## SOLUTION FINANCIAL ACCOUNTING PRACTICE NOVEMBER 2009

### QUESTION 1

a) Pramsoman Company

Cash Flow Statement for the year ended 31 December 2008

| | GH¢'000 | GH¢'000 |
|---|---|---|
| Cash Flow for Operating Activities | | |
| Operating profit | | 14,300 |
| Adjustments for non-cash items: | | |
| Depreciation | | 3,800 |
| Profit on sale of PPE | | (300) |
| Share issue of costs | | 100 |
| Decrease in inventory | | 1500 |
| Increase in trade receivables | | (2,000) |
| Increase in trade payables | | 8,500 |
| Net cash flow from operating activities before Interest and Tax | | 26,460 |
| Interest: Finance charge | | (300) |
| Others (200 + 400) – 300 | | (300) |
| Taxation | | (2,300) |
| Net cash flow from operating activities | | 23,000 |
| | | |
| Investing Activities | | |
| Sale of PPE | 2,200 | |
| Purchase of PPE | (9,700) | |
| Net cash outflow from Investing Activities | | (7,500) |
| | | |
| ***Financing*** | | |
| Finance lease capital repayment | (1,800) | |
| Dividends (800 + 2000) – 400 | (2,400) | |
| Issue of shares | 2,700 | |
| Redemption of preference shares | (2,800) | |
| Redemption of loan ……. | (2,000) | |
| Share issue costs | (100) | |
| Net cash outflow from financing | | (6,400) |
| Increase in cash & cash equivalent | | 9,100 |

Reconciliation of Cash & Cash Equivalent in the Balance Sheet

| | GH¢'000 |
|---|---|
| Balance as at 31/12/07 | 300 |
| Increase during the year | 9,100 |
| Balance as at 31/12/08 | 9,400 |

b) Workings

PPE

| | | | |
|---|---|---|---|
| Balance | 20,000 | Disposal | 1,900 |
| Valuation …. | 700 | Depreciation | 3,800 |
| Obligation under Finance lease | 2,800 | Balance | 27,500 |
| Cash | 9,700 | | |
| | 33,200 | | 33,200 |

Obligation Under Finance Lease

| | | | |
|---|---|---|---|
| Cash | 1,800 | Balance b/f: Current | 300 |
| | | Non | 4,200 |
| Balance c/d: Current | 500 | Current | 2,800 |
| Non current | 5,000 | PPE | |
| | 7,300 | | 7,300 |

Taxation

| | | |
|---|---|---|
| Bal b/f: Current | 1,200 | |
| Deferred | 800 | 2,000 |
| | | 3,200 |
| Profit & Loss | | 5,200 |
| Balance c/d: Current | 1,700 | |
| Deferred | 1,200 | 2,900 |
| Cash paid | | 2,300 |

c) The arguments which can be advanced in favour of the direct method are as follows:

i. The direct method shows:

| | |
|---|---|
| Cash received from customers | x |
| Cash paid to suppliers | (x) |
| Cash paid to employees | (x) |
| Net cash flow from operations | x |

The information disclosed is not shown elsewhere in the accounts and cloud be a useful data.

ii. The direct method is arguably easier to explain to non-financially ……… managers as charges in working capital items are not included.

iii. The information may be more relevant for business or decisions.

**QUESTION 2**

a) One or more of the creditors of the firm may institute insolvency against all the partners jointly.

If a particular order is made against all the partners jointly, the order shall have the effect of appointing the official trustee to be the liquidator of the firm. From the date of the order, all the interest of the partners and all powers and authority of the partner in relation to the firm shall vest in the official trustee. A copy of the protection order shall be ……. by the official trustee to the Registrar for registration.

If an insolvency order is made against the partners jointly, all the assets of the firm shall be administered by the official trustee as if they were joint estate of the partners but the creditors of the firm shall be entitled to prove for such debts against both the firm's assets and the separate estate of each liable partner.

b) Goodwill ……………

i. QS Chartered Accountants

Valuation

| Year | Profit GH¢'000 | Weighted | Weighted profit GH¢'000 |
|---|---|---|---|
| 2006 | 9,000 | 1 | 9,000 |
| 2007 | 10,500 | 2 | 21,000 |
| 2008 | 14,000 | 3 | 42,000 |
| | | 6 | 72,000 |

