

**Being Paper Delivered - Dr Ikpefan, O. Ailemen At ReCh Management Centre,**

**14<sup>th</sup> June, 2016**

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**Course Title: Finance for Non Finance Managers/Global Treasury Management/Financial Accounting**

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**Objectives**

At the end of this course delegates will be able to understand the following:

- Framework/The Nature and purpose of Accounting, Statement of Financial Position, Income statement and Statement of Cashflow.
- Working capital and its application, stock, creditors and cash etc. Optimising working capital, sources of funding
- You would have acquired the requisite knowledge for preparation/analysing and interpretation of statement of cashflow. This course consists of three modules.

**Module One**

Framework/The Nature and Purpose of Accounting, Profit and Loss Accounts, Balance Sheets and Cash Flow Statements, Their structure and terminology, Profit types - trading, asset and business, Inventory, Depreciation, Capitalized interest, Minority interests and consolidation, Exceptional and material items. Detailed review of the Balance Sheet including explanation of all significant accounting terminology.

**Module Two**

Control of working capital,stock, creditors, debtors and cash. Cost accounting and control. Optimizing working capital for your organization and the implications for negotiating with customers and suppliers.The distinction between profit and cash flow, considering sources of funding.

**Module Three**

Understanding cash flows, Detailed review of the Cash Flow Statement, Analysing and interpreting cash flows. Summarizing cash flows for analysis. Cash flow analysis. Dealing with the consequences of growth and no-growth

**Essential Reading:** Olanrewaju, O. Oladimeji (2012): International Financial Reporting PAL, Dimkem Publications Ltd, Lagos

**Pre-reading:** Pandey, I. M (2003): **Financial Management** (8<sup>th</sup> ed.) Vikas Publishing House PVT Ltd New Delhi.

**Further Reading:** IFRS Publications

**MODULE ONE**

**Framework**

The framework for the Preparation and Presentation of Financial Statements states basic principles for IFRS. These are concepts and principles that underpin the preparation of Financial Statements

**Objectives of Framework**

**Fundamental accounting principles are essential for preparing financial statements. The major reasons for providing the framework are to;**

- Identify the essential concepts underlying the preparation and presentation of financial statements;
- Guide standard setters in developing new accounting standards and reviewing existing standards;
- Assist preparers in preparing financial statements and dealing with topics that are not covered by a specific IFRS;
- Assist auditors in forming an opinion as to whether a set of financial statements conforms with IFRS; and
- Assist users in interpreting the financial information contained in a set of financial statements that comply with IFRS.

**Objective/Purpose of Financial Statements**

The framework states that the objective of financial statements is to provide information about the financial position, performance and changes in the financial position of an entity that is useful to a wide range of users in making economic decisions, and to provide the current financial status of the entity to its shareholders and public in general. Financial statements should be understandable, relevant, reliable, and comparable.

Reported assets, liabilities and equity are directly related to an organization's financial position.

Reported income and expenses are directly related to an organization's financial performance. Financial statements are intended to be understandable by readers who have "a reasonable knowledge of business and economic activities and accounting and who are willing to study the information diligently." Users of financial information include present and potential capital providers, employees, lenders, suppliers, customers, and the government etc.

## **Underlying assumptions**

The underlying assumptions used in International Financial Reporting Standard (IFRS) are:

- **Accrual basis** – the effect of transactions and other events are recognized when they occur, not as cash is received or paid
- **Going concern** – the financial statements are prepared on the basis that an entity will continue in operation for the foreseeable future
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## **Elements of Financial Statements**

**The framework sets out the statement of financial position (balance sheet) as comprising:**

**\*Assets** - resources controlled by the entity as a result of past events and from which future economic benefits are expected to the entity.

**\*Liabilities** – a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

**\*Equity** – the residual interest in the asset of the entity after deducting all its liabilities. This is being referred to as **Shareholders' fund**

**Statement of comprehensive income (income statement) as comprising:**

**\*Income** is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or reductions in liabilities.

**\*Expenses** are decrease in such economic benefits.

**Measurements of the Elements of financial Statements/ Understanding how operational income and costs are accounted for and the implications for how you manage costs in your department.**

Measurement is how the responsible accountant determines the monetary values at which items are to be valued in the income statement and balance sheet. The basis of measurement has to be selected by the responsible accountant. Accountants employ different measurement bases to different degrees and in varying combinations. They include, but are not limited to:

**\*Historical cost:** Assets are recorded at the amount paid or fair value of consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation.

**\* Current cost:** Assets are carried at the amount of cash and cash equivalents that would have to be paid if the same equivalent asset were acquired currently. Liabilities are carried at the

undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

**\*Realisable (settlement) value:** Assets are carried at the amount of cash and cash equivalents that would be obtained by selling the assets in an orderly disposal. Liabilities are carried at their settlement values, that is, the undiscounted amount of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

**\*Present value:** are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

### **Snapshot of Key Provisions of IFRS**

#### **Content of financial statements consist of:**

\*a balance sheet

\*income statement

\*either a statement of changes in equity (SOCE) or a statement of recognized income or expense

\*a cash flow statement

\*notes, including a summary of the significant accounting policies

### **The Importance of Accounting for Business Operations**

Accounting, in its most fundamental sense, is merely a system of record keeping. Income statements and balance sheets are the formalized documents used to summarize and report accounting data. Firms engage in real and monetary activities and these must be recorded and reported to tax authorities, creditors, equity holders, and the firm's managers. The following story is offered as an example of how financial statements can be used to summarize the operations of small firms as well as large. It also demonstrates that financial statements can be constructed for any time period - a day, a week, a quarter, a year, or any other period.

#### **Depreciation/Material items**

Depreciation is charged to write off the cost or valuation of the asset over its estimated useful life down to the recoverable amount. The cost of depreciation is recognized as an expense in the income statement unless it is included in the carrying amount of another asset.

Depreciation of Property, plant and equipment (PPE) used for development activities may be included in the cost of an intangible asset in accordance with IAS 38. Property, plant and equipment may be revalued to fair value if the entire class of assets to which it belongs is so

treated (for example, the revaluation of all freehold properties). Surpluses on revaluation are recognized directly to equity, not in the income statement; deficits on revaluation are recognized as expenses in the income statement.

The depreciation method and recoverable amount is reviewed at least annually. In most cases the method is “straight line”, with the same depreciation charge from the date when an asset is brought into use until it is expected to be sold or no further economic benefits obtained from it, but other patterns of depreciation such as ‘reducing balance’ is used if assets are used proportionately more in some periods than others.

### **Material items**

The nature and amount of items of income and expense are disclosed separately, where they are material. Disclosure may be in the statement, or in notes. Such income or expenses might include restructuring costs; write-downs of inventories or property, plant and equipment; litigation settlements; and gains or losses on disposal of non-current assets.

Other comprehensive income: An entity presents each component of other comprehensive income in the statement either (a) net of its related tax effects, or (b) before its related tax effects, with the aggregate tax effect of these components shown separately

### **Inventory (stock)**

Inventory is stated at lower of cost and net realizable value, which is similar in principle to lower of cost or market.

Cost comprises all costs of purchase, costs of conversion and other costs incurred in bringing items to their present location and condition. Where individual items are not identifiable, the “first in first out” (FIFO) method is used, such that cost represents the most recent items acquired.” Last in first out” (LIFO) is not acceptable.

