting & Heating	934
Wages	32,182	Loan from Sobereko	8,000
Rent and Rates	2,500	Discounts Received	2,000
Cash at Bank	10,574		
Carriage outwards	1,490		

Stock on hand at 31st March, 19x7 was valued at N25,208. Provision for depreciation on shop fittings is to be provided at 5% on cost. The provision for doubtful debts is no longer required. The loan from Sobereko was made on 31st December, 19x6.

You are required to prepare a trading, profit and loss and appropriation account for the year ended 30th June 19x7 and a balance sheet as at that date.