Weighted Average = $\frac{\text{GH¢}72{,}000{,}000}{6}$ = GH¢12,000,000

Valuation = GH¢12m x 2 = GH¢24,000,000
Book value = GH¢11,000,000
Goodwill GH¢13,000,000

ii. PA Chartered Accountants

Valuation

| Year | Profit GH¢'000 | Weighted | Weighted profit GH¢'000 |
|---|---|---|---|
| 2006 | 4,000 | 1 | 4,000 |
| 2007 | 5,500 | 2 | 11,000 |
| 2008 | 3,000 | 3 | 9,000 |
| | | 6 | 24,000 |

Weighted Average = $\frac{\text{GH¢}24{,}000{,}000}{6}$ = GH¢4,000,000

Valuation = GH¢4m x 2 = GH¢8,000,000
Book value = GH¢5,000,000
Goodwill GH¢3,000,000

Partners Capital Accounts (GH¢'000)

| | Adom | Boafo | Nhyira | Dzidbodi | Esinam |
|---|---|---|---|---|---|
| Balance b/f | 4,800 | 3,200 | 2,600 | 3,200 | 1,800 |
| Transfer of current account | 200 | 120 | 80 | - | - |
| Goodwill | 5,200 | 5,200 | 2,600 | 1,800 | 1,200 |
| Goodwill written off | (4,000) | (3,200) | (3,200) | (3,200) | (2,400) |
| | 6,200 | 5,320 | 2,080 | 1,800 | 600 |

Excellent Chartered Accountants
Balance Sheet as at 1 January 2009

| | GH¢'000 | GH¢'000 |
|---|---|---|
| Non Current Assets | | |
| Business premises | | 7,000 |
| Office equipment | | 2,200 |
| | | 9,200 |
| Current Assets | | |
| Receivables from clients | 6,800 | |
| WIP unbilled | 2,800 | |
| Prepayments | 140 | |
| Cash & Cash equipment | 1,000 | |
| | 10,740 | |
| Current Liabilities | | |
| Creditors & accrued expenses | 1,940 | |
| Net Current Assets | | 8,800 |
| | | 18,000 |
| Less loan from Adom | | (2,000) |
| Net Assets | | 16,000 |
| Financed by: | | |
| Partners Capital Account | | |
| Adom | | 6,200 |
| Boafo | | 5,320 |
| Nhyira | | 2,080 |
| Dzibodi | | 1,800 |
| Esinam | | 600 |
| | | 16,000 |

**QUESTION 3**

| | | |
|---|---|---|
| To | : | The Board of Joe Ltd |
| From | : | Accountant |
| Subject | : | Overtrading Suggestion |
| Date | : | November, 2009 |

1. ***Introduction***

This report presents my findings regarding the suggestion made at the last board meeting that our company is overtrading.

Overtrading is also known as undercapitalisation, and occurs when the volume of trade is not supported by an adequate supply of capital.

***2.*** S***igns of Overtrading***

There are a number of generally recognised signs that a company may be overtrading. These are considered together with relevant financial data from appendix 1 or working 1.

(a) Rapid increase in turnover
The financial statements for 2008 show that our turnover had increased by 25% during the year.

(b) Rapid increase in current asset

Current assets increased by 27%, lightly more than the increase in turnover.

(c) Increase in stock days and debtor days trade receivable increased from 110 to 121 days with a 38% increase in trade receivables but inventories did not increase, instead fell from 265 days to 238 days. Nevertheless a 19% increase in inventories was recorded for 2008.

(d) Increased reliance on short term finance.
Retained earnings increased by GH¢100 whereas total assets also increased by GH¢1,400. The expansion of our business activity is therefore based primarily on an expansion of short term finance (Trade Payables and Overdraft).

Creditor days increased from 177 to 190 days while in relative terms creditors increased by 42% more than the rise in turnover (25%) and in our overdraft (20%).

(e) Decrease in current ratio and quick ratio
The current ratio fell very slightly from 1.04 to 1.0, but the quick ratio increased from 0.44 to 0.47.

Conclusion on Overtrading

Most of the evidence suggests that our company is moving into the overtrading situation, although the evidence is not conclusive.

Effort should be introduced to reduce the bank overdraft levels. Improved working capital management could reduce the level of investment in trade receivables and to lesser extent perhaps in stocks, which would ease our financial difficulties.

A further consideration is that our company has no long term debt and given our continuing growth, this source of finance also deserves serious consideration.