Net realizable value is the estimated selling price less the costs to complete and costs to sell

### **Presentation of Financial Statements IAS 1**

Management prepares its financial statements, except for cash flow information, under the accrual basis of accounting. There is no prescribed format for the financial statements. However, there are minimum disclosures to be made in the primary statements and the notes.

### **Statement of Financial Position (Balance Sheet)**

The following items, as a minimum, are presented on the face of the balance sheet:

#### **\*Assets**

**\*Equity**

**\*Liabilities**

**\*Assets and Liabilities held for sale**

**\*Current and non-current assets and current and non-current liabilities**

**Statement of Comprehensive Income**

The statement of comprehensive income presents an entity's performance over a specific period. Entities have a choice of presenting this in a single statement or as two statements. Under the two statement approach, all components of profit or loss are presented in an income statement, followed immediately by a statement of comprehensive income. This begins with the total profit or loss for the period, displays all components of comprehensive income and ends with total comprehensive income for the period.

Items to be presented in statement of comprehensive income. The following items, as a minimum, are presented in the statement of comprehensive income:

\*revenue

\*finance costs;

\*share of the profit or loss of associates and joint ventures accounted for using the equity method

\*tax expense;

\*post-tax profit or loss of discontinued operations aggregated with any post-tax gain or loss recognized on the measurement to fair value less costs to sell (or on the disposal) of the assets or disposal group(s) constituting the discontinued operation.

\*profit or loss for the period;

\*each component of other comprehensive income classified by nature

\*share of the other comprehensive income of associates and joint venture accounted for using the equity method; and

\*total comprehensive income.

**\*The Income Statement**

The income statement, also called an earnings statement or a profit and loss statement, is an accounting statement that matches a company's revenues with its expenses over a period of time, usually a quarter or a year. The components of the income statement involve a company's recognition of income and the expenses related to earning this income. Revenue less expenses results in a profit or loss.

The income statement is a flow measure statement meaning that each value on an income statement represents the cumulative amount of that item through the given accounting period. Thus, the revenue on a first quarter income statement equals the cumulated amount of all sales during the first three months of the firm's fiscal year. The revenue on the second quarter income statement equals the cumulated amount of all sales during the second three months of the firm's fiscal year. The same applies to expenses and therefore profits.

### Example One

Consider the following monthly data for Bixel, Inc. for January through June:

Month	Sales	Expenses
January	N20,000	N15,000
February	N30,000	N20,000
March	N40,000	N30,000
April	N30,000	N20,000
May	N50,000	N40,000
June	N20,000	N15,000

### QUESTION 1

Assuming that the first quarter of 2003 includes the months of January, February and March, what would Bixel, Inc. report as revenue on its first quarter income statement? What would Bixel, Inc. report as expenses on its first quarter income statement? What would Bixel, Inc. report as profit (or loss) on its first quarter income statement?

Answers: N90,000; N65,000; N25,000

### QUESTION 2

Assuming that the second quarter includes the months of April, May and June, what would Bixel, Inc. report as revenue on its second quarter income statement? What would Bixel, Inc. report as expenses on its second quarter income statement? What would Bixel, Inc. report as profit (loss) on its second quarter income statement?

Answer: N100,000; N75,000; N25,000

### QUESTION 3

What would Bixel, Inc. report as profit (loss) on its income statement covering the period January through June?

Answer: N50,000

It is important to realize that profit on an income statement seldom corresponds with a company's actual cash flow. In fact, while all companies seek to maximize their cash flow (since cash is necessary to pay bills, salaries, loans, dividends and so on), not all companies attempt to maximize reported earnings. In fact, many companies actually try to minimize reported earnings in an attempt to reduce taxes.

The reason why income and cash flow seldom match is that most companies elect to prepare their income statements (and thereby their balance sheets) using accrual accounting as opposed to cash accounting. Accrual accounting recognizes revenues as earned when sales are transacted, regardless of when the company actually receives payment. Likewise, expenses are recognized when they are incurred rather than when the actual payment is made. In contrast, cash accounting recognizes revenues as earned only when payment is received and recognizes expenses as costs only when cash is actually paid out. Statement of cash flows (specifically, cash flows from operating activities) represents the conversion of an accrual accounting income statement into a cash accounting income statement.

The basic structure of a multi-step income statement. The term multi-step means that four profit measures are designated on the statement: **gross profit**, **operating profit** (sometimes referred to as operating income, Earnings before Interest and Taxes, or EBIT), **profit before taxes** (sometimes referred to as Earnings before Taxes or EBT), and **net income** (also referred to simply as earnings).

Note that these are not the only accounts that may appear on an income statement and some income statements may utilize slightly **different terminology**. Some companies offer more detail on their statements than others. Certain expense items that are important for one company



may be minor or nonexistent for another company. Nonetheless, these are the major items and delineations that appear on most standard income statements and this is the income statement structure that we will use throughout.

## Income Statement

Company Name

For the Time Period Ending Date

Net sales

- Cost of goods sold

**Gross profit**

– Operating expenses

**Operating profit**

- Interest expense

**Profit before taxes**

- Taxes

**Net income**

**Net sales** - Sales revenue is recorded when a product is shipped, or more precisely, when ownership of the product (or service) is transferred from the seller to the buyer. Whereas identifying this point in time is relatively easy for merchandise sold at a retail store, it is often more complicated to pinpoint the exact transfer time of services. For example, a health club membership provides membership services over a period of time. When is revenue recognized? The law allows the income recognition to take place as soon as the member signs a contract. Although this is not exactly correct in terms of the definition, it is nonetheless allowed and used.

In general, companies prefer to record revenue as soon as possible. Accurate reporting, however, must note that some of this revenue may never actually be collected. Often times people sign a service contract (for example, a health club membership) and then cancel without ever paying any cash. Companies and individuals sometimes purchase products on credit but do not pay when their bill arrives. Consumer rights legislation, lemon laws, money-back guarantees, trial periods, credit card company stop-payment return policies, defaults, and so on, mean that not all sales will result in full payment. To account for this fact and possibility, firms calculate net sales as follows:

**Net sales = Gross sales - (Returns and Allowances).**

Some firms also offer sales discounts for large volume purchases - in such cases, these are also netted out of gross sales. Often returns and allowance numbers are estimates. If actual returns turn out to be less than estimated returns, a credit is made to net sales during the next accounting period. If, however, actual returns turn out to be greater than estimated returns, the allowance account should be increased during the next accounting period to reflect this fact.

### **Illustration**

**Tanner, Inc. had gross sales of \$1,253,400.** The company's management reported a Returns and Allowances estimate of \$53,400 in 2003. What did Tanner, Inc. report as Net sales in 2003?

Answer: N1,200,000.

**Cost of goods sold** - Whenever a product is manufactured or sold, certain direct costs are incurred. These costs are designated on the income statement as cost of goods sold, or COGS. For a retail company, direct costs are simply the cost of materials purchased for resale. For a manufacturing company, direct costs can also include labor costs, manufacturing overhead, and depreciation expenses associated with production. Since service companies incur few direct costs, their income statements usually do not include cost of goods sold. For uniformity and simplicity, unless otherwise specifically noted, we will assume throughout this section of the text that all firms are retailers, or at least that COGS is equal to materials purchased for resale.

Whenever an item is sold, that item must be allocated a certain cost, that is, a cost of goods sold. If a retail company sells 25 shirts in a given accounting period (assume one day), each of the 25 shirts must be assigned a cost. If the retail company purchased the 25 shirts from a manufacturer for N10 per shirt, cost of goods sold would be N250.

Assume, however, that the retail company actually purchased 45 shirts from the manufacturer during the accounting period in batches of 20 shirts at N8 per shirt, 15 shirts at N10 per shirt and 10 shirts at N14 per shirt. Thus, the retailer purchased N450 worth of shirts from the manufacturer (at an average cost of N10 per shirt). If the retailer only sells 25 shirts during the accounting period, he must assign a cost to these 25 shirts as cost of goods sold and record the remaining amount as inventory. If the retailer chooses to assign the average purchase cost to each shirt, cost of goods sold will be N250 and ending inventory will be N200.

**In general,**

**Cost of goods sold = Beginning inventory + Materials purchases - Ending inventory.**

Thus, Cost of goods sold = N0 + N450 - N200 = N250.

Firms can choose between three methods of inventory valuation (and thereby cost of goods sold valuation): FIFO, LIFO, and Average Cost. Refer to a basic accounting text for more information on the three methods if necessary. Here, suffice to say that different inventory valuation methods can produce different cost of goods sold values.

**Operating expenses** - Operating expenses are expenses other than cost of goods sold that a company incurs in the normal course of business. These include items such as management salaries, advertising expenditures, repairs and maintenance costs, research and development expenditures, lease payments, and general and administrative expenses. This latter category includes everything from salaries of office staff to paper clips. As mentioned above, for a manufacturer, depreciation expense is considered as a cost of goods sold; for a retailer, depreciation is included in operating expenses. Because we are limiting our focus to retail companies only, depreciation will be noted throughout the text as an operating expense - often times listed separately on the income statement.

**Interest expense** - Interest expense is the cost to the firm of borrowing money. It depends on the overall level of firm indebtedness and the interest rate associated with this debt. Interest expense is generally a small fraction of total firm expenses; however, this expense as a percent of revenue can fluctuate dramatically with changes in the firm's borrowing requirements or with the general level of interest rates in the economy.

**Taxes** - Income taxes are a necessary part of business for all profitable for-profit firms. Earned income can be taxed at the federal, state and/or local levels and the provision for income taxes can be calculated using published tax tables from the respective government agencies. Because taxes are paid on an estimated basis throughout the year (with the minimum estimated tax being equal to what was owed in the prior year) and taxes owed are calculated at the end of the year based on the firm's actual profit before taxes, reported taxes and actual cash taxes paid will often differ. This difference is reported on the balance sheet under the deferred tax account.

**Net income** - Net income (also called net profit or earnings) is the "bottom line" of the income statement. It represents the base profit earned by a firm in a given accounting period. Net income divided by the number of common shares outstanding is referred to as earnings per share, or EPS. This value represents the profit earned for each share of stock. The current market price of the stock divided by EPS is called a P/E ratio. Analysts often consider EPS and P/E ratios to be important indicators of a firm's current and potential future performance. These measures and their significance will be explained in greater detail later in the book.

**Problem:** In 2003, Osaze, Inc. (a hardware retail company) sold 10,000 units of its product at an average price of N400 per unit. The company reported estimated Returns and allowances in 2003 of N200,000. Osaze actually purchased 11,000 units of its product from its manufacturer in 2003 at an average cost of N300 per unit. Osaze began 2003 with 900 units of its product in inventory (carried at an average cost of N300 per unit). Operating expenses (excluding depreciation) for

Osaze, Inc. in 2003 were N400,000 and depreciation expense was N100,000. Osaze had N2,000,000 in debt outstanding throughout all of 2003. This debt carried an average interest rate of 10 percent. Finally, Osaze's tax rate was 40 percent. Osaze's fiscal year runs from January 1 through December 31.

**Given this information, construct Osaze's 2003 multi-step income statement.**

Answer:

Income Statement

Osaze, Incorporated

For the 12 month period Ending December 31, 2003

	N
Net sales	3,800,000
Cost of goods sold	3,000,000
Gross profit	800,000
Operating expenses (excl. depreciation)	400,000
Depreciation expense	100,000
Operating income	300,000
Interest expense	200,000
EBT	100,000
Taxes	40,000
Net income	60,000

Notes: Net sales = Gross sales – Returns and Allowances = (10,000) (N400) – 200,000. Cost of goods sold = # units sold x Cost per unit = (10,000) (N300). Interest expense = (Debt outstanding) (Average interest rate) = (N2,000,000) (.10). Taxes = (EBT) (Tax rate) = (N100,000) (.40).

**Problem:** What was Osaze's 2003 ending inventory balance (in both units and in dollars)?

**Answer: 1,900 units and N570,000**

A firm's income statement indicates a great deal about the health of a company. Analysis of this statement, in particular analysis of trends over time, provides a firm's managers, creditors and stockholders with important insights into the future potential of the company. Good analysis will also highlight areas where changes need to be considered. Hopefully, you now understand the basic structure and composition of an income statement. This understanding is essential before any type of meaningful financial analysis or management can occur. Be sure that you can properly define, identify and classify each item on the company's income statement. If you can do so, then you are ready to go on.

**Problem:** Prepare a multi-step income statement for the Adu Company (a clothing retailer) for the year ending December 31, 2003 given the information below:

Advertising expenditures	68,000
Beginning inventory	256,000
Depreciation	78,000
Ending inventory	248,000
Gross Sales	3,210,000
Interest expense	64,000
Lease payments	52,000
Management salaries	240,000
Materials purchases	2,425,000
R&D expenditures	35,000
Repairs and maintenance costs	22,000
Returns and allowances	48,000
Taxes	51,000

**Answer:**

Income Statement

The Adu Company For the 12 month period Ending December 31, 2003

Net sales	3,162,000
Cost of goods sold	<u>2,433,000</u>
<b>Gross profit</b>	729,000
Operating expenses (excluding depreciation)	417,000
Depreciation	<u>78,000</u>
<b>Operating profit</b>	234,000
Interest expense	<u>64,000</u>
<b>Earnings before taxes</b>	170,000
Taxes	<u>51,000</u>
<b>Net income</b>	119,000

### **The Balance Sheet**

The balance sheet is a summary statement of what a company owns (or is owed) and what a company owes (or what others own) at a specific point in time. It categorizes all of a company's resources as assets, liabilities, and owner's equity.

Note, as with the income statement, that these are not the only accounts that may appear on a balance sheet and some balance sheets may utilize slightly different terminology. Some companies offer more detail on their statements than others. Certain accounts that are important for one company may be minor or nonexistent for another company. Nonetheless, these are the major items and delineations that appear on most standard balance sheets.

**The basic balance sheet identity is: Total Assets = Total Liabilities + Shareholders Equity.**

It is very important to note that a balance sheet is a stock measure statement, meaning that each value on a balance sheet is the value of that account on the specific date associated with the balance sheet. The value of the account (particularly liquid asset and liability accounts) at a later date may differ substantially from that reported on the balance sheet.

## What is capitalized interest?

Capitalized interest is the cost of the funds used to finance the construction of a long-term asset that an entity constructs for itself. The capitalization of interest is required under the accrual basis of accounting, and results in an increase in the total amount of fixed assets appearing on the balance sheet. An example of such a situation is when an organization builds its own corporate headquarters, using a construction loan to do so.