Appendix 1/Workings

| | | | | |
|---|---|---|---|---|
| Growth in turnover | = | 100 x (8300 – 6638)/6638 | = | 25% |
| Growth in current assets | = | 100 x (5950 – 4700)/4700 | = | 27% |
| Increase in overdraft | = | 100 x (2750 – 2300)/2300 | = | 20% |
| Increase in account payables | = | 100 x (2550 – 1800)/1800 | = | 42% |

| | 2008 | | 2007 | |
|---|---|---|---|---|
| Stock days | 365 X 3200/4900 | = 238 days | 365 x 2700/3720 | = 265 days |
| Debtor days | 365 x 2750/8300 | = 121 days | 365 x 200/6638 | = 110 days |
| Creditor days | 365 x 2550/4900 | = 191 days | 365 x 1800/3720 | = 177 days |
| Current ratio | 5950/5800 | = 1.03 | 4700/4500 | = 1.04 |
| Quick ratio | 2750/5800 | = 0.47 | 2000/4500 | = 0.44 |

b) a.

- The District Assemblies Common fund (DACF) was established under Sect. 252 of the 1992 constitution (Act 455 of 1993). It started disbursement operations in 1994.
- The fund is to strengthen the financial base of the District Assemblies (DAS) in order to ensure effective discharge of statutory functions.
- The DACF is a prol of resources (7½%) of nationally generated revenue set aside to be shared among all the Metropolitan, Municipal and District Assemblies.
- It is a development fund for use to the benefit of all Ghanaians and the distribution formula is approved by Parliament annually.

b. (i) To encourage local governance and deeper the Government's commitment to decentralisation in general and fiscal decentralisation in particular and promote sustainable self-help development.

(ii) Complement the internally generated funds of the Metropolitan, Municipal and District Assemblies to undertake development programmes in their areas of jurisdiction.

(iii) To ensure equitable distribution of development resources in every part of the country

(iv) To make up for development deficiencies in deprived communities

(v) To support creation and improvement of socio-economic infrastructure in Ghana.

c) (i) The Need Factor
This is meant to address the current inbalances in development

(ii) The Responsive Factor
This is to motivate the Assemblies to generate more revenues improvement in revenue generation and collection is based as an indicator

(iii) The Equalising Factor
This ensures that the Assemblies have access to specified minimum funds to start with. This involves a straight forward division of a portion of the fund by the number of Assemblies

(iv) The Service Pressure Factor
This is to assist in improving existing services which as a result of population pressure are deteriorating faster than envisaged. Population densities are the main basis for determining this factor.

**QUESTION 4**

(a) (i) The lease transfer ownership of the asset to the leassee by the end of the lease term

(ii) The leassee has the option to purchase the asset at a bargain price and it seems likely that at the inception of the lease, the opinion will be exercised

(iii) The lease term is for the major part of the useful life of the asset even if tithe is not tr5ansferred

(iv) At the inception of the lease, the present value of the minimum lease payments is greater or equal to substantially all of the fair value of the lease asset

(v) The lease asset is of a ………. nature such that only the leassee can use them without major modifications

(vi) The lease has the ability to continue the lease for a secondary period at a rent which is substantially lower than market rent.

(b) i. Finance Lease

Income Statement for the year ended 31 December 2008 (Extract)

| | GH¢ |
|---|---|
| Expenses | |
| Depreciation of leased asset $\frac{70,000}{4} \times \frac{6}{12}$ | 8,750 |
| Finance cost (w1) | 2,500 |

Statement of Financial Position as at 31 December 2008

| | GH¢ | GH¢ |
|---|---|---|
| Non-Current Assets | | 70,000 |
| Leased vehicle at cost | | 8,750 |
| Depreciation | | 61,250 |
| | | |
| Non current Liabilities | | |
| Obligation under finance lease (50,000 – 15,000) | | 35,000 |
| | | |
| Current Liabilities | | |
| Obligation under finance lease | | 15,000 |
| Accrued interest | | 2,500 |
| | | 17,500 |

Operating Lease
Income Statement for the year ended 31 December 2008 (Extract)

| | GH¢ |
|---|---|
| Vehicle rental $20,000 \times \frac{6}{12}$ | 10,000 |

Statement of Financial Position as at 31 December 2008 (Extract)

| | GH¢ |
|---|---|
| Current Asset | |
| Prepayment $20,000 \times \frac{6}{12}$ | 10,000 |