This interest is added to the cost of the long-term asset, so that the interest is not recognized in the current period as interest expense. Instead, it is now a fixed asset, and is included in the depreciation of the long-term asset. Thus, it initially appears in the balance sheet, and is charged to expense over the useful life of the asset; the expenditure therefore appears on the income statement as depreciation expense, rather than interest expense.

The record keeping for the recordation of capitalized interest can be complicated, so it is generally recommended that the use of interest capitalization be confined to situations where there is a significant amount of related interest expense. Also, interest capitalization defers the recognition of interest expense, and so can make the results of a business look better than is indicated by its cash flows.

Generally, borrowing costs attributable to a fixed asset are those that would otherwise have been avoided if the asset had not been acquired. There are two ways to determine the borrowing cost to include in an asset:

- *Directly attributable borrowing costs.* If borrowings were specifically incurred to obtain the asset, then the borrowing cost to capitalize is the actual borrowing cost incurred, minus any investment income earned from the interim investment of those borrowings.
- *Borrowing costs from a general fund.* Borrowings may be handled centrally for general corporate needs, and may be obtained through a variety of debt instruments. In this case, derive an interest rate from the weighted average of the entity's borrowing costs during the period applicable to the asset. The amount of allowable borrowing costs using this method are capped at the entity's total borrowing costs during the applicable period.

Capitalization of borrowing costs terminates when an entity has substantially completed all activities needed to prepare the asset for its intended use. Substantial completion is assumed to have occurred when physical construction is complete; work on minor modifications will not

extend the capitalization period. If the entity is constructing multiple parts of a project and it can use some parts while construction continues on other parts, then it should stop capitalization of borrowing costs on those parts that it completes.

### **Capitalized Interest Example #1**

ABC International is building a new world headquarters in Rockville, Maryland. ABC made payments of N25,000,000 on January 1 and N40,000,000 on July 1; the building was completed on December 31.

For the construction period, ABC can capitalize the full \$25,000,000 of the first payment and half of the second payment, as noted in the following table:

<u>Date</u>	<u>Payment</u>	<u>Capitalization Period*</u>	<u>Average Payment</u>
1/1	N25,000,000	12/12	N25,000,000
7/1	40,000,000	6/12	20,000,000
			<u>N45,000,000</u>

\* The number of months between the payment date and the date when interest capitalization ends.

During this time, ABC has a loan outstanding on which it pays 7.5% interest. The amount of interest cost it can capitalize as part of the construction project is N3,375,000 (N45,000,000 x 7.5% interest).

### **Extraordinary Items**

#### **Overview of Extraordinary Items**

An extraordinary item in accounting is an event or transaction that is considered abnormal, not related to ordinary company activities, and unlikely to recur in the foreseeable future. The formal use of extraordinary items has recently been eliminated under Generally Accepted Accounting Principles (GAAP), so the following discussion should be considered historical in nature.

The reporting of an extraordinary item used to be an extremely rare event. In nearly all cases, an event or transaction was considered to be part of the normal operating activities of a business, and so was reported as such. Thus, a business might never report an extraordinary item.



GAAP specifically stated that write-offs, write-downs, gains, or losses on the following items were not to be treated as extraordinary items:

- Abandonment of property
- Accruals on long-term contracts
- Disposal of a component of an entity
- Effects of a strike
- Equipment leased to others
- Foreign currency exchange
- Foreign currency translation
- Intangible assets
- Inventories
- Receivables
- Sale of property

Examples of items that could be classified as extraordinary were the destruction of facilities by an earthquake, or the destruction of a vineyard by a hailstorm in a region where hailstorm damage was rare. Conversely, an example of an item that did not qualify as extraordinary was weather-related crop damage in a region where such crop damage was relatively frequent.

The intent behind reporting extraordinary items within separate line items in the income statement was to clarify for the reader which items were totally unrelated to the operational and financial results of a business.

International Financial Reporting Standards (IFRS) do not use the concept of an extraordinary item at all.

### **Disclosure of Extraordinary Items**

An extraordinary item used to be separately stated in the income statement if it met any of the following criteria:

- It was material in relation to income before extraordinary items
- It was material to the trend of annual earnings before extraordinary items
- It was material by other criteria

Extraordinary items were presented separately, and after the results of ordinary operations in the income statement, along with disclosure of the nature of the items, and net of related income taxes.

If extraordinary items were reported on the income statement, then earnings per share information for the extraordinary items were to be presented either in the income statement or in the accompanying notes.

## **Exceptional Item**

### **WHAT IT IS:**

An **exceptional item** is an unusually large and uncommon transaction charge that must be disclosed on the balance sheet in accordance with GAAP.

### **HOW IT WORKS (EXAMPLE):**

An *exceptional item* should not be confused with an extraordinary item. An extraordinary item is also an unusual charge but does not accrue during the ordinary course of business and does not need to be reported.

An exceptional item may be either an outgoing charge or an incoming surplus of significant size.

Let's assume Company ABC is experiencing poor business. It may choose to undergo restructuring which costs a significant amount of money and is unusual during the normal cycle of business. The large transaction costs would be reported as an "exceptional item" on the balance sheet because it was significant and unusual. If the reorganization continues for the next several years, the transaction costs continue to be listed as "exceptional items" for the subsequent years until the reorganization is complete.

### **WHY IT MATTERS:**

Exceptional items are important because they are a way to separate normal business operation transactions from unusual ones. Though they are generally not disclosed on a company's income statement, exceptional items are usually disclosed on the balance sheet and extraordinary items are usually disclosed in the notes to financial statements.

Exceptional items can be easily manipulated by a company trying to "window dress" its performance. Investors may consider researching the reasoning behind exceptional items on a given company's balance sheet before investing further in that company.

#### **exceptional items**

1. items which arise from normal **trading** but which are unusual because of their **size** or nature

(**Note** Such items are shown separately in a note to the company's **accounts** but not on the face of the P & L account unless they are profits or losses on the **sale** or termination of an **operation**, or **costs** of a fundamental **reorganisation** or **restructuring** which have a material **effect** on the nature and focus of the reporting entity's operations, or profits or losses on the **disposal** of **fixed assets**.)

2. items in a **balance sheet** which do not appear there each **year** and which are included in the accounts before the pre-tax **profit** is calculated, as opposed to extraordinary items which are calculated after the pre-tax profit

## **The Method of Reporting a Minority Interest in Consolidated Financial Statements**

If your company holds substantial ownership interests in other businesses, you might need to prepare consolidated financial statements that combine the profits, losses and other financial activities of your company and its subsidiaries. And if you own less than 100 percent in any of these businesses, the amounts attributed to minority interest holders must also be disclosed. Under generally accepted accounting principles, or GAAP, there is a specific method of reporting these minority interests on consolidated financial statements.

#### **When Consolidated Financial Statements Are Required**

Under the general financial accounting rule, the determining factor for whether consolidated financial statements comes down to the level of control your company has over each business it has an ownership interest in. Sufficient control exists if you hold a majority of all voting rights in a company -- meaning you control more than 50 percent of the votes. The requisite control usually exists if you own more than 50 percent of an incorporated business's outstanding common stock. If consolidated financial statements are necessary, you'll need to account for the minority interest of each company included in the consolidation.

#### **Minority Or Noncontrolling Interests**

When one entity or person possesses the requisite majority control, all other business investors or owners make up the minority, or non-controlling, interest. For example, suppose you hold 70

percent of the outstanding voting shares in a corporation. Controlling more than 70 percent of shareholder votes requires you to prepare consolidated financial statements that include 100 percent of the corporation's income, losses and assets, as well as all other items that are disclosed on financial statements. But since you don't own 100 percent of the corporation, GAAP also requires you to report the amounts attributed to the 30-percent ownership of minority interest holders.

### The Difference Between Interest Receivable & Interest Revenue

#### **Consolidated Balance Sheet Reporting**

Your consolidated balance sheet will already include all of the subsidiary's assets and liabilities, so it isn't necessary, nor is it correct, to report your investment in the subsidiary on the consolidated balance sheet. A consolidated balance sheet must disclose the minority interest holders' total share of the subsidiary's net assets. To illustrate, suppose the subsidiary has \$100,000 in net assets -- which is reflected on your consolidated balance sheet. Thirty percent, or \$30,000, of those net assets technically belongs to minority interest holders and must be disclosed on the consolidated balance sheet. This is done by reporting \$30,000 on a line, such as "Minority interest in net assets," before the equity section of the consolidated balance sheet.

#### **Consolidated Income Statement Reporting**

Like the balance sheet, your consolidated income statement also includes 100 percent of the subsidiary's revenue and expenses. To compute consolidated net income, however, GAAP requires that you subtract the income or loss attributed to minority interest holders and discloses that amount on a line such as, "Net income attributable to the non-controlling interest." In other words, if the subsidiary reports net income of \$100,000, the full amount is included in the consolidated income statement but you'll disclose that \$30,000 of it is attributed to minority shareholders.

## **MODULE TWO: WORKING CAPITAL**

Working Capital can be defined as capital available for conducting day-to-day operations of the business. It is the excess of current assets over current liabilities. Working Capital emphasizes the liquidity objective. Typical management decision include the level of fund the company is ready to allocate to different forms of current assets, how the current assets should be financed and the relationship between the level of fixed and current asset. The relationship between current assets and current liabilities is such that the current assets should be twice the size of current liabilities hence it is said that the ideal current ratio is generally accepted to be 2:1 while the ideal quick ratio is 1:1

### **Effect of Inadequate and Excess Working Capital**

Inadequate working capital has the following consequences on an organization:

- (a) It affects growth by making it difficult to undertake profitable project
- (b) Opportunities to invest in attractive short term ventures are lost
- (c) The company may lose its reputation based on its failure to fulfill short term obligations
- (d) Operating Plans/Budget becomes difficult to implement

Excess working capital has the following consequences for an organization:

- (a) It is an indication of a defective credit policy and slack collection period
- (b) It may lead to bad debt and loss of profit
- (c) It results in unnecessary build up of inventory which increases the incidence of deterioration, handling and high insurance cost.

The following factors affect the level at which each component of working capital is maintained

- (i) nature of the industry (ii) the growth pattern of a particular company (iii) the financial management style and capabilities (iv) Customers (v) available investment opportunities

## **MANAGEMENT OF THE COMPONENTS OF WORKING CAPITAL**

No business can survive without adequate funding i.e. cash. The success of any business venture is therefore predicted on how the management has planned and controlled its cash flows. Cash can be managed efficiently using the following two methods (i) cash monitoring (ii) cash budgeting

### **Cash Monitoring**

This involves ensuring that the company's financial resources are efficiently policed ensuring that the customers pay as at when due (ii) banking company's cash as soon as possible instead of causing the company's cash to be idle.

### **Cash Budgeting**

This involves predicting how the company's cash can be generated and effectively utilized with a view to identifying periods of deficit and surplus.

### **Economic Order Quantity (EOQ)**

EOQ is the point where the carrying and ordering cost are at their minimum and are equal. Since both constitute the total cost, the EOQ will then be at the lowest point of the total cost curve, which is also the point of intersection between the carrying and ordering costs

#### **Assumptions of EOQ.**

1. There must be constant demand.
2. Instantaneous Supply.
3. There must be constant lead time.
4. There must be no stock out.
5. There must be fixed cost per batch.
6. The holding cost per unit per annum can be determined accurately

### **Optimal Inventory Levels and Derivation of EOQ (Economic Order Quantity)**

The important issue is to keep enough inventories to optimize sales while minimizing inventory costs. There are three basic inventory costs that a company has to contend with:

(a) Ordering Costs (cost of replenishing inventory). These include:

- (i) Cost of preparing and placing orders
- (ii) Cost of preparing storage space for inventory
- (iii) Cost of preparing production line, if the company has to produce the order

(b) Carrying or Holding cost (cost of storing inventory):

- (i) Cost of maintaining inventory stores against theft

- (ii) Depreciation, obsolescence, deterioration, shrinkage, damage cost
  - (iii) Property (inventory) taxes, insurance
  - (iv) Opportunity cost or lost income arising from investment in inventory
- (c) Shortage (out-of-stock cost) arising from inability to satisfy user demand. These include:
- (i) Cost of sales (profit and goodwill lost)
  - (ii) Cost of speeding up inventory orders to reduce/avoid shortage
  - (iii) Cost of readjusting the production line to produce more to deal with a shortage

As the inventory level increases, the ordering costs and shortage cost decreases but the cost of carrying that increasing inventory level rises but as the number of inventory order decreases, the ordering cost also increases since it is fixed per order, but the carrying and shortage costs drop **(illustrate with diagram)**

#### **STORE/STOCK CONTROL**

The water corporation of Ayewa State has been mandated to effect the installation of water in a newly completed housing estate for the legislature. The corporation requires a special pipe – gbomiwa which it uses regularly and is not available in the country. To ensure a hitch free execution of the project, the management directs the project manager to liaise with the accountant and to ensure that nothing delays the project. The project engineer informs the accountant that for the particular pipe, the following information are relevant;

Re-order quantity = 175,000 units

Maximum delivery time = 4 month

Minimum delivery time = 2 months

Maximum usage per month = 87,500 units

Minimum usage per month = 28,000 units

#### **Required:**

As the account to the corporation, you are required to calculate, for this material:

- (i) Re-order level

(ii) Minimum stock level

(iii) Maximum stock level

### Solution

Average delivery time =  $\frac{\text{Max time} + \text{Min delivery time}}{2}$

$$= \frac{4 + 2}{2} = \underline{3 \text{ months}}$$

Average usage =  $\frac{\text{Max} + \text{Min usage}}{2}$

$$\frac{87,500 + 2,800}{2} \text{ units}$$
$$= \underline{57,750 \text{ units}}$$

(i) Re-order level = Maximum delivery time X maximum units

$$= (4 \times 87,500) \text{ units}$$

$$\underline{350,000}$$

(ii) Minimum Stock level = (Re-order level – Average delivery time X average usage)

$$350,000 - (3 \times 57,750) \text{ units}$$

$$350,000 - 173,250 \text{ units}$$

$$= \underline{176,750 \text{ units}}$$

(iii) Maximum Stock level:  $RL + RQ - (\text{Av Dev. Time} \times \text{Average usage})$

$$= 350,000 + 175,000 - (3 \times 57,750) \text{ units}$$

$$= 525,000 - 173,250 \text{ units}$$

$$= \underline{351,750 \text{ units}}$$



## DEBTORS AND CREDITORS MANAGEMENT

When goods are supplied to a company on credit pending when the company will be in a position to effect payment, the company enjoys a credit facility the cost of which includes the loss of supplier goodwill and loss of cash discount if maximum use of it is utilized.