In the books of the lessor
Income Statement for the year ended 31 December 2008 (Extract)

| | GH¢ |
|---|---|
| Turnover | 70,000 |
| Cost of sale | (64,000) |
| Gross profit | 6,000 |
| | |
| Other Income | |
| Finance Income | 2,500 |
| | |
| Expenses: | |
| Professional expenses $\frac{400}{4} \times \frac{6}{12}$ | 50 |

(c) Income statement for the year ended 31 December 2008 (Extract)

(i)

| | |
|---|---|
| Turnover | 70,000 |
| Cost of sale | 64,000 |
| Profit margin | 6,000 |

(ii) Other Income:

Interest Income 2,500

| | Tax charge | Accounting charge | ………… Difference | Deferred Tax at 30% |
|---|---|---|---|---|
| | ¢ | ¢ | ¢ | ¢ |
| 2005 | 32,000 | 20,000 | 12,000 | 3,600 |
| 2006 | 32,000 | 20,000 | 12,000 | 3,600 |
| 2007 | 16,000 | 20,000 | (4,000) | (1,200) |
| 2008 | - | 20,000 | (20,000) | (6,000) |

Provision for Deferred Tax

| | | ¢ | | | ¢ |
|---|---|---|---|---|---|
| 2005 | Balance c/d | 3,600 | 2005 | Income Statement (Tax) | 3,600 |
| 2006 | Balance c/d | 7,200 | 2006 | Balance b/d | 3,600 |
| | | 7,200 | | Income Statement (Tax) | 3,600 |
| | | | | | 7,200 |
| 2007 | Income Statement (Tax) | 1,200 | 2007 | Balance b/d | 7,200 |
| | Balance c/d | 6,000 | | | |
| | | 7,200 | | | 7,200 |
| 2008 | Income Statement Tax | 6,000 | 2008 | Balance b/d | 6,000 |

(d) Carrying value of plant as at 1/1/08

| | GH¢ |
|---|---|
| Plant at cost | 30,000 |
| Account depreciation | 12,000 |
| Net Book Value | 18,000 |

Carrying value of the production unit basis had been applied:

| | GH¢ |
|---|---|
| Plant at cost | 30,000 |
| Account depreciation | 18,000 |
| Net Book Value | 12,000 |

The charge in accounting policy in January 2008 will require retrospective prior year adjustment.

Debt Retained Earnings GH¢6,000

Credit Accumulation Depreciation GH¢6,000

In the 2008 Income Statement, Depreciation charge will be GH¢6,000.

The Balance Sheet as at 31 December 2008 have the following extracts.

| | |
|---|---|
| Plant at cost | 30,000 |
| Account depreciation | 24,000 |
| Net Book Value | 6,000 |

Workings

Depreciation calculation under Production Units Basis

| | | GH¢ |
|---|---|---|
| 2006 | $\frac{5000}{15000} \times 30,000$ | 10,000 |
| 2007 | $\frac{4000}{15000} \times 30,000$ | 8,000 |
| 2008 | $\frac{3000}{15000} \times 30,000$ | 6,000 |
| 2009 | $\frac{20,000}{15000} \times 30,000$ | 4,000 |
| 2010 | $\frac{1000}{15000} \times 30,000$ | 2,000 |

**QUESTION 5**

b) Five (5) principal situations in which net realisable value of inventory is likely to be less than cost

1. Fall in the general price level
2. Changes in technology against the asset
3. Management of the entity decides that the NRV should be less than the cost
4. Obsolescence of the asset
5. It becomes …….

c) Three (3) conditions under which a change in accounting policy is required/permitted

An entity shall change an accounting policy only if the change:

(1) is required by a standard

(2) is required by an interpretation

(3) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cashflows.

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Comment

The cash flow position of the company appears strong.  With net investments of GH¢75m, the company appears to be expanding.  These investments are expected to generate positive cash flows from operations.  This claim is supported by the net positive cash flows from operating activities.

As inflows are generated from operations financing obligations in terms of ……. and related equity capital is expected to be reduced through settlement.  Thus, the net outflows from financing operations are indicative of financial stability.

As the cash generated from operations exceed the investing and financing requirements, the net cash and cash equivalents balance of GH¢9,100,000 indicates a strong liquidity position that can support net only recurrent expenditure requirements but also further investment. `