Remark such as 2/10/45 is sometimes found on sales invoice. This simply means a cash discount of 2% will be given if payment is made within 10 days of the invoice otherwise payment must be made at worst by 45<sup>th</sup> day. The company who is the buyer has the choice of paying 98% of the actual bill on the invoice on day 10 or invest the 98% for an additional 35 days and eventually pay the supplier the entire bill amount of the invoice.

Therefore, the buyer has the choice as to whether the discount should be accepted or not and this depends on the opportunity cost of investing the 98% for 35 days. If the company refuses the cash discount and pays in full at the end of or on the 45<sup>th</sup> day implied cost of interest per annum would be calculated:

$$\frac{\% \text{ age of discount}}{100 - \% \text{ age discount}} \times \frac{365}{\text{Max. payment period less max discount period}}$$

### Decision Variables.

#### Debtors

1. If implied cost is greater than the cost of capital, the buyer should accept the discount.
2. If implied cost is less than the cost of capital, the buyer should reject the discount.

#### Creditors

1. If the implied cost is less than the cost of capital, the supplier should give the discount.
2. If implied cost is greater than the cost of capital, the supplier should not give the discount

$$\frac{\% \text{ age of discount}}{100 - \% \text{ age discount}} \times \frac{365}{\text{Max. payment period less max discount period}}$$

$$\frac{2}{98} \times \frac{365}{35} = 21.28\%$$

### Illustration

B.J Ventures can invest cash to obtain a return of 25% p.a and an invoice had been received from the company's suppliers for N10,000 at 2/10 net 45. Advise the company whether it is worthwhile to accept the discount or not.

**Solution**

	<b>REFUSE DISCOUNT</b>	<b>ACCEPT DISCOUNT</b>
	N	N
Payment to suppliers	10, 000	9, 800
Return from investing		
N9,800 between day		
11 & day 45		
N9,800 x 365 x 25%	(235)	–
Total payment	9, 765	9, 800

**Decision:** Cheaper to refuse the discount because the investment rate of return exceeds the savings from the discount.

**Evaluating Discount From the Point of View of the Supplier**

To justify the acceptance of a credit policy, the supplier would need to be able to invest the net amount on receipt for the remaining days to cover the entire duration of payment (less the discount period). We are still keeping our previous data intact.

**Illustration**

Osaro Nigeria Ltd just issue to one of its buyers an invoice for N10, 000 at 2/10 net 45. The company can invest on short term basis at 25% p.a. Advise the company whether it should continue to give discount or not

**Solution**

	<b>GIVE DISCOUNT</b>	<b>DON'T GIVE DISCOUNT</b>
	N	N
Receipt from buyers	9, 800	10, 000
Return from investing		

N9,800 for 35 days

$N9,800 \times 25\%/365$

235

10,035

10,000

It is advisable for the company to continue to give discount. When evaluating discount from the point of view of the buyer accept the discount if the implied cost of the discount is higher than the cost of capital. Reject if it is lower. When evaluating the discount from the point of view of the supplier: Give discount if the implied cost of the discount is lower than the cost of capital. Do not grant discount if it is higher.

### **Management of Debtors**

Ideally, a company will like to receive cash at the point of sale. Many retail organizations are in this fortunate position. But for most business there will be a grace period. The longer this period is, the more it cost the company in terms of resources piled up in debtor. The amount of debtor in a particular business will depend on period of credit, credit terms of the company, the effectiveness of its credit policy, follow up procedures in case of default, volume of credit sales of the company.

### **Management of Cash**

The level of cash and bank balance indicates the financial health of a badly managed company. Cash balance should be planned figure rather than residual item and in the long run surplus cash should be invested in long-term project or distributed to shareholders.

### **Factors to Consider When Formulating Credit Control Policy**

The following should be considered: Administration cost of debt collection, procedures for controlling credit to individual customer, the amount of extra capital required to finance an extension to total credit, cost of additional finance required for any increase in the volume of debtors, any savings or additional expenses in operating the credit policy and the ways in which credit control policy can be implemented i.e. discount can be offered for early payment

### **Motive of Holding Cash**

The following are the motive for holding cash:

(i) Transaction motive: this is the amount of cash held to meet necessary payment in the day to day operation of a business

(ii) Precautionary Motive: This is the amount of cash held above specific transaction required to meet contingent payment that may occur

(iii) Speculative Motive: This is the amount of cash held in reserve to meet unexpected purchase that may occur. It is important for a company to maintain sufficient level of cash to meet the above requirement. However, any surplus cash held above this requirement will result in lower profit. The company should therefore through cash budgeting and planning ensure that it does not fail in the trap of holding too little or too much cash

## **WORKING CAPITAL CYCLE (OPERATING CYCLE)**

The working capital or operating cycle of a business is the length of time between payment for raw material and receipt of proceeds from sale. The objective of any good management is to minimize the length of operation cycle such that the investment in working capital is reduced to the barest minimum.

### **Operating Cycle**

This is the length of time it takes to acquire inventory of raw materials, convert them to finished products, sell them and collect cash from sales. Therefore, operating cycle begins life as inventory; it is converted account receivables when it is sold and finally converted cash. The process consists of 1-6.

1. Receive raw materials
2. Pay for raw materials
3. Issue raw materials
4. Finished goods
5. Sell goods
6. Receive money from debtors.

### **Cash Cycle.**

Is the number of days that pass before collection of cash from sales. It is therefore the difference between operating cycle and account payable i.e. it explains the time interval required by a firm to meet its financial obligation

### Distinction between Operating and Cash Cycle

Operating Cycle	Cash Cycle
<p>This is the length of time it takes to acquire inventory of raw materials, convert them to finished products, sell them and collect cash from sales. Thus operating cycle begins life as inventory, it is converted to account receivable when it is sold and is finally converted to cash when we collected cash when we collect cash from sales</p>	<p>This is the number of days that pass before we collect the cash from sales measured from when we actually pay for inventory. Cash cycle is therefore the difference and the accounts payable i.e it explains the time interval required by a firm to meet its financial obligation</p>

The operating cycle is determined as follows:

$$\text{A. Period of raw material stock} = \frac{\text{Raw materials}}{\text{Purchase per annum}} \times 365 \text{ days}$$

$$\text{B. Credit payment Period} = \frac{\text{Creditors}}{\text{Purchase per annum}} \times 365 \text{ days}$$

$$\text{C. Period of Production} = \frac{\text{Work in Progress}}{\text{Cost of Sales Per annum}} \times 365 \text{ days}$$

$$\text{D. Period Turnover} = \frac{\text{Goods}}{\text{Cost of sales per annum}} \times 365 \text{ Days}$$

$$E. \text{ Debtors Collection Period} = \frac{\text{Debtors}}{\text{Credit Sales}} \times 365 \text{days}$$

$$\text{Operating Cycle} = (A+C+D+E) - B$$

### Action Necessary to Reduce Working Capital

(i) Reduce raw material stock holding: This can be achieved by reviewing slow moving lines and re-enter levels. Operation research and stock control technique can be use to formulate policies on minimum and maximum stock as well as optimal order quantity.

(ii) Obtain more fund from suppliers by delaying payment

(iii) Reduce stock of goods: This can be achieved by re-organizing production schedule and / or distribution methods.

(iv) Reduce the period of credit given to Customers: This can be achieved through discount incentive or proper follow-up procedure

### Illustration

The working capital (operating) cycle of a business is the length of time between payment of materials entering into stock and receipts of the proceeds of sales. The table below gives information extracted from the annual account of management plc for the past three years. You are required to: -

1. Calculate the length of the working capital cycle assuming 365 days in a year.
2. List the possible actions that might be taken to reduce the length of that cycle.

### Management plc. - Extract from Annual Accounts.

	Yr 1	Yr 2	Yr 3
Stock: Raw Material	108,000	145,800	180,000
Work- in- progress	75,600	97,200	93,360
Finished goods	86,400	129,600	142,875
Purchases	518,400	702,000	720,000
Cost of goods sold	756,000	972,000	1,098,360
Debtors	172,800	259,200	297,000
Sales	864,000	1,080,000	1,188,000
Trade Creditors	86,400	105,300	126,000

## **Solution**

### **(1) The operating cycle can be summarized as follows:**

1. Receive raw materials
2. Pay for raw materials
3. Issue raw materials
4. Finished goods
5. Sell goods
6. Receive money from debtors.

## **OVERCAPITALIZATION /(UNDERTRADING) and UNDERCAPITALISATION**

### **(OVERTRADING)**

#### **Overcapitalization/ Undertrading**

Overcapitalization occurs where a company commits excessive capital into the company's trading activities so that there are excessive stocks, debtors, cash and very few creditors. If a company manages its working capital inefficiently, i.e. if working capital is excessive the company becomes over-capitalized and the return on capital employed would be lower than what should be and long-term funds would be unnecessarily "tied up" when they could be invested elsewhere to earn profits. The warning signals of excessive working capital would be poor accounting ratios

#### **Undercapitalization/ Overtrading.**

Over trading occurs when a company tries to do much with very little capital. An overtraded business can be operating at a profit, nevertheless, it will eventually run into serious trouble because of shortage of fund and this liquidity troubles sharing from the fact it does not have enough capital to pay its debts as they fall due.

## **JUST-IN-TIME TECHNIQUES AND TOTAL QUALITY MANAGEMENT**

### **Just – In – Time Techniques**

This is a term used to describe a policy of obtaining goods from suppliers at the latest possible time i.e. when they are needed thereby eliminating the need to carry any material or

component stock. Introducing just –in – time techniques might bring the following benefits:

-

1. Reduction in stock holding cost or carrying cost.
2. Improved labour productivity I e. raw materials are available.
3. Reduction in risk of deterioration.
4. Reduction in the number of accounting transactions.

Reduced stock level i.e. a lower level of investment in working capital will be required, less fund is spend. JIT will not be applicable to organizations such as service organizations, hospitals etc, JTI may be inappropriate in some cases such as hospitals where a stock out will be dangerous, thus JIT is not recommended for such.

### **Total Quality Management.**

This is a management techniques derived from Japanese company which focuses on the belief that the total quality of a product is essential for its surviving in a global market. i.e. total quality management states “the Cost of preventing the mistake in a country is less that the cost of correcting it when it has occurred”. Therefore, TOM is saying that we “should produce at the highest possible standard (100%).

### **TYPES OF SOURCES OF FINANCE**

There are two main types of sources of finance which are;

- Internal Sources of Finance and
- External Sources of Finance

#### **Internal Sources of Finance**

Start-up or Additional Capital

Retained Earnings

Sale of Stock

Sale of Fixed Assets

Debt Collection

#### **External Sources of Finance**



External financing is used to describe funds that firms obtain from outside of the firm. It is contrasted to internal financing which consists mainly of profits retained by the firm for investment. There are many kinds of external financing. The two main ones are equity issues and debt finance. Others include trade credit, accounts payable, and taxes owed to the government.

External financing is generally believed to be more expensive than internal financing, because the firm often has to obtain it at a cost.

### **CLASSIFICATION OF SOURCES OF FINANCE**

The known sources of external finance are widely classified into three groups namely short, medium and long term sources of finance.

#### **Short Term Sources of Finance**

Short-term sources of finance are usually available for up to one year.

#### **Main Sources**

1. **Bank Overdraft**
2. **Commercial Paper (CP):** This is an instrument that allows the business to raise money from third parties rather than from banks directly. Large well-known companies issue them.
3. **Trade Credit:** This is a major source of short-term finance for small and big companies. It is created when the business purchases goods for resale or manufacture and the seller allows a period of credit. *Trade acceptances* involves a formalized agreement through the use of a bill of exchange while *notes payable* only requires that the company to acknowledge its debt formally and are more common in international trade. *Open account* is the commonest type that allows the customer to settle accounts on regular basis.
4. **Debt Factoring:** This is a method of raising short term financing which involves an institution known as a Factor.
5. **Invoice Discounting:** This is a method that involves the sale of the receivables (debts) of the company to an institution specializing in this function- the Factor.

6. **Bills discounting:** This is a situation where term bills of exchange are discounted and the drawer of the bills receives funds before its maturity.
7. **Franchise:** A franchise is an alternative to raising more capital for growth. This short term finance is more suitable for a business expansion. It is a method whereby a business is expanded on less capital than needed otherwise.
8. **Acceptance Credit/Bankers Acceptance:** This is a draft {BOE} or an order to pay specifying the amount and the date. It is normally drawn on an individual bank by a business firm and becomes a banker's acceptance when the bank commits itself on it by signing, "accepted" on it.
9. **Accruals:** These are amounts being owed for services by the business but yet to be paid and deferred till a more acceptable or plausible date. A perfect example of accrual is tax payable that may not be paid until the end of the accounting period. Another type is wages that can be held back until it is due for payment. This source of finance is usually cheap as it is without any cost to the business.

### **Other Forms of Short Term Sources of Finance**

1. **Borrowing from Co-operatives**
2. **Borrowing from Friends and Relatives**

### **Medium Term Sources of Finance**

This is a method of financing that last between one year and five years. Medium term financing can, in some cases last beyond 5 years depending on the financial regulations.

### **Main Sources**

1. **Bank Term Loan**
2. **Venture Capital:** this is a medium term finance that involves provision of finance for a new business process or system. It is also common for businesses undergoing a reengineering or restructuring program. Venture capital is normally provided by rich and comfortable organisations.
  - i. *Wealthy Families*

- ii. *Banks*
  - iii. *Other large Non-Banking Industrial Firms or Companies*
  - iv. *Industrial Investors*
  - v. *International Organisations*
  - vi. **Stages of Venture Capital Financing**
- 3. Project Financing**
  - 4. Leasing**
  - 5. Hire Purchase**
  - 6. Mortgages**

### **Term Sources of Finance**

Long-term finance represents one of the means through which the business finances its capital assets. The common methods are:

1. Bonds/ debentures/Loan Stock
2. Preferred stock or preference shares
3. Common stock or ordinary shares.

### **Method of Raising Common Stock for Publicly Quoted Company:**

1. *Stock Exchange Introduction*
2. *Placing*
3. *Offer for Sale*
4. *Offer for Subscription*
5. *Offer for Sale by Tender*
6. *Right Issue*

## **MODULE THREE**

### **CONCEPT AND BENEFIT OF CASHFLOW STATEMENT**

**IAS 7** explains cashflow statement i.e sources and application of funds. A

Cashflow statement is a statement which shows how cash can be generated and disposed off by the organization. It reveals how cash is generated from operations. It reveals how cash is generated from operations or through new capital raised and how payment are made for taxes, dividend, new investment etc

Cash flow provides information about cash receipts and cash payment; it recognizes the net cash flows from operating activities and helps to assess liquidity strength; it identifies investments and takes account of capital flows and discloses net flow from investment operations; it indicates the pattern of cash generation and utilization, showing a trend with comparative figures of the previous year; it shows how the opening cash position relates with net cash generated from operating, investing and financing activities during the period to produce the closing cash balance at the accounting date, and the potential for dividends; it shows how liquid a company is, rather than its net profit or loss position and helps to assess financial impact of operations, on-going operational commitments, obligations, and potentials to meet liabilities in the short and long term.

#### **Uses of Cashflow Statement**

- (i) A cashflow statement highlights the liquidity position of an enterprise or an organization ability to meet maturing obligations as at when due.
- (ii) It also shows whether cash has been well managed.
- (iii) It shows what extent a firm may be gearing up for future operation.
- (iv) It shows how far future shares issued may be needed.
- (v) It provides a yardstick for the valuation of a firm.
- (vi) It facilitates comparison of cashflow performance of different entities using cashflow.

#### **Benefits of cash flow statement**

- (i) It helps to assess the current liquidity of the business
- (ii) It assist users of financial statements in making judgment on the amount, timing and degree of certainty of future cash flows;
- (iii) It gives an indication of the relationship between profitability and cash generating ability of the profit earned;
- (iv) It removes accrual from financial information

## **CLASSIFICATION OF CASHFLOW STATEMENT**

Cash flow can be categorized into the following broad headings

1. Operating activities
2. Investing activities
3. Financing activities

### **OPERATING ACTIVITIES**

They are principal revenue producing activities. Examples are

1. Cash received from sale of goods and rendering of services.
2. Cash payment to suppliers to goods and services.
3. Cash payments to and on behalf of employees
4. Cash receipt and payment of an insurance nature e.g. claims, annuities, premium, and on the benefits.
5. Cash payment or refund of income taxes unless they can be specifically identified with the financing and investing activities.

### **INVESTING ACTIVITIES**

These are the acquisition and disposal of long term assets and other investments not included in cash equivalent and include the following

- i. Cash payment to acquire property, plants and equipments intangible and other long term assets.
- ii. Cash receipt for the sale of property, plant and equipment and other long term assets
- iii. Cash payment and recipe to acquire equity or debt instrument of an organization and interest in joint ventures.
- iv. Cash receipt and payments of advances made to other parties (other than loans) made by the financial institution.

### **FINANCING ACTIVITIES**

These are activities that result in changes in the size and composition of equity capital and loan stock of an organization. There are as follows

1. Cash proceeds from the issuing of shares from other instrument.
2. Cash payment maintenance to acquire or redeem the company's shares.
3. Cash proceed from issuing debentures.
4. Cash repayment of amount borrowed.
5. Cash payment by leasee for the reduction of an outstanding liability relating to finance lease.

## FORMAT FOR CALCULATING CASHFLOW

There are two methods involved

1. Direct method/Gross basis
2. Indirect method/Net basis

### Direct Method

Direct method is also called the gross basis method/approach. It is a method where cash flow from operating activities is disclosed based on the nature of items that generate cash flow. It is the recommended technique because it gives a clear view of the cash flow position compared to the indirect method which does adjustment to profit figure.

#### Direct method

<b>Operating activities</b>	₦	₦
Cash from customers	X	
Cash to suppliers	(X)	
Cash paid for tax	(X)	
Extra ordinary items		
(If not investing or financing)	<u>(X)</u>	
<b>Net Cash provided by operation</b>	<b>X</b>	<b>X</b>

#### Investing activities

Fixed asset bought	(X)	
Fixed assets sold	X	
Investments sold	<u>X</u>	
<b>Net cash provided by investing activities</b>	<b>X</b>	<b>X</b>

#### Financing activities

Cash obtained from loan stock	X	
Repayment of loan	(X)	
Cash retained from issue of shares	<u>X</u>	

<b>Net cash provided by financing activities</b>	<b>X</b>	<b>X</b>
Net Cash flow for the year		X
Net Cashflow b/f		<u>X</u>
Net Cashflow c/f		<u>X</u>

### Indirect Method

This is known as the net basis method/approach. It is a method where cash flows from operating activities are disclosed based on the net products on all items that are generated or used. Under this method the total cash flow from operating activities is derived or arrived after adjusting items not involving the movement of cash and changes in working capital in the profit before tax i.e changes in working capital (debtors, creditors, stocks).

<b>Operating Activities</b>	<b>N</b>	<b>N</b>
Profit before tax	X	
Add/deduct items not involving movement of cash		
- Depreciation	X	
- Provision of bad debts	X	
- Profit/Loss or disposals	<u>X</u>	
	X	
<b>Increase/Decrease in working capital</b>		
- Debtors	X	
- Creditors	X	
- Stocks	X	
- Tax Paid	(X)	
- Extra-Ordinary items if not investing	<u>X</u>	X
- <b>Investment Activities (as in direct method)</b>		<b>X</b>
- <b>Financing activities (as in direct method)</b>		<b><u>X</u></b>
Net cashflow for the year		X
Net cashflow b/f		<u>X</u>
Net cashflow c/f		X

### Factors Affecting the Cash Flow (source and uses of fund)

1. Availability of fund
2. Cost : the rate of interest will determine whether you borrow

3. In the past the CBN determines who get what loan, but this structure has been destroyed. A company cannot give more than one third of its paid up capital to one customer.
4. Type of lending activities the company engage in will determine the source of fund.
5. Nature of use: how the fund will be utilized.

Cash flow is very important for planning; it is presently called cash flow statement. Your computation of this statement must be on a continuous basis for every use of fund there must be a source e.g. asset represent use of fund and every asset is represented by liability which is the net worth. If we compute the projected sources and use of fund in negative or positive inflow or outflow, it will become obvious.

Because an enterprise will need to make profit and minimize cost there is need to plan for the achievement of these goals. The assets and liabilities we find in the books of financial institutions are deliberately decided. If you have 70% of the total asset of your bank in loans and advances, it is a deliberate act and not by accident. Similarly if deposit constitutes 80% of your liabilities it is not by accident but deliberately planning. This is as a result of the strategy, policy and tactics we have employed in cash flow management and it is the responsibility of the board of directors.

The board of directors must approve the strategy; policy as well as tactics to be used by management. Whatever policy strategy and tactics we want to use must be known in advance e.g. the bank should be able to decide the kind of deposit it wants like volatile deposit, residual deposit, and vulnerable deposit.

### **Review Questions**

- (i) Distinguish between direct and indirect method
- (ii) Explain with examples three types of deposit
- (iii) (a) Discuss the Uses of cash flow statement  
(b) Outline and explain the factors affecting cash flow